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# Chapter

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## Introduction to Accounting

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(会计概述)



## Learning Objectives ▶▶▶

After studying this unit, you should be able to:

- ◆ Define accounting;
- ◆ Understand the functions of accounting;
- ◆ Understand the development of accounting;
- ◆ Identify the divisions of accountants work.

One day, Tony, a freshman, met Doan on campus, sophomore majored in accounting. He asked Doan for some help. (T: Tony, D: Doan)

**T:** Hi, glad to meet you, Doan. I'm a bit fed up these days. Can you give me a hand?

**D:** Oh, what's up?

**T:** God, it seems mountains of questions. Let me clear them up a bit. Er...er...mr, the first one, my major is accounting, you know, but to tell the truth, I hardly have interest...I've no idea...I'm afraid I can't get along well with my study. Maybe it will be a mess.

**D:** Oh, so it is! You see, my major is also accounting. During one year study, I know a lot about it. Er, or let's take it in another path. Look, here is a question: what do you know about accounting?

**T:** I only know some ABC. It is said accounting is complicated, and being an accountant is a tiring job. Hard to imagine!

**D:** Your answer may seem right to some extent. As a matter of fact, every one of us uses accounting knowledge or practices accounting activities in one form or another. For example, when we think about buying a house, we use accounting-type information to determine whether we can afford it, whether to lease or buy, and when we wanna buy a car, something like that.

**T:** Really? You bet.

**D:** Likewise, when you decide to go to college, you would consider your tuition fees, your textbooks, and some other learning tools. And you also want to find a desirable job in the future with what you have learned. Is that true?

**T:** Yeah, before I came here, father mentioned such things. He hopes me to get a wise head. Oh, some daily practice has something to do with accounting? Amazing!

**D:** Of course, learning accounting well will give you an economic head. Perhaps a little exaggerated, but the accounting information related is really an important factor in our decision-making. So I'm keen on my major now, you see, I spend much time reading some relevant materials in my spare time. Now I always make up my minds to

do many things with what I've learned. Very helpful!

**T:** Thanks a lot. I think... I should put my heart on it. What you said spurs me a lot. I hope we can have further discussion later. OK?

**D:** Certainly. I'd love to, but sorry. I've to go now. Someone is waiting for me to do some accounting reading.

**T:** OK, thank you so much. See you later.

**D:** See you.

## 1.1 Accounting Is an Information System

Accounting is an information system necessitated by the great complexity of modern business.

One of the most important functions of accounting is to accumulate and report financial information that shows an organization's financial position and the results of its operations to its interested users. These users include managers, stockholders, banks and other creditors, governmental agencies, investment advisors, and the general public. For example, stockholders must have an organization's financial information in order to measure its management's performance and to evaluate their own holdings. Banks and other creditors must consider the financial strength of a business before permitting it to borrow funds. Potential investors need financial data in order to compare prospective investments. Also, many laws require that extensive financial information be reported to the various levels of government. Businesses usually publish such reports at least annually. To meet the needs of the external users, a framework of accounting standards, principles and procedures known as "generally accepted accounting principles (GAAP)" have been developed to insure the relevance and reliability of the accounting information contained in these external financial reports.

Another important function of accounting is to provide the management inside an organization with the accounting information needed in the organization's internal decision-making, which relates to planning, control, and evaluation within an organization. For example, budgets are prepared under the directions of a company's financial executives on an annual basis and express the desires and goals of the company's management. A performance report is supplied to help a manager focus his attention on problems or opportunities that might otherwise go unnoticed. Furthermore, cost-benefit data will be needed by a company's management in deciding among the alternatives of reducing prices, increasing advertising, or doing both in

attempt to maintain its market shares. The process of generating and analyzing such accounting information for internal decision-making is often referred to as management accounting and the related information reports being prepared are called internal management reports. As contrasted with financial accounting, management accounting information system provides both historical and estimated information that is relevant to the specific plans on more frequent basis.

The growth of organizations, changes in technology, government regulations, and the globalization of economy during the twentieth century have spurred the development of accounting. As a result, a number of specialized fields of accounting have evolved in addition to financial accounting and management accounting, which include auditing, cost accounting, tax accounting, budgetary accounting, governmental and nonprofit accounting, human resources accounting, environmental accounting, social accounting, international accounting, etc. For example, tax accounting encompasses the preparation of tax returns and the consideration of the tax consequences of proposed business transactions or alternative courses of action. Governmental and nonprofit accounting specializes in recording and reporting the transactions of various governmental units and other nonprofit organizations. International accounting is concerned with the special problems associated with the international trade of multinational business organizations. All forms of accounting, in the end, provide information to the related users and help them make decisions.

## 1.2 Definition of Accounting

Accounting is an information system of interpreting, recording, measuring, classifying, summarizing, reporting and describing business economic activities with monetary unit as its main criterion. The accounting information is primarily supplied to owners, managers and investors of every business, and other users to assist in the decision-making process. Therefore, accounting is also called “the language of business”.

Accounting is a basic and vital element in every modern business. It records the past growth or decline of a business. Careful analysis of these results and trends may suggest the ways in which the business may grow in the future. How do business executives know whether a company is earning profit or incurring loss? How do they know the company is solvent or insolvent, and whether it probably will be solvent, say, a month from today? The answer to all these questions in one word is accounting.

### Distinction Between Booking and Accounting

Earlier accounting procedures were simple in comparison with modern methods. The simple bookkeeping procedures of a hundred years ago have been replaced in many cases by the data-processing computer. The control of the fiscal affairs of an organization must be as scientific as possible in order to be effective.

## 1.3 Divisions of Accounting Profession

The field of accountants' work is divided into three broad areas: public accounting, accounting for private businesses, and accounting for governments and non-profit organizations.

### 1. Public Accounting

Public accountants who are similar to doctors or lawyers can offer their accounting service to the public on a fee basis. Public accounting firms are organizations in which public accountants mainly work. Most people in the public accounting firms are licensed as certified public accountants (CPAs). Thus, public accounting firms are often called CPA firms. These firms vary in size from one-person practices to large, international organizations with several thousand professional accountants. Almost all countries in the world have promulgated laws for the CPAs. In the United States, the certification examinations are prepared and administrated by the American Institute of Certified Public Accountants (AICPA). The various states or other major governmental jurisdictions set additional qualifications for residence, experience, and so on. The British equivalent for a CPA is called a chartered accountant. In China, the institute same as AICPA, which is responsible for administrating CPAs, is the Chinese Institute of Certified Public Accountants (CICPA).

The primary services offered by CPA firms include auditing, income tax services, and management advisory services.

#### 1) Auditing

The principal function of CPAs is auditing. Auditing is an analytical process applied to everyday business situations. Hence it is closely related to existing business practices. The CPAs study the company's accounting records and gather other evidence regarding every item in the financial statements through the investigation. Therefore, persons outside the business, such as bankers, investors and government officials,

attach great importance to the auditing report.

### 2) Income tax services

An important element of decision-making by business executives is consideration of the income tax consequences of an alternative course of action. The CPAs are often called upon for “tax planning”, which will help the business executives to hold the companies’ income taxes to a minimum amount. The CPAs are also frequently retained to prepare the income tax returns. To render tax services, the CPAs must have extensive knowledge of tax statutes, regulations, as well as a thorough knowledge of accounting.

### 3) Management advisory services

Many CPA firms offer their clients a wide range of management consulting services. The services include the following: What are the resources of the business? What debts does it owe? Will the business be able to meet these debts as they mature? Are accounts owed by customers collected properly? Is too little or too much inventory being kept? Are expenses too large in relation to sales? Does the business earn profit properly? Should the plant be expanded? Should a new production line or new product be introduced? Business executives often seek their CPAs’ advice on a wide range of problems from the illustration of accounting information to business decision.

## 2. Accounting for Private Businesses

The accountants in a private business, large or small, must record transactions and prepare periodic financial statements from accounting records. The chief accounting officer in a medium-sized or large business is usually called the controller, who manages the work of the accounting staff. As a part of the top management team, the controller is charged with the task of running the business, setting its objectives, and seeing that these objectives are met.

### **The work of the accountants in a private business mainly includes the following areas:**

(1) Design of the accounting system. Although the same basic accounting principles are applicable to all types of businesses, each enterprise requires an individually tailored financial information system. This system consists of accounting forms, records, instruction manuals, flow chart, computer programs, and reports to fit the particular needs of the business.

(2) Cost accounting. Accountants must know the cost of a particular product in order to make business decisions. Calculating and controlling cost is vital to the efficient management of a business. The phase of accounting particularly concerned with collecting and interpreting cost data is called cost accounting.

(3) Internal control and auditing. A key responsibility of the manager of a business is to keep its operations under control. Internal control is a management priority, not merely a part of the accounting system. Thus it is not only a responsibility of accountants but of managers as well. To make internal control effective, internal auditing in a business is very important. Most large corporations maintain staff of internal auditors with the responsibility of evaluating the efficiency of operations and determining whether company policies are being followed consistently in all divisions of the corporation.

### 3. Accounting for Governments and Non-profit Organizations

Many accountants work in government offices or for non-profit organizations. These two areas are often joined together under the term governmental accounting and non-profit accounting. All of these accountants, like those in private businesses, work on a salary basis.

Most enterprises face government regulations. Government officials rely on information to help them direct the affairs of their agencies just as doing the executives of corporations. For example, in the United States, there are two of the governmental agencies, which perform extensive accounting work. One is the Securities and Exchange Commission (SEC); another is the Internal Revenue Service (IRS). The SEC establishes requirements regarding the content of financial statements and the reporting standards to be followed. All corporations which offer securities for sale to the public must file annually with the SEC audited financial statements so as to meet these requirements. Local, state, and federal governments levy taxes on individuals and business. The IRS handles the millions of income tax returns filed by individuals and corporations, and frequently performs auditing functions relating to these income tax returns and the accounting records on which they are based.

Many governmental accounting problems are similar to those applicable to private businesses. In other respects, however, accounting for governmental affairs requires a somewhat different approach because the objective of earning a profit is absent from public affairs. Non-profit organizations include universities, hospitals, churches, and charitable organizations. Non-profit accounting also follows a pattern of accounting that is similar to governmental accounting.

## 1.4 The Development of Accounting

Accounting has a long history. Ancient accounting evidences were found in China, Babylonia, Greece, and Egypt. In the fifteenth century, Luca Pacioli, an Italian, established a system of record keeping which came to be called “double entry”. “It is one of the most beautiful inventions of the human spirit, and every good businessman should use it in his economic undertakings,” said Goethe, a German poet. Double-entry-system is the foundation of the modern accounting. During the eighteenth century, the Industrial Revolution brought many social and economic changes. The specialized field of cost accounting emerged to meet the need for the analysis of various costs and for recording techniques. In the nineteenth century, the growth of corporations speeded the development of accounting. More and more individuals and institutions looked to accountants to provide information about these enterprises. The development of corporation also created a new social need—the need for an independent audit to provide some assurance that management’s financial representations were reliable. In the United States, American Institute of Certified Public Accountants (AICPA) is the largest professional organization of accountants, same as to Chinese Institute of Certified Public Accountants (CICPA) in China. Computers have revolutionized accounting recently. We have outstanding software to help us quickly and easily. In summary, accounting has developed new concepts and techniques to meet the ever increasing needs for financial information.

## 1.5 Professional Ethics of Accounting

Ethics is essentially the study of right and wrong, and has been a prominent and sensitive issue in the accounting profession for years.

Ethical codes serve as a foundation for developing ethical behavior in professions. They also provide a framework for ethical practice. In recent years there has been widespread interest in accounting ethics, due partly to wide media coverage of events involving a host of misdeeds, such as inside trading, tax evasion, audit failure, and fraud. Reports of unethical behavior are a threat to public confidence in the accounting profession.



A full explanation of ethical standards in accounting is beyond the scope of this introductory course. However, it is not too early to introduce some basic ethical standards that are expected of professional accountants. Four key standards are below:

### **1. Integrity**

Accountants have a responsibility to report favorable as well as unfavorable information and to refrain from taking actions which undermine an organization's legitimate and ethical objectives. Integrity implies that accountants should not take unfair advantage of information and should act in the interests not only of their clients but of other indirect users. Accountants should also disassociate themselves from any attempts to disclose misleading information.

### **2. Confidentiality**

Accountants have a duty to refrain from disclosing confidential information unless legally obligated to do so. The work of the accountant regularly involves dealing with confidential files about the personal and business affairs of their clients. Decisions made on information provided by accountants can materially affect the lives of clients and others, often referred to as third parties, which include employees, creditors, investors, suppliers, customers, government, and the general public.

### **3. Competence**

Accountants have a duty to perform their professional duties according to high standards and to ensure that they stay current with changes in the profession. Users of accounting information may not have accounting expertise. Thus, members of the accounting profession enjoy a position of power. To be worthy of user confidence, accountants must not abuse this power and must act according to a high ethical standard. Accountants have an ethical obligation to maintain both technical competence and moral competence.

### **4. Objectivity**

Accountants must fully disclose all relevant information that assists users to understand financial reports. Business, governments, and the public at large depend on the accounting profession to provide fair financial reporting and business advisory services. Accountants, therefore, are obligated to provide information that is objective so that users can rely on its accuracy when making investment and credit decisions.

## Vocabulary

|                          |             |
|--------------------------|-------------|
| accounting <i>n.</i>     | 会计;会计学      |
| information <i>n.</i>    | 信息,资料       |
| business <i>n.</i>       | 商业;企业,公司    |
| financial <i>a.</i>      | 财务的,财政的     |
| financial position       | 财务状况        |
| investment <i>n.</i>     | 投资          |
| measure <i>v.</i>        | 估量,判定;测量,度量 |
| principle <i>n.</i>      | 法则,原则       |
| financial report         | 财务报告        |
| budget <i>v.</i>         | 预算          |
| management accounting    | 管理会计        |
| financial accounting     | 财务会计        |
| audit <i>n. &amp; v.</i> | 审计          |
| tax <i>n.</i>            | 税,税金        |
| income tax return        | 所得税申报单      |
| account <i>n.</i>        | 账,账目,账户     |
| transaction <i>n.</i>    | 交易,业务       |

## Exercises

1. Read the following sentences carefully and fill in the blanks with appropriate words.

(1) \_\_\_\_\_ is an information system that identifies, measures, records and communicates relevant, reliable, consistent and comparable information about an organization's economic activities.

(2) An individual who earns a living by recording the financial activities of a business is known as a(an) \_\_\_\_\_.

(3) The process of classifying and summarizing business transactions and interpreting their effects is accomplished by the \_\_\_\_\_.

(4) An \_\_\_\_\_ is any economic unit that controls resources and engages in economic activities.

2. Read each of the following statements and decide whether it is true(T) or false(F).

(1) The accounting process generates financial reports for both "internal" and "external" users. ( )

(2) GAAP are not like laws of math and science; they are guidelines which define

correct accounting practice at the time. ( )

(3) A business should be understood as an entity that is separate and distinct from its owners, customers, and creditors. ( )

(4) CPAs can offer their services to the public on an individual consultant basis for which they receive fees. ( )

(5) The objectives of non-profit organizations are profit. ( )

### 3. Translate the following sentences into English.

(1) 会计是当今经济社会中发展最快的行业之一。

(3) 注册会计师现在享有和医生或律师一样的职业地位。

(4) 20 世纪以来,会计行业的迅速发展造就了一大批经过专业培训的会计师。

(5) 会计是可以用来衡量一个公司盈利能力和偿债能力的手段。

### 4. Translate the following passage into Chinese.

Accounting has a long history. Accounting records date back to the ancient civilizations of China, Babylon, Greece and Egypt. Modern accounting is services designed to accumulate, measure and communicate economic data of organizations. Actually, nearly everyone practices accounting in one form or another on an almost daily basis. Whether you are preparing a household budget, balancing your check-book, preparing your income tax return, or managing a company, you are working with accounting concepts and accounting information.

Decision-makers need accounting information. Virtually all businesses and most individuals keep accounting records to aid in making decision. For specific examples of these decisions, consider the following questions. What prices should the firm set on its products? If production is increased, what effect will this have on the cost of each unit produced? Will it be necessary to borrow from the bank? How much will costs increase if a pension plan is established for employees? Is it more profitable to produce and sell product A or product B? Shall a given part be made or be bought from suppliers? Should an investment be made in new equipment? All these issues call for decisions that should depend, in part at least, upon accounting information. It might be reasonable to turn the question around and ask: What business decisions could be made intelligently without the use of accounting information? Examples would be hard to find.

## *Reading Material*

### **Accounting Is a Business Language**

Some people think of accounting as a highly technical field which can be understood only by professional accountants. Actually, nearly everyone practices accounting in one form or another on an almost daily basis. Accounting is the art of measuring, describing, and interpreting economic activity. Whether you are preparing a household budget, balancing your checkbook, preparing your income tax return, or running General Motors, you are working with accounting concepts and accounting information.

Accounting has often been called “the language of business”. Every investor, manager, and business decision maker needs a clear understanding of accounting terms and concepts.

The underlying purpose of accounting is to provide financial information for decision making about an economic entity. In this book the economic entity we concentrate upon is a business enterprise. Business executives and managers need the financial information provided by an accounting system to help them plan and control the activities of the business. For example, management needs answers to such questions as the profitability of each department of the business, the adequacy of the company's cash position, and the trend of earnings.

Many businesses also compile non-financial information needed for decision making. An airline, for example, must have information about on-time arrivals, repair schedules, and physical examinations of flight crews. The use of computers makes possible the operation of a Management Information System (MIS) which provides decision makers with both financial and non-financial information.

The accounting system is the most extensive and important component of a management information system because it is used by the entire business entity and by outsiders as well. Financial information about a business is needed by many outsiders. These outsiders include owners, bankers, other creditors, potential investors, labor unions, government agencies, and the public, because all these groups have supplied money to the business or have some other interest in the business that will be served by information about its financial position and operating results. A labor union, for example, needs to be informed of a company's financial strength and profits before beginning negotiations for a new labor contract. Remember that every individual as well as every business must make economic decisions about the future. Therefore,

everyone needs some understanding of accounting as a basis for making sound decisions.

To emphasize our basic concept; the goal of the accounting system is to provide useful information to decision makers. Thus, accounting is the connecting link between decision makers and business operations.



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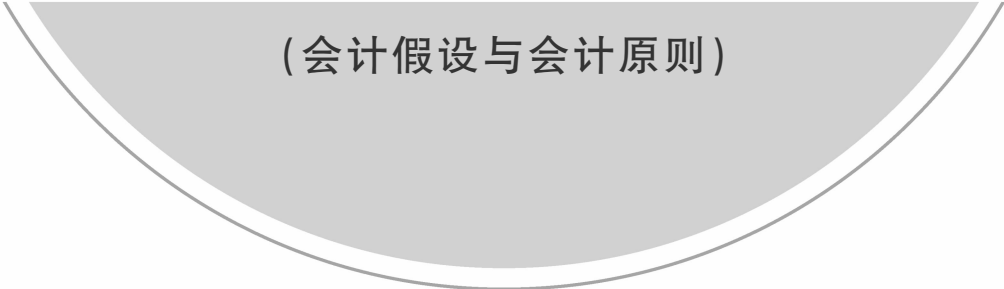
# Chapter

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## **Accounting Assumptions and Principles**

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(会计假设与会计原则)



## Learning Objectives ▶▶▶

After studying this unit, you should be able to:

- ◆ Understand the accounting assumptions and principles.

The following is an excerpt from a conversation between Gabella Bellamy and Kille Cfi. Gabella is debating whether to buy a stereo system from Mega Sound, a local electronics store, or Decibel Electronics, a mail-order electronics company.

**Gabella:** Kille, I don't know what to do about buying my new stereo.

**Kille:** What's the problem?

**Gabella:** Well, I can buy it locally at Mega Sound for \$495.00. However, Decibel Electronics has the same system listed for \$499.99.

**Kille:** So what's the big deal? Buy it from Mega Sound.

**Gabella:** It's not quite that simple. Decibel Electronics said something about not having to pay tax, since I was out-of-state.

**Kille:** Yes, that's a good point. If you buy it at Mega Sound, they'll charge you 5% sales tax.

**Gabella:** But Decibel Electronics charges \$12.50 for shipping and handling. If I have them send it next day by air, it'll cost \$25 for shipping and handling.

**Kille:** I guess it is a little confusing.

**Gabella:** That's not all. Mega Sound will give an additional 1% discount if I pay cash. Otherwise, they will let me use my Master Card, or I can pay it off in three monthly installments.

**Kille:** Anything else?

**Gabella:** Well ... Decibel Electronics says I have to charge it on my Master Card. They don't accept checks.

**Kille:** I am not surprised. Many mail-order houses don't accept checks.

**Gabella:** I give up. What would you do?

### ■ Discuss:

1. Assuming that Decibel Electronics doesn't charge sales tax on the sale to Gabella, which company is offering the best buy?
2. What might become considerations other than price that might influence Gabella's decision on where to buy the stereo system?
3. If you were Gabella, where would you buy the stereo system?

## 2.1 Accounting Assumptions

Accounting practice needs certain qualitative requirements to action. Accounting theory provides the rationale or justification for accounting practice. In USA, GAAP is used to instruct accounting practice. GAAP, established by the Financial Accounting Standards Board (FASB), is a widely accepted set of rules, conventions, standards, and procedures for reporting financial information.

To achieve basic business accounting objectives and implement fundamental qualities, GAAP has four basic assumptions, four basic principles, and four basic constraints.

### 1. Accounting Entity Assumption

The most basic concept in accounting is that of the accounting entity. An accounting entity is any economic unit which controls resource and engages in accounting practice. Transactions between accounting entities are recorded in the accounts of both entities. Each accounting entity interprets transactions from its own viewpoint. For example, the same transaction may be recorded as a sale by one accounting entity and as a purchase by another. Similarly, one accounting entity may record a transaction as an investment, while the other accounting entity may record it as a capital contribution.

In any particular case the identification of the accounting entity may be difficult. Consider, for example, the case of a large chain of retail stores. Is the accounting entity the whole business, a regional operation, a single store or a single department in that store? The answer can be found only by looking at the organization of the business. If a department has its own accounting system and records transactions with other departments, then it is an entity for accounting purpose. If it has no records, then it is not an accounting entity. The accounting entity is, therefore, identified as the smallest unit of activity with a self-contained accounting system.

### 2. Monetary Unit Assumption

Money is the common unit in which accounting measurements are made and measured. All transactions are measured, recorded and reported in terms of money unit. The stable-money-unit concept is the basis for ignoring the effect of inflation in the accounting records. It allows accountants to add and subtract dollar amounts as though each dollar has the same purchasing power as any other dollar at any other time. Nevertheless, the value of money is not constant over time. The purchasing power



of money changes as a result of either inflation or deflation.

The use of money as the unit of account is accepted today without question, but that has not always been the case. For example, such commodities as cattle, salt, shells, and tobacco are said to be employed as a unit of account.

The use of money as a unit of account does create some difficulties. In the first place, transactions must be expressed in money before they can be recorded in the accounts. In some cases transactions or events may not have an obvious money amount. Transactions and events of this type are either ignored or assigned a subjective or arbitrary money amount.

The second difficulty associated with the monetary convention is that the value of money is not constant over time. Its purchasing power changes as a result of either inflation or deflation. Accountants conventionally choose to ignore the changes in the purchasing power of money in the accounts. And this will cause some deficiencies in accounting reports.

### **3. Going Concern Assumption**

According to the going concern concept, accountants assume that the business will remain in operation long enough to use existing assets for their intended purpose. However, under the situation of going out of business, because an enterprise that is holding a going-out-of-business sale is trying to sell its assets, the relevant measure of the asset is their current market value. The going concern assumption allows the accountant to record assets at what they are worth to a business in normal use, rather than what they would sell for in a liquidation sale.

The assumption of continuity is made in the absence of evidence to the contrary. In other words, when it is clear that an assumption of continued existence would result in misleading financial reports, then the assumption is not made. A major problem the accounting profession facing is identifying the circumstances under which the continuity assumption should be abandoned. Sometimes company failures occur with the accounting reports continuing to be based upon the going concern convention. These accounting reports are subsequently considered as misleading. And premature abandonment of the continuity assumption by accountants may cause liquidation if it results in demands by creditors for repayment of accounts outstanding. Authoritative guidelines are needed in this area if continuity is to remain a basic assumption of contemporary accounting.

### **4. Accounting Period Assumption**

Most accounting entities are assumed to have an indefinite life. But accountants are asked to measure operating results and changes in economic position at relatively short time interval during this indefinite life. Consequently, accountants must divide

the life of a business into time periods of equal length, called accounting period. Accounting period is normally divided into one year, one quarter or one month.

The economic activity of a business is continuous. All transactions are recorded in the accounts and change the picture of the firm, as revealed in financial statements. The firm changes continuously as it carries out its operations. Changes cease only when the firm ceases operations. In this world of continuity of operations and change, accountants are required by law to report on financial position and results at least annually. This requirement for annual reporting is a relatively modern development. Even as late as the 19th century major businesses presented financial statements at irregular and lengthy intervals. Annual reporting probably arose from the demands of investors, owners, creditors and taxation authorities who were not prepared to wait until the end of a firm's life before the success of its operation was measured.

The accounting period convention does, however, lead to difficulties. First, it should be realized that the shorter the reporting period the greater the need for estimates and judgement. Over a short period, few transactions will be completed and there will be more accruals and deferrals than for longer period. Incorporating accruals and deferrals into the accounts increase the subjectivity of financial statements. In addition, financial reports for short periods may provide misleading impressions of the long-run prospects for the firm. A balance sheet represents a "snapshot" of the entity's financial position at an instant of time. Immediately before and after the date of the balance sheet, the financial position is different. By the time the balance sheet is published the financial position of the firm may have changed dramatically. As a result, the balance sheet is out of date the day after the end of the accounting period, and by the time it is published, it is of historical interest only.

### Changes in Accounting Assumptions

Accounting assumptions do not remain the same all the time, thus revising is called for constantly, with the development of economic environment. The reason lies in that past assumptions are just based on judgment by accountants from certain facts and observations.

During the era of inflation, the denial of stable currency assumption brings out accounting for price changes or current cost accounting; in the information age, the connotation of separate entity assumption has been extended. Going concern assumption no longer gets along well with all of the enterprises, and that's why application for liquidation accounting arises. When the unit-of-measure assumption no longer lives up to our demand for information, human

resource accounting emerges as the time requires. The derivative of financial tools speaks for the efforts people made in order to steady currency.

## 2.2 Accounting Principles

The accounting principles based upon this foundation provide guidelines or directives to accounting practice.

### 1. The Cost Principle

The financial statements are affected by cost principle. All goods and services purchased by an enterprise are recorded at acquisition cost and appear on financial statements at cost. Because cost is a reliable measure, the cost principle states that the accounting records should maintain the historical cost of an asset for as long as the business holds the asset. The cost principle is based on the assumption that cost is equal to fair market value at the date of acquisition and subsequent changes are not relevant to it.

### 2. The Revenue Realization Principle

The revenue realization principle indicates that revenue should be recognized at the time goods are sold or services are rendered. At this time, the business has essentially completed the earning process and the sales value of the goods or service can be measured objectively. In most cases, revenue is earned when the business has delivered completed goods or services to the customer. The reason is that the business has done everything required by the agreement including transferring the item to the customer. At any time prior to sale, the ultimate sales value of the goods or services sold can only be estimated. The revenue should be recognized and reported in the financial statement when the timing of revenue is reasonably determinable and the earning process is completed.

### 3. The Matching Principle

The matching principle requires that revenues and expenses should be matched each other. The measurement of expenses occurs in two stages: ①measuring the cost of goods and services that will be consumed or expired in generating revenue and ②determining when the goods and services acquired have contributed to revenue and their cost thus becomes an expense. The second aspect of the measurement process is often referred to as matching cost and revenue and fundamental to the accrual basis of

accounting. To match expenses against the revenues means to subtract the expenses from the revenues in order to compute net earning or net loss.

#### 4. The Adequate Disclosure Principle

The adequate disclosure principle holds that a company's financial statements should report enough information for outsiders to make knowledgeable decision about the company. In short, the company should report relevant, reliable, and comparable information about its economic affairs. Adequate disclosure can be accomplished either in the financial statements or in the notes accompanying the statements. Such disclosure should make the financial statements more useful and less subject to misinterpretation. The key point to bear in mind is that the supplementary information should be relevant to the interpretation of the financial statements.

### Vocabulary

|                       |           |
|-----------------------|-----------|
| accountant <i>n.</i>  | 会计师, 会计人员 |
| financial statement   | 财务报表      |
| classify <i>v.</i>    | 分类        |
| corporation <i>n.</i> | 股份公司      |
| salary <i>n.</i>      | 工资        |
| revenue <i>n.</i>     | 收益        |
| asset <i>n.</i>       | 财产, 资产    |

### Exercises

1. Read the following sentences carefully and fill in the blanks with appropriate words.

(1) The \_\_\_\_\_ requires business transactions and financial statements to be based upon objective and verifiable evidence.

(2) The \_\_\_\_\_ states that for accounting purposes, all business transactions will be recorded at cost or the dollars actually paid.

(3) \_\_\_\_\_ assumption holds that the entity will remain in operation for the foreseeable future.

(4) The \_\_\_\_\_ principle requires that revenue be recognized at the time it is earned.

(5) The \_\_\_\_\_ indicates that the requirements of accounting principles may be ignored if their effects on the financial statement are unimportant to users.

(6) The \_\_\_\_\_ assumption identifies a business's activities during a specific time period.

2. The following questions are related to the topic of this chapter. You can find answers to part of them immediately from the text of this chapter. However, some of them are beyond the text and require the combination of your mastery of accounting and English. We highly suggest that you pay enough attention to them and believe that you would benefit more from them.

(1) Which of the following statements is false? ( )

- A. Accounting principles prevent financial data from bias and inconsistency.
- B. Accounting principles have proved useful through many years' practice.
- C. Accounting principles are immutable laws like those in the physical science.
- D. Accounting principles may change over time.

(2) A company should disclose a summary of the accounting principles it follows in preparing its financial statements. Which of the following items would be included in the summary? ( )

- A. Depreciation methods.
- B. Inventory pricing methods.
- C. Methods of accounting for intangibles.
- D. All of the above.

(3) It can be inferred from the text that an all inclusive legal liability means that \_\_\_\_\_.

- A. business assets are available to personal creditors
- B. business creditors may have legal access to both business and personal assets
- C. both A and B
- D. none of the above

(4) According to the materiality principle, which of the following items should not be permitted to have its cost expensed? ( )

- A. Pencil sharpeners.
- B. Waste paper baskets.
- C. A new machine.
- D. Small tools.

(5) Which of the following statements is true? When transactions are still in progress, \_\_\_\_\_.

- A. accounting determinations should be subject to a range of optimistic
- B. the accountants should use the most conservative accounting procedures which intend to understate net assets and income
- C. possible errors in measuring net assets and income should tend toward understatement
- D. possible errors in measuring net liabilities and loss should tend toward overstatement

(6) According to the consistency assumption, which of the following statements is

true? ( )

A. In any instance, only one method of applying a generally accepted accounting principle is possible.

B. Two firms that have identical operating situations should choose the same accounting method so as to report equal amounts for the same types of transactions.

C. Unless otherwise disclosed, accounting reports are prepared on a basis consistent with the preceding period.

D. None of the above.

(7) To inform users properly, the firm should disclose the facts that have considerable influence on the firm's financial status and \_\_\_\_\_.

A. pertain to the period covered by the statements

B. arose subsequent to the balance sheet date

C. both A and B

D. none of the above

(8) We can infer from the text, accounting data are \_\_\_\_\_.

A. subject to the idea of management

B. subject to the idea of the accountant who prepares or audits the statements

C. always based on objectively determined evidence

D. sometimes based on subjective estimates of regulations

### *Reading Material*

## **The New Corporate Accounting Guidelines**

In 2006, China enacted the new corporate accounting guidelines, which becomes a hot topic for a lot of people to learn; it acts as an instructive and theoretic guideline, even providing a theory basis for studying the specific guidelines.

This paper first expounds on the necessity and meaning of this basic guideline amending and its effect and status. It thinks the basic guideline amending is the first step of "walking on two steps" for the finance accounting concept framework that our country intends to construct; secondly, it makes a research on the comparison between the old basic guideline before amending and the new one after amending, considering the new accounting guideline constructs a complete set of stratified system for accounting guideline. Besides broadening its established laws and regulations, it carries through a research on the difference comparison according to the accounting objective, the quality requirement of accounting information, the confirmation of finance accounting elements, and the finance report system. Thirdly, the paper stresses

to study the comparison between the guideline and IASB “making framework for finance report form”, making a comparison research respectively on guideline’s legal status, enacting objectives, structure, finance accounting objectives, basic assumption, element characteristic of finance report form, confirmation and measurement. Although our country’s accounting guideline is based on IASB’s IFRS, it still keeps its own feature with further strengthening the international synchronization.

In the end, the paper takes a look at the prospect of our country’s basic guideline, making efforts to transform it into the finance accounting concept framework which will comply with the international practice even more, and finish the significant second step of the “walking on two steps” policy.



**3**


# Chapter

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## Accounting Elements

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(会计要素)





## Learning Objectives ▶▶▶

After studying this unit, you should be able to:

- ◆ Explain the accounting elements;
- ◆ Explain the classification of the accounting elements.

Daffodil Inc. has decided to expand its operations to owning and operating theme parks. The following is an excerpt from a conversation between the chief executive officer, Jimmy Hanson, and the vice-president of finance, Charley Fowler.

**Jimmy:** Charley, have you given any thought to how we're going to finance the acquisition of Water Wave Corporation?

**Charley:** Well, the two basic options, as I see it, are to issue either preferred stock or bonds. The equity market is a little depressed right now. The rumor is that the Federal Reserve Bank's going to increase the interest rates either this month or next.

**Jimmy:** Yes, I've heard the rumor. The problem is that we can't wait around to see what's going to happen. We'll have to move on this next week if we want any chance to complete the acquisition of Water Wave.

**Charley:** Well, the bond market is strong right now. Maybe we should issue debt this time around.

**Jimmy:** That's what I would have guessed as well. Water Wave's financial statements look pretty good, except for the volatility of their income and cash flows. But that's characteristic of their industry.

### ■ Discuss:

Discuss the advantages and disadvantages of issuing preferred stock versus bonds.

Financial accounting information is classified into the categories of assets, liabilities, owner's equity, revenues, expenses and net earning. The above accounting information is also called accounting elements, which form the basic structure of financial statements. A good understanding of these accounting elements will be a good basis and start in learning financial accounting.

## 3.1 Assets

Assets are economic resources, which are measurable by money value, and which are owned or controlled by an enterprise, including all property, rights as a creditor to others, and other rights. Assets can be classified into current assets and long-term assets. Current assets refer to those assets which will be realized or consumed within one year of their acquisition, or within an operating cycle longer than a year, including cash, accounts receivable, and inventories, etc. Long-term assets consist of those economic resources that are held for operational purposes, including plant and equipment and intangible assets, etc.

### 1. Current Assets

Current assets also called trading assets, are the economic resources that would be liquidated within one year or one operating cycle (whichever is longer). Examples of current assets include cash, trade receivable and inventory. These are items that can be converted to cash within one year or in the normal operating cycle of a business. Also included in this category are any assets held that can be readily turned into cash with little effort, such as government and short-term investments (marketable securities), etc.

#### 1) Cash

Accountants define cash as the money on deposit in banks and any items that banks will accept for immediate deposit. These items include not only coins and paper money, but also checks and money orders. On the other hand, notes receivable, IOUs, and postdated checks are not accepted for immediate deposit and are not included in the definition of cash.

In the balance sheet, cash is listed first among the current assets, because it is the most current and liquid of all assets. The banker, credit manager, or investor who studies a balance sheet critically is always interested in the total amount of cash as compared with other balance sheet items, such as accounts receivable.

#### 2) Accounts Receivable

Accounts receivable arise when a business sells goods and services on credit. Sales and profits can be increased by granting customers the privilege of making payment a month or more after the date of sale. However, no business concerned wants to sell on credit to the customer who will prove unable or unwilling to pay his or her account.

Consequently, most business organizations have a credit department which investigates the credit worthiness of each prospective customer.

### 3) Inventory

Inventory refers to various assets that are stocked for the purpose of sale, production or consumption during the process of the production and operation for a business. The definition of inventory is applied to manufacturing enterprises as well as merchandising enterprises. For a merchandising enterprise, inventory consists of all goods owned and held for sale in the regular course of business. In manufacturing enterprises, there are three major types of inventories: raw materials, goods in process, and finished goods. Since inventories will typically be sold within a year or during a firm's normal operating cycle if it should be longer than a year, inventories are classified as current assets. In the balance sheet, inventory is listed immediately after receivables.

The method selected for determining cost should be one that results in fairest matching of costs against revenues regardless of whether or not the method corresponds to the physical flow of the goods.

In general, inventories are priced at their cost. Inventory valuation is quite simple when acquisition price remains constant. When price for like items changes during the accounting period, it is not always apparent which price should be used to measure the ending inventory. The four inventory valuation methods to be used usually are known as specific identification method, weighted-average method, first-in, first-out method (FIFO), and last-in, first-out method(LIFO).

#### (a) Specific Identification Method.

The specific identification method (also known as specific invoice) requires the recording of detailed information for each purchase transaction so that merchandise on hand at the end of an accounting period can be identified with a specific order. Each purchase may be assigned a special number, or a special tag may be placed on each specific order so that each sale can be identified to the related invoice. In this way, the merchandise on hand may be obtained from the purchase invoice.

The specific identification method is best suited to inventories of high-priced, low-volume items. New automobiles and construction equipment are good examples. The method of pricing inventory is required to identify the units in the ending inventory as coming from specific purchases. Specific identification is not feasible where products are of a small unit price and involve large volumes. If the units in the ending inventory can be identified as coming from specific purchases, they may be priced at the amounts listed on the purchase invoices.

### Example 3-1

*Green Lawn Products Company uses the specific invoice method for valuing the ending inventory. During its first year in business, the following purchases of merchandise were made:*

| Purchase date | Quantity(bags) | Unit price( \$ ) | Total cost( \$ ) |
|---------------|----------------|------------------|------------------|
| Mar. 10       | 80             | 6.00             | 480              |
| Apr. 20       | 100            | 6.50             | 650              |
| Jul. 12       | 100            | 6.50             | 650              |
| Sept. 5       | 60             | 6.60             | 396              |
| Total         | 340            |                  | 2 176            |

During the year, 280 bags of merchandise were sold and 60 bags were on hand at the end of the year. The 60 bags in the ending inventory could be specifically identified as 30 bags acquired on September 5 and 30 bags acquired on July 12.

$$\text{Cost of ending inventory} = 30 \times 6.6 + 30 \times 6.5 = \$393$$

#### (b) Weighted-average Method.

The weighted-average method of valuing inventory recognizes that prices will vary as merchandise is purchased during the fiscal period. Therefore, under this method the units in the ending inventory are priced at the average unit cost of the merchandise on hand during the entire fiscal period. Before computing the value of the ending inventory using the weighted-average method, the average cost for one unit must be obtained and then applied to the number of units in the ending inventory.

### Example 3-2

*Using the data given in Example 3-1, the ending inventory under the weighted-average method is computed as follows:*

$$\text{Average unit cost} = \frac{\$2\,176 \text{ total cost}}{340 \text{ bags purchased}} = \$6.4$$

$$\text{Cost of ending inventory} = \$6.4 \times 60 = \$384$$

#### (c) First-in, First-out(FIFO) Method.

The first-in, first-out(FIFO) method of inventory valuation assumes that the first goods purchased are the first goods sold. Therefore, the merchandise on hand at the end of period would consist of the last or most recent purchase valued at the current or last purchase price.

**Example 3-3**

Using the data given in Example 3-1, the ending inventory under the FIFO method would be computed as follows:

| Purchase date | Quantity(bags) | Unit price( \$ ) | Total cost( \$ ) |            |
|---------------|----------------|------------------|------------------|------------|
| Mar. 10       | 80             | 6.00             | 400              | sold 80    |
| Apr. 20       | 100            | 6.50             | 650              | sold 100   |
| Jul. 12       | 100            | 6.5              | 650              | sold 90    |
|               |                |                  |                  | on hand 10 |
| Sept. 5       | 60             | 6.60             | 396              | on hand 60 |
| Total         | 340            |                  | 2 176            |            |

Cost of ending inventory by FIFO method =  $60 \times 6.60 + 10 \times 6.5 = \$461$

## (d) Last-in, First-out(LIFO) Method.

The last-in, first-out(LIFO) method of inventory valuation assumes that the last goods purchased are the first ones sold. The goods that remain unsold at the end of the period would consist of goods in the beginning inventory and/or the first goods purchased. When using the LIFO inventory pricing method, the first items purchased are assumed to be the last items sold. Therefore, the ending inventory would be valued at the earliest or first purchase price.

**Example 3-4**

Using the data given in Example 3-1, the ending inventory under the LIFO method would be computed as follows:

| Purchase date | Quantity(bags) | Unit price( \$ ) | Total cost( \$ ) |            |
|---------------|----------------|------------------|------------------|------------|
| Mar. 10       | 80             | 6.00             | 480              | On hand 80 |
| Apr. 20       | 100            | 6.50             | 650              | On hand 10 |
|               |                |                  |                  | Sold 90    |
| Jul. 12       | 100            | 6.5              | 650              | Sold 100   |
| Sept. 5       | 60             | 6.60             | 396              | Sold 60    |
| Total         | 340 bags       |                  | 2 176            |            |

Cost of ending inventory by LIFO method =  $80 \times 6.00 + 10 \times 6.50 = \$545$

When prices are rising, LIFO results in lower reported income and thus may provide a related tax benefit. LIFO better matches current costs against current revenues because the most recent purchases are reflected as cost of goods sold. However, it consequently processes the ending inventory at the older, less realistic unit price. Because of this, the LIFO inventory figure on the balance sheet often becomes quite meaningless in terms of current cost prices. This method is not allowed to use in IAS and Chinese GAAP any more.

## 2. Non-current Assets

Non-current assets are items which a business cannot easily turn into cash and consumed within business-cycle activity. Other non-current assets may include investments, prepayment and receivable from subsidiaries, and receivables from officers and employees.

The term plant and equipment is used to describe long-term assets acquired for use in the operation of the business and not intended for resale to customers. Among the more common examples are land, buildings, machinery, furniture and fixtures, office equipment, and automobiles.

The term fixed assets or plant assets have been used in accounting literature to describe all types of plant and equipment. This term, however, has virtually disappeared from the published financial statements of large corporations. Plant and equipment appear to be a more descriptive term. Another alternative term used on many corporation balance sheets is property, plant, and equipment. It is convenient to think of a plant and equipment as a stream of services to be received by the owner over a period of years.

Plant and equipment items are often classified into the following groups:

### (a) Tangible Plant Assets.

The term tangible plant assets denote physical substances, as exemplified by land, a building, or a machine. This category may be subdivided into two distinct classifications:

- Plant property subject to depreciation. Assets are plant assets of limited useful life such as buildings and office equipment.

- Land. The only plant asset not subject to depreciation is land, which has an unlimited term of existence.

### (b) Natural Resources.

Timber, fossil, mineral deposits, and other natural resources are different from depreciable assets because they are physically extracted during company operations and they are replaceable only through natural processes.

(c) Intangible Assets.

The term intangible assets are used to describe assets which are used in the operation of the business but no physical substance, and are non-current. Current assets such as accounts receivable or prepaid rent are not included in the intangible classification, even though they are lacking in physical substance. The intangible assets will be separately discussed in the later part.

**Various intangible assets are described as follows:**

**Patents**

Patents are granted by the government, and convey the exclusive right to use a product or process for a period of certain years.

**Copyrights**

Copyrights are also granted by the government, and convey the exclusive right to use artistic or literary works for a period of certain years beyond the author's death. Common examples of works that can be copyrighted include books, songs, and movies. The economic life of a copyright may be considerably shorter than its legal life.

**Trademarks**

Trademarks are words, symbols, or other distinctive elements used to identify a particular firm's products.

**Franchises and licenses**

Franchises and licenses are rights to market a particular product or service or to engage in a particular activity. For example, Pizza Hut sells franchises to various individuals and businesses. A franchise permits the holder to operate a Pizza Hut restaurant at a specified location. This right has economic value to the holder and would be reflected as an asset.

**3. Other Assets**

Under the other assets category, several items can be lumped together. The following items may be itemized separately on other balance sheets, and if significant, should be closely examined: investments, intangible, and miscellaneous assets.

### Long-term Investment

One corporation may invest in another corporation by acquiring either debt securities or equity securities of the other corporation. The objective of an investment in another corporation is to earn a return on idle cash, or to obtain influence or control over the other corporation. Short-term investments are defined as those that meet two tests: ready marketability and management intention to convert them to cash in the short run. Those not meeting these two tests are classified as long-term investments.

The purpose of this part is to discuss measuring and reporting of long-term investments in both voting common shares and debt securities.

#### (1) Measuring and reporting investments in common shares.

Accounting for long-term investments in voting common shares involves measuring the investment amount that should be reported on the balance sheet and the periodic investment revenue and should be report on the income statement. In accordance with the cost principle, long-term investments in the voting shares of another company are measured and recorded, at the dates of acquisition of the shares, as the total consideration given to acquire them. This total includes the market price, plus all commissions and other buying costs.

#### (2) Measuring and reporting bond investments.

Investors may buy bonds at their date of issuance or at subsequent dates during the life of the bonds. Regardless of the timing of the bonds' acquisition, at the end of each accounting period, the investors must measure the cost, adjusted for the cumulative amount of discount or premium that has been amortized, and interest revenue earned.

At the date of acquisition, a bond investment is measured, recorded, and reported in accordance with the cost principle. The purchase cost, including all incidental acquisition cost is debited to an investment account such as long-term investment. The amount recorded under the cost principle is the current cash equivalent amount; and it may be the same as the maturity amount, less than the maturity amount, or more than the maturity amount. The premium or discount on a bond investment usually is not recorded in a separate account reflecting the current book or carrying amount.



## 3.2 Liabilities

Liabilities are debts born by an enterprise, measurable by money value, which will be paid to a creditor using assets or services. Liabilities are generally classified into current liabilities and long-term liabilities. Current liabilities refer to the debts which should be paid off within a year or an operating cycle longer than a year, including notes payable, accounts payable, advances from customers, accrued expenses, and taxes payable, etc; long-term liabilities refer to the debts which will be repayment after a year including long-term notes payable, bonds payable, and mortgage note, etc.

### 1. Current Liabilities

#### 1) Accounts Payable

Accounts payable are often subdivided into the categories of trade accounts payable and other accounts payable. Trade accounts payable are short-term obligations to suppliers for purchases or merchandise. Other accounts payable include goods and services other than merchandise.

Accounts payable usually do not require the payment of interest. This makes the form of liability very desirable, and it represents an “interest-free” loan from the supplier.

#### Example 3-5

*Assume that a business bought a machine \$10 000 on credit. The journal entry for this transaction was as follows:*

|                      |        |
|----------------------|--------|
| Dr. Machinery        | 10 000 |
| Cr. Accounts Payable | 10 000 |

The record having bought the machine on credit for \$10 000.

#### 2) Notes Payable

Notes payable are issued whenever bank loans are obtained. Other transactions which may give rise to notes payable include the purchase of real estate or costly equipment, the purchase of merchandise, and the substitution of a note for a past-due account payable.

Notes payable usually require the borrower to pay an interest charge. Normally, the interest rate is stated separately from the principal amount of the note.

**Example 3-6**

Assume that on November 1, M&Q Company borrowed \$10 000 from its bank for a period of six months at an annual interest rate of 12%. Six months later, on May 1, PT Company would have to pay the bank the principal amount of \$20 000 plus \$1 200 interest. As evidence of this loan, the bank would require PT Company to issue a note payable. The journal entry in PT Company's accounting records for this November 1 borrowing was as follows:

|                   |        |
|-------------------|--------|
| Dr. Cash          | 20 000 |
| Cr. Notes Payable | 20 000 |

To record having borrowed \$20 000 for six months at 12% interest per year.

Notice that no liability was recorded for the interest charges when the note was issued. At the date that money was borrowed, the borrower had a liability only for the principal amount of the loan; the liability for the interest accrued day by day over the life of the loan. On December 31, two months' interest expense had been incurred, and the following year-end adjusting entry was made:

|                      |     |
|----------------------|-----|
| Dr. Interest Expense | 400 |
| Cr. Interest Payable | 400 |

To record interest expense incurred through year-end on 12% six-month, not dated Nov. 1.

The entry to record payment of the note on May 1 would be:

|                   |        |
|-------------------|--------|
| Dr. Notes Payable | 20 000 |
| Interest Payable  | 400    |
| Interest Expense  | 800    |
| Cr. Cash          | 21 200 |

To record payment of 12%, six-month note on maturity date and to recognize interest expense incurred since year-end.

### 3) The Current Portion of Long-term Debt

Some long-term debts, such as mortgage loans, are payable in a series of monthly or quarterly installments. In these cases, the principal amount due within one year (or the operating cycle) is regarded as a current liability, and the remainder of the obligation is classified as a long-term liability.

As the maturity date of a long-term liability approaches, the obligation eventually becomes due within the current period. Long-term liabilities which become payable within the coming year are reclassified in the balance sheet as current liabilities. Changing the classification of a liability does not require a journal entry; the obligation merely is shown in a different section of the balance sheet.

## 2. Accrued Liabilities

Accrued liabilities arise from the recognition of expenses for which payment will be made in a future period. Thus, accrued liabilities are also called accrued expenses. The need to record accrued liabilities arises from the fact that certain expenses are incurred by the business before they are actually paid. Examples of accrued liabilities include interest payable, income taxes payable, and amounts related to payrolls.

All companies incur accrued liabilities. In most cases, however, these liabilities are paid at frequent intervals. Therefore, they usually do not accumulate to large amounts. In a balance sheet, accrued liabilities are sometimes included in the amount shown as “accounts payable”.

### 1) Long-term Liabilities

Long-term liabilities are companies' obligations that extend beyond the current year, or alternately, beyond the current operating cycle. Most commonly, these include long-term debts such as company issued bonds.

The most common examples of long-term liabilities are long-term notes payable, bond payable and mortgage payable. Long-term financing by issuing notes payable to banks or to insurance companies can provide corporations with only a limited amount of funds.

### 2) Long-term Notes Payable

A borrower may desire a longer term for their loan. It would not be uncommon to find two, three, or five-year, and even longer-term notes. These notes may evidence a “long-term loan”, where “interest only” is paid during the period of borrowing, and balance of the notes are due at maturity date.

#### Example 3-7

*Assume that Nilson Company issued par value \$10 000, a five-year, 8% term note, with interest paid annually on September 30 of each year. Thus Nilson Company would record the issuance of the note as follows:*

|         |              |        |
|---------|--------------|--------|
| 9-30-×× | Cash         | 10 000 |
|         | Note Payable | 10 000 |

To record note payable at 8% per annum, maturity date on September 30.

|          |                  |     |
|----------|------------------|-----|
| 12-31-×× | Interest Expense | 200 |
|          | Interest Payable | 200 |

To record accrued interest for 3 months(  $\$10\,000 \times 8\% \times 3/12$ ) at the end of each year.

|         |                  |     |
|---------|------------------|-----|
| 9-30-×× | Interest Expense | 600 |
|         | Interest Payable | 200 |
|         | Cash             | 800 |

To record interest payment ( $\$10\,000 \times 8\% = \$800$ ), of which \$200 was previously accrued at the prior year end each September.

|         |                  |        |
|---------|------------------|--------|
| 9-30-×× | Interest Expense | 600    |
|         | Interest Payable | 200    |
|         | Note Payable     | 10 000 |
|         | Cash             | 10 800 |

To record having paid the final interest and balance of note at maturity.

### 3) Bonds Payable

Bonds represent an obligation to repay a principal amount at a future date and pay interest, usually on a semi-annual basis. Unlike notes payable, which normally represent an amount owed to one lender, a large number of bonds are normally issued at the same time to different lenders. These lenders, also known as investors, may sell their bonds to another investor prior to their maturity.

#### (1) The Book Elements of Bonds.

The company that issues bonds enters into a contract, called a bond indenture, with the bondholders. The contract generally includes the following items:

- Face value. The face value (also called par value or maturity value) is the principal that the company is required to pay at maturity.
- Due date. The due date means the day of maturity.
- Coupon rate. The coupon rate (also called nominal interest rate, contractual rate, stated rate) determines the amount of interest that the company is required to pay every year.
- The issuing company. Bonds are “issued” by companies (“issuers”) that wish to borrow money from the general public.

#### (2) Types of Bonds.

There are many different types of bonds available to interested investors. Some of the more common forms are:

##### (a) Convertible bonds.

Convertible bonds are bonds that can be exchanged for a fixed number of shares of the company’s common stock. In most cases, it is the investor’s decision to convert the bonds to stocks, although certain types of convertible bonds allow the issuing

company to determine if and when bonds are converted.

(b) Registered bonds.

Registered bonds are issued in the name of a specific owner. This is how most bonds are issued today. Having a registered bond allows the owner to automatically receive the interest payments when they are made.

(c) Bearer bonds.

Bearer bonds are bonds that require the bondholder, also called the bearer, to go to a bank or broker with the bond or coupons attached to the bond to receive the interest and principal payments. They are called bearer or coupon bonds because the person presenting the bond or coupon receives the interest and principal payments.

(d) Secured bonds.

Bonds are secured when specific company assets are pledged to serve as collateral for the bondholders. If the company fails to make payments according to the bond terms, the owners of secured bonds may require the assets to be sold to generate cash for the payments.

(e) Debenture bonds.

These unsecured bonds require the bondholders to rely on the good name and financial stability of the issuing company for repayment of principal and interest amounts. These bonds are usually riskier than secured bonds. A subordinated debenture bond means the bond is repaid after other unsecured debt, as noted in the bond agreement.

(3) The Nature of the Bonds Payable.

Bonds payable are a form of long-term debt. Bonds are issued by corporations, hospitals, and governments. For example, public utilities will issue bonds to help finance a new electric power plant, hospitals issue bonds for new buildings, and governments issue bonds to finance projects, cover deficits, or pay for older debt that is now maturing.

The issuer of bonds makes formal promises to pay interest usually every six months (semiannually) and to pay the principal or maturity amount at a specified date many years in the future.

(4) Accounting for Bonds Payable.

(a) Bonds issued at par.

Accounting for bonds payable closely parallels accounting for notes payable. The events in the life of a bond issue usually are issuance of the bonds, semiannual interest payment, accrual of interest payable at the end of each accounting period, and retirement of the bonds at maturity.

**Example 3-8**

Assume that on March 1, 2013, WS Corporation issued \$1000 000 of 12% ,20-year bonds payable. These bonds were dated March 1, 2013, and interest was computed from this date. Interest on the bonds was payable semiannually, each September 1 and March 1. If all of the bonds were sold at par, they could be recorded by the following entry:

|                   |           |
|-------------------|-----------|
| Dr. Cash          | 1 000 000 |
| Cr. Bonds Payable | 1 000 000 |

To record having issued 12% ,20 years bonds payable at a price of \$100.

Every September 1, during the life of the bond issue, WS Corporation must pay \$60 000 to the bondholders. This semiannual interest payment will be recorded as follows:

|                           |        |
|---------------------------|--------|
| Dr. Bond Interest Expense | 60 000 |
| Cr. Cash                  | 60 000 |

To record semiannual payment of bond interest.

Every December 31, WS Corporation must make an adjusting entry to record the four months interest which has accrued since September 1 as follows:

|                           |        |
|---------------------------|--------|
| Dr. Bond Interest Expense | 40 000 |
| Cr. Bond Interest Payable | 40 000 |

To accrue bond interest payable for four months ended on December 31.

Note that the accrued liability for bond interest payable months and, therefore, is classified as a current liability.

Two months later, on March 1, a semiannual interest payment is made to bondholders. The entry to record the semiannual payments every March 1 will be:

|                            |        |
|----------------------------|--------|
| Dr. Bonds Interest Expense | 20 000 |
| Bond Interest Payable      | 40 000 |
| Cr. Cash                   | 60 000 |

To record semiannual interest payment to recognize two months' interest expense accrued since year-end.

When the bonds mature 20 years later on March 1, 2029, two entries are required: one entry to record the semiannual interest payment and a second entry to record the retirement of the bonds. The entry to record retirement of the bond issue is:

|                  |           |
|------------------|-----------|
| Dr. Bond Payable | 1 000 000 |
| Cr. Cash         | 1 000 000 |

To record having paid face amount of bond at maturity.

(b) Bonds issued at a discount.

There is always some delay between the time a bond's coupon rate is decided upon

and when the bond is actually available to be issued to the public. During this delay, the prevailing rate of return on bonds of comparable risk may have changed.

When the coupon rate is below the market rate, the investor won't buy the bonds unless they are sold at a discount from the par or face value. Because the coupon rate does not provide the investor with a rate of return equal to that available on other similar investments.

### Example 3-9

*Assume that on January 1, 2013, MR Company sold \$1 000 000 of 9% ,40-year bonds to an underwriter at a price of \$98. On January 1, 2013, MR Company received \$980 000 cash from the underwriter and recorded a liability in this amount. But when these bonds mature in 40 years, the MR Company will owe its bondholders \$1 000 000. Thus, the company's liability to bondholders will increase by \$20 000 over the life of the bond issue.*

*When bonds are issued, the amount of any discount is debited to an account entitled Discount on Bonds Payable. Thus MR Corporation will record the issuance of these bonds as follows:*

|                           |           |
|---------------------------|-----------|
| Dr. Cash                  | 980 000   |
| Discount on Bonds Payable | 20 000    |
| Cr. Bonds Payable         | 1 000 000 |

To record having issued \$1 000 000 face value 40-year bonds to an underwriter at a price of \$98.

The debit balance account, Discount on Bonds Payable, is a contra-liability account. Over the 40-year life of the bond issue, adjusting entries are made to gradually transfer the balance in the discount account into interest expense. Thus, the balance in the discount account gradually declines, and the carrying value of the bonds—face value less the unamortized discount—rises toward the bonds maturity value. At the end of each year, MR Corporation will make the following adjusting entry to amortize the bond discount:

|                               |     |
|-------------------------------|-----|
| Dr. Interest Expense          | 500 |
| Cr. Discount on Bonds Payable | 500 |

Recognized one year's amortization of discount( $20\ 000/40 = 500$ ) on 40-year bonds payable.

Notice that amortization of the discount increases MR Corporation's annual interest expense. It does not, however, require any immediate cash outlay. The interest expense represented by the discount will not be paid until the bonds mature.

(c) Bonds issued at a premium.

When bonds are issued at a premium, the borrower pays back less than the amount originally borrowed. As a result, the total interest cost over the life of the bonds is equal to the interest paid minus the amount of the premium.

### Example 3-10

Assume that the MR Corporation issued \$1 000 000, 9%, 40-year bonds at a price of \$102. The entry to record the issuance of the bonds would be as follows:

|                          |           |
|--------------------------|-----------|
| Dr. Cash                 | 1 020 000 |
| Cr. Bonds Payable        | 1 000 000 |
| Premium on Bonds Payable | 20 000    |

To record having issued \$1 000 000 face value 9%, 40-year bonds at a price of \$102.

The amount of any unamortized premium is added to the maturity value of the bonds payable to show the current carrying value of the liability. Over the life of the bond issue, this carrying value will be reduced toward the maturity value of \$1 000 000, as the premium is amortized.

Premium is amortized over the 40-year life of the bonds in a manner similar to the amortization of discount. However, instead of increasing interest expense, amortization of premium decreases interest expense. The entry to amortize bond premium for one year is illustrated below:

|                              |     |
|------------------------------|-----|
| Dr. Premium on Bonds Payable | 500 |
| Cr. Interest Expense         | 500 |

Recognized one year's amortization of premium ( $20\,000/40 = 500$ ) on 40-year bonds payable.

(5) Mortgage Payable.

The long-term financing used to purchase property is called a mortgage. The property itself serves as collateral for the mortgage until it is paid off. A mortgage usually requires equal payments, consisting of principal and interest, throughout its term. The early payments consist of more interest than principal. Over the life of the mortgage, the portion of each payment that represents principal increases and the interest portion decreases. This decrease occurs because interest is calculated on the outstanding principal balance that declines as payments are made.



## 3.3 Owner's Equity

Owner's equity refers to the interest or the claim of the investors remaining in the net assets of an enterprise. Net assets are the difference between the amount of assets and the amount of liabilities. Owner's equity includes owner's investment in a business and accumulated operating results since the beginning of the operation. Capital, net assets, and shareholder's equity are the other terms for owner's equity. Owner's equity is a broader term because the concepts being presented are equally applicable to the ownership equity in single proprietorships, partnerships, and corporations.

### 1. Accounting for Single Proprietorship

For a single proprietorship, the owner's equity is represented by the term capital. The total capital comes from the owner's initial investment and net earning. The net earning is the excess of revenue over expenses for the accounting period and it is the increase in capital resulting from profitable operation of a business.

A single proprietorship is not required to maintain a distinction between invested capital and earned capital. Consequently, the balance sheet of a single proprietorship will have only one item in the owner's equity section, as illustrated below:

Owner's equity:

|                     |          |
|---------------------|----------|
| Bill White, Capital | \$30 000 |
|---------------------|----------|

The distribution of cash for a single proprietorship takes the form of personal withdrawals, and a drawing account is used to show the decrease in capital. In single proprietorship, all owner's equity transactions are recorded in only two accounts: Capital and Drawings.

### Example 3-11

*If Megan Wilkes decided to withdraw \$1 300 cash for personal use or as salary, the entry was:*

|                        |       |
|------------------------|-------|
| Megan Wilkes, Drawings | 1 300 |
| Cash                   | 1 300 |

To record having withdrawn \$1 300 for personal use.

### 2. Accounting for Partnership

A partnership is a voluntary association of two or more persons for the purpose of

conducting a business for profit. Each general partner is an agent for the partnership, having unlimited liability for partnership obligations, and firm property with all partners.

The books of a partnership are opened with an entry reflecting the net contribution of each partner to the firm. Assets invested in a partnership should be recorded initially at their current fair values. New partners may be admitted to a partnership either by purchasing an interest or by investing assets. Likewise, a retiring partner may sell his or her interest to an outsider or to one or more of the remaining partners, or receive payment for the interest from partnership funds. The transfer of interest is a personal transaction between the parties involved. Under such conditions, there will be no change in the firm's assets.

Partnership profits and losses are divided among partners according to the sharing agreement. If there is no sharing agreement, profits and losses are divided equally. The agreement may just specify a fixed ratio (such as 60% to 40%, 5 : 3 : 2, etc.) or provide a sharing formula of some kind. The formula may be based on:

- The relative investments of the partners according to the beginning or average capital ratio for the year;
- The services performed by the partners—a salary allowance for each partner with the remainder of net earning to be divided equally;
- The salary allowance and an interest allowance for each partner with the remainder of net earning to be divided equally.

### Example 3-12

*Assume that the Ames and Baker partnership had a profit of \$18 000 for the year and that the partners' relative capital balances before any profit distribution at the end of the year were as follows:*

| Ames, Capital        | Baker, Capital                       |
|----------------------|--------------------------------------|
| 2013<br>Jan. 130 000 | 2013<br>Jan. 110 000<br>Jul. 110 000 |

*Ames and Baker have the following sharing agreement: salaries of \$6 000 to Ames and \$4 000 to Baker; 6% interest on average capital balances; the remainder of net income to be divided equally. The net income \$18 000 would therefore be divided as follows:*

|   | Ames            | Baker          |                |
|---|-----------------|----------------|----------------|
| Earnings to be divided                                  |                 |                | \$18 000       |
| Salary allowances:                                      |                 |                |                |
| Ames  | \$6 000         |                |                |
| Baker   |                 | \$4 000        | \$10 000       |
|   |                 |                | <u>\$8 000</u> |
| Allowances for interest on<br>Average capital balances: |                 |                |                |
| Ames( \$30 000×0.06)                                    | \$1 800         |                |                |
| Baker( \$15 000* ×0.06)                                 |                 | \$900          | \$2 700        |
|   |                 |                | <u>\$5 300</u> |
| Remainder( \$5 300) divided equally                     | <u>\$2 650</u>  | <u>\$2 650</u> |                |
| Each partner's share                                    | <u>\$10 450</u> | <u>\$7 550</u> |                |

\* ( \$10 000×6 months + \$20 000×6 months) ÷ 12 = 15 000

The closing entry would be:

|                |        |
|----------------|--------|
| Income Summary | 18 000 |
| Ames, Capital  | 10 450 |
| Baker, Capital | 7 550  |

*If Ames and Baker had withdrawn cash equal to their salary allowances, their drawing accounts at the end of the year would show debit balances of \$6 000 and \$4 000 respectively. The entry to close the drawing accounts would be :*

|                |       |
|----------------|-------|
| Ames, Capital  | 6 000 |
| Baker, Capital | 4 000 |
| Ames, Drawing  | 6 000 |
| Baker, Drawing | 4 000 |

The statement of partners' capital must portray the changes in the capital balances of each partner, as shown in Exhibit 3-1.

## Exhibit

AMES AND BAKER  
 Statement of Partners' Capital  
 for the Year 2013

Unit: \$

|                                | Ames                 | Baker                | Total                |
|--------------------------------|----------------------|----------------------|----------------------|
| Capital balance, Jan. 1, 2013  | 30 000               | 10 000               | 40 000               |
| Add: Additional contributions  |                      | 10 000               | 10 000               |
| Net income for 2013            | <u>10 450</u>        | <u>7 550</u>         | <u>18 000</u>        |
|                                | 40 450               | 27 550               | 68 000               |
| Less: Withdrawals              | <u>6 000</u>         | <u>4 000</u>         | <u>10 000</u>        |
| Capital balance, Dec. 31, 2013 | <u><u>34 450</u></u> | <u><u>23 550</u></u> | <u><u>58 000</u></u> |

The situations that arise during partnership liquidations can be quite complex. In short, when a business partnership is discontinued, the assets are sold, liabilities are paid, and the remaining cash is distributed to the partners. Essentially, gains and losses realized in selling assets are carried to the partners' capital accounts (in the established profit and loss sharing ratio), and each partner eventually receives the balance remaining in his or her capital account.

### 3. Accounting for Corporation

#### 1) Definition of the Corporation

A corporation is an entity that is owned by its shareholders and raises equity capital by selling shares of stock to investors.

A corporation is a legal entity, having an existence separate and distinct from that of its owners. The assets of a corporation belong to the corporation itself, not to the stockholders. The corporation is responsible for its own debts, and must pay income taxes on its earnings.

#### 2) Advantages of the Corporate over Other Organizational Forms

A corporation is considered to be a person who is completely separate from its owners. Owners are known as shareholders because they own only a share or part of the organization. Like a person, corporations may own property and assets, take on debt to finance operations, and sell shares to raise money. The corporation enjoys the following four major advantages that, when combined, make this type of organization attractive for large ventures.

Clearly, corporations have some major advantages over the other two organizational forms. Limited liability, permanency, transferability of ownership, and

easier access to capital make corporations the best choice when large ventures are planned.

However, corporations also have one major disadvantage—income made by the corporation is taxed twice. The first taxation occurs because the corporation is considered to be a person and, therefore, is taxed accordingly. Then, the income gained through ownership of the corporation is taxed as personal income in the owners' income tax. This double taxation dilutes the profitability of the corporation and makes ventures that much more risky because they cost more. Essentially, the corporation must get a greater return on investments to cover the corporation's taxes while still maintaining profitability to shareholders.

### 3) Accounting for Corporation

Accounting for corporation is distinguished from accounting for single proprietorship and partnership. In the corporation, owner's equity is separated into capital stock and retained earnings. The reason for this separation is that most states prohibit corporations from paying dividends from other than retained earnings.

Capital stock is further divided, and so we have three major capital accounts: paid-in capital (contributed capital), additional paid-in capital and retained earnings. Paid-in capital shows the par value of the stock issued by the corporation. It is recorded in separate accounts for each class of stock. Additional paid-in capital refers to amounts paid in beyond the par value of stock. Retained earnings refer to the accumulated earnings arise from profitable operation of the business.

## 3.4 Revenue

Revenue is the economic resources flowing into a business as a result of rendering goods and services sold during a given accounting period. Sales revenue, service revenue, and investment revenue are subdivisions of revenue. Increase in revenue will increase owner's equity.

In business, revenue is the assets increase that a company receives from its normal business activities, usually from the sales of goods and services to customers.

### 1. What Is Revenue?

Revenue is income that arises in the course of ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends, etc. Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of a business when those inflows result in increases in

equity.

Various terms are used to describe different types of revenue. For example, the revenue earned by a real estate broker might be called Sales Commissions Earned, or alternatively, Commission Revenue. In the professional practice of lawyers, physicians, dentists, and CPAs, revenue is called Fees Earned. A business which sells merchandise rather than services will use the term Sales to describe the revenue earned. Another type of revenue is Interest Revenue, which means the amount received as interest on notes receivable, bank deposits, government bonds, or other securities.

## 2. Measurement of Revenue

Revenue should be measured at the fair value of the consideration received or receivable. The amount of revenue arising in a transaction is usually determined by the agreement between the enterprise and the buyer or user of the asset. It is measured at the fair value of the consideration received or receivable taking into account the amount of any trade discounts and volume rebates allowed by the enterprise.

In most cases, the consideration is in the form of cash or cash equivalents and the amount of revenue is the amount of cash or cash equivalents received or receivable. However, when the inflow of cash or cash equivalents is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable. For example, an enterprise may provide interest free credit to the buyer or accept a note receivable bearing a below-market interest rate from the buyer as consideration for the sale of goods. When the arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest. The imputed rate of interest is more clearly determinable of either: the prevailing rate for a similar instrument of an issuer with a similar credit rating; or a rate of interest that discounts the nominal amount of the instrument to the current cash sales price of the goods or services.

When the fair value of the goods or services received cannot be measured reliably, the revenue is measured at the fair value of the goods or services given up, adjusted by the amount of any cash or cash equivalent transferred.

## 3. Recognition of Revenue

The generally accepted accounting principles (GAAP) determine the specific conditions under which income becomes realized as revenue. Generally, revenue is recognized only when a specific critical event has occurred and the amount of revenue is measurable.

For most businesses, income is recognized as revenue whenever the company delivers or performs its product or service and receives payment for it. Revenue

recognition needs to meet the following conditions: (1) Revenue is realized when cash or claims to cash (receivable) are received in exchange for goods or services. (2) Revenue is realizable when assets received in such exchange are readily convertible to cash or claims to cash. (3) Revenue is earned when such goods or services are transferred (rendered). Both such payment assurance and final delivery completion (with a provision for returns, warranty claims, etc.) are required for revenue recognition.

In practice, this means that revenue is recognized when an invoice has been sent.

**The ways to recognize the revenue in the following four types of transactions:**

- (1) Revenues from selling goods are recognized at the date of sale often interpreted as the date of delivery.
- (2) Revenues from rendering services are recognized when services are completed and billed.
- (3) Revenue from permission to use company's assets (e. g. interests for using money, rent for using fixed assets, and royalties for using intangible assets) is recognized as time passes or as assets are used.
- (4) Revenue from selling an asset other than inventory is recognized at the point of sale, when it takes place.

## 3.5 Expenses

Expenses are the outflow of a business's economic resources resulting from earning revenue or the cost of the operational activities for the business. Expenses include cost of goods sold, administrative expenses, selling expenses, and financial expenses, etc. Increase in expenses will decrease owner's equity.

### 1. What Is Expenses?

Expenses are the cost of the goods and services used up in the process of earning revenue. Examples include the cost of employees' salaries, advertising, rent, utilities, and the gradual wearing-out (depreciation) of such assets as buildings, automobiles, and office equipments. All these costs are necessary to attract and service customers and thereby earn revenue. Expenses are often called the "costs of doing business", that is,

the cost of the various activities necessary to carry on a business.

An expense always causes a decrease in owner's equity. The related changes in the accounting equation can be either (1) a decrease in assets, or (2) an increase in liabilities. An expense reduces assets if payment occurs at the time that the expense is recorded or if payment has been made in advance. If the expense will not be paid until later, as, for example, the purchase of advertising services on account, the recording of the expenses will be accompanied by an increase in liabilities.

A significant relationship exists between revenue and expenses. Expenses are incurred for the purpose of producing revenue. In measuring net earning for a period, revenue should be offset by all of the expenses incurred in producing that revenue on a basis of "cause and effect", which is called the matching principle.

## **2. Recognition of Expenses**

The matching principle states that all expenses that were incurred to generate the revenue appearing on a given period's income statement should appear as an expense on the same income statement. In other words, we should match expenses against revenue. Revenue is first recognized and expenses are then matched with those revenue. Commonly, an entity shall recognize an expense when and only when (1) it is probable that the expenses have occurred, and (2) the expenses can be measured reliably.

Where an item does not satisfy the recognition criteria, and that information is material and relevant to users of the financial statements, the notes to the financial statements should disclose the item. An entity should recognize expenses for the period the entity was responsible for the relevant functions.

## **3. Categories of Expenses**

The categories of expenses (according to their nature or type) included in this section reflect common expense categories. They are salary expenses, supplies and services, borrowing cost expenses, depreciation, loss on disposal of non-current assets, inventory expenses, bad and doubtful debts, resources provided or received free of charge, expenses related to assumed liabilities, extraordinary items and so on. The following are several simple expenses.

### **1) Salary Expenses**

Salary expenses are the entitlements which employees accumulate as result of rendering their services to an employer. Salary expenses are the employing entity's



own expenditure. Salary expenses should reflect the cost of staff as they provide their services on an accrual basis.

## **2) Supplies Expenses**

Supplies expenses include recurrent expense items such as accommodation, repairs and maintenance, minor assets not required to be capitalized, travel and associated travel costs, office requisites, postage, audit fees, computer services, legal services, consultants, telecommunication services, insurance premiums, and other supplies expenses.

## **3) Borrowing Cost Expenses**

Borrowing cost expenses are defined as “interest and other costs incurred by an entity in connection with the borrowing of funds”.

Borrowing cost expenses include interest on bank overdrafts and short-term and long-term borrowings, amortization of discounts or premiums relating to borrowings, amortization of ancillary costs incurred in connection with the arrangements of borrowings, and finance charges in respect of finance lease recognized.

## **4) Depreciation and Amortization**

Depreciation(amortization) is a periodic expense of operations and is associated with the consumption or loss of service potential of non-current assets. This consumption or loss may occur through use, wear and tear, or obsolescence. Amortization is used in relation to intangible and leased assets, while depreciation is applied to physical assets such as property, plant and equipment.

## **5) Inventory Expenses**

Inventory expenses are the reduction in the inventory assets by way of use or loss (theft, damage or obsolescence). Where the inventory assets are entity assets, the inventory expenses are entity's expenses.

## **6) Bad and Doubtful Debts Expenses**

Bad and doubtful debts expenses are, in effect, reduction of the “allowance of asset”. Doubtful debts expenses are an estimate of the amount of receivables outstanding at the end of the reporting period that the entity anticipates it will not recover, but has not written off as a bad debt. Bad debts expenses represent receivables that the entity has written off as uncollectible. The debtor may not be able to make payment, or the entity may have decided that it is impracticable to enforce payment.

When an entity considers it probable, it will not receive full or part payment of a receivable, and the entity shall recognize an expense as soon as it considers that the receivable will not be recovered. This may be done by writing off receivable as a bad debt or by making an allowance for a doubtful debt.

## 3.6 Net Earning

Net earning (or net loss) is the result of matching revenue with expenses. When revenue exceeds expenses, net earning occurs, otherwise net loss occurs. The net earning is a major goal of almost every enterprise. Profit and earnings are the other terms for net earning.

Net earning can be defined as the difference between a company's total revenues (money earned from sales or investments) and total expenses (money paid to produce goods or services, plus salaries, rent, depreciation, etc.) for a given period of time. It is also known as net worth, after tax income, or profit, or net loss (depending on whether the figure is positive or negative). Net earning is the "bottom line" since it is listed at the bottom of the formal accounting report known as the income statement. It is out of this figure that dividends are normally paid. In the U. K., net income is known as "profit attributable to shareholders". If a company's total expenses exceed its total revenues for a certain period, it can be said to have experienced a net loss. If revenues and expenses should turn out to be equal, the company will have broken even. The net worth of companies owned by individuals includes original investment of owners plus additional investments they have made plus accumulated or retained profits less whatever losses have been sustained less any withdrawals by the owners.

Operating profit is the balance of operating revenue after deducting operating cost, periodic expenses and all turnover taxes, surtax and fees. Net investment profit is the balance of income on external investment after deducting investment loss.

Loss incurred shall be made up according to the stipulated procedures. Items that constitute the profits and the distribution of profits shall be shown separately in the financial statement.

On corporate balance sheets, net worth may be broken down into the following categories: capital stock, paid-in or capital surplus and earned surplus. While the

balance sheet gives a very detail description of a business, it does not indicate whether a company is making a profit or losing money.

Net income is one of the most important indicators of the financial health of a business. "Some people view the income statement as the most important of the three required financial statements (the others are the balance sheet and income statement and the statement of cash flows), because it is designed to report the amount of net income and the details of how that amount was earned," according to Glenn A. Welsch, Robert N. Anthony, and Daniel G. Short in their book *Fundamentals of Financial Accounting*.

## Vocabulary

|                                 |            |
|---------------------------------|------------|
| deposit <i>n.</i>               | 存款         |
| IOU(I owe you 的缩写)              | 欠条,借据      |
| postdated check                 | 远期支票       |
| check account                   | 支票账户       |
| petty <i>a.</i>                 | 小的,次要的     |
| petty cash                      | 备用金        |
| bank statement                  | 银行对账单      |
| outstanding check               | 未兑现的支票     |
| uncollectible accounts          | 无法收回的账款,坏账 |
| allowance for doubtful accounts | 坏账准备       |
| bad debt                        | 坏账,呆账      |
| balance sheet approach          | 资产负债表法     |
| income statement approach       | 利润表法       |
| discount <i>n.</i>              | 折扣         |
| raw material                    | 原材料        |
| goods in process                | 在产品        |
| finished goods                  | 产成品        |
| perpetual <i>a.</i>             | 不间断的,持续的   |
| periodic <i>a.</i>              | 定期的,周期的    |
| cash outlay                     | 现金支出       |
| freight                         | 货物,运费      |
| installation <i>n.</i>          | 安装,装设,装置物  |

|                           |                      |
|---------------------------|----------------------|
| proceeds <i>n.</i>        | 收入, 收益               |
| accumulated depreciation  | 累计折旧                 |
| overhead                  | 间接费用, 制造费用           |
| variable overhead         | 变动间接费用               |
| accelerated method        | 加速折旧法                |
| declining-balance method  | 余额递减法                |
| patent <i>n.</i>          | 专利权                  |
| copyright <i>n.</i>       | 版权                   |
| trademark <i>n.</i>       | 商标                   |
| franchises and licenses   | 经营权                  |
| amortization <i>n.</i>    | 摊销                   |
| amortization expense      | 摊销费用                 |
| impairment <i>n.</i>      | 减值                   |
| accrued liabilities       | 应计负债                 |
| trade accounts payable    | 应付商业账款               |
| interest free             | 无息                   |
| real estate <i>n.</i>     | 房地产, 不动产             |
| principal                 | 本金                   |
| installment <i>n.</i>     | 分期付款                 |
| income taxes payable      | 应付所得税                |
| payroll <i>n.</i>         | 工资总支出; 工资名单          |
| estimated liabilities     | 估计负债                 |
| warranty <i>n.</i>        | 保证书, 保修单             |
| mortgage payable          | 应付抵押款                |
| face value                | (邮票、钱币、票等的) 面值, 票面价值 |
| par value                 | (股票的) 面值, 票面价值       |
| coupon <i>n.</i>          | 息票                   |
| coupon rate               | 息票利率                 |
| nominal interest rate     | 名义利率                 |
| registered bond           | 记名债券                 |
| bearer bond               | 不记名债券                |
| secured bond              | 担保债券                 |
| collateral <i>n.</i>      | 抵押品                  |
| discount on bonds payable | 应付债券折价               |

|                           |                |
|---------------------------|----------------|
| underwriter               | 证券代销商          |
| carrying value            | 账面价值, 置存价值     |
| premium <i>n.</i>         | 溢价             |
| premium on bonds payable  | 应付债券溢价         |
| proprietorship <i>n.</i>  | 所有(权)          |
| sharing agreement         | 分配协议           |
| salary allowance          | 薪金补贴           |
| interest allowance        | 利息补贴           |
| additional <i>a.</i>      | 附加的, 额外的       |
| paid-in capital           | 缴入股本, 投入股本     |
| contributed capital       | 实缴资本           |
| outstanding stock         | 流通股            |
| common stock              | 普通股            |
| cumulative <i>a.</i>      | 累积的            |
| convertible <i>a.</i>     | 可转换的, 可兑换的     |
| board of director         | 董事会            |
| call privilege            | 优先赎回           |
| call price                | 赎回价格           |
| redeem <i>n.</i>          | 赎回             |
| cash dividend             | 现金股利           |
| stock dividend            | 股票股利           |
| stock-option plan         | 股票期权计划         |
| inflow <i>n.</i>          | 流入, 涌入         |
| commission revenue        | 佣金收入           |
| interest revenue          | 利息收入           |
| rebate <i>n.</i>          | 折扣, 回扣         |
| imputed rate              | 应计利率, 推算利率     |
| prevailing rate           | 现时利率, 现行利率     |
| equivalent <i>n.</i>      | 等价物            |
| cash equivalent           | 现金等价物          |
| recognition               | 认出, 识别; 承认, 认可 |
| salary expenses           | 工资费用           |
| borrowing cost expenses   | 借款成本费用         |
| bad and doubtful expenses | 坏账费用           |

|                             |      |
|-----------------------------|------|
| consultant <i>n.</i>        | 顾问   |
| telecommunication <i>n.</i> | 电信   |
| insurance premium           | 保险费用 |
| ancillary <i>a.</i>         | 辅助的  |

## Exercises

1. Read the following sentences carefully and fill in the blanks with appropriate words.

(1) \_\_\_\_\_ is a current asset that includes currency, coins, and money orders received from customers.

(2) \_\_\_\_\_ refers to how readily an asset can be converted into other types of assets, or is used to buy services or satisfy obligations.

(3) \_\_\_\_\_ are amounts owed by customers on account, resulting from the sale of goods and services.

(4) There are two basic systems used in inventory accounting: \_\_\_\_\_ and \_\_\_\_\_.

(5) The major methods of determining inventory costs are: \_\_\_\_\_, \_\_\_\_\_, \_\_\_\_\_, and \_\_\_\_\_.

(6) The total amount of depreciation expense is recorded in the contra-asset account called \_\_\_\_\_.

(7) In accordance with the \_\_\_\_\_ principle, the recording of depreciation allocates the cost of the assets to the accounting periods that benefit from the assets' use.

(8) If the coupon rate of a bond coincides with the market rate of interest when the bonds are actually sold to investors, the bonds will be sold at \_\_\_\_\_.

(9) \_\_\_\_\_ account, which is the debit balance account, is a contra-liability account.

(10) \_\_\_\_\_ is a corporation's own stock that has been issued and subsequently reacquired by purchase.

(11) The amount paid in excess of par value by a purchaser of newly issued stock is called a \_\_\_\_\_.

(12) \_\_\_\_\_ is the cost of goods and services used up in the process of earning revenue.

(13) An \_\_\_\_\_ always causes a decrease in owner's equity.

## 2. Translate the following sentences into English.

(1) 无论企业多么小心地保持永续盘存的记录,其准确性仍必须通过每年至少一次的对各种商品的盘点来加以验证。

(2) 预估无法收回应收账款的可能金额时常用的办法是建立在应收账款的账龄分析上的。

(3) 一笔逾期的应收款可能被作为信用损失核销。

(4) 固定资产的账面净值是它的成本价减相对应的累计折旧。

(5) 折旧的基本目的是实现配比原则——从一个会计年度的收益中扣减为实现收益而付出的商品或服务的成本。

(6) 债券的购入成本包括支付给卖方的金额以及其他的相关成本,如经纪人的佣金等。

(7) 投资者购入债券时支付的价格可能高于或低于债券的面值或原始发行价格。

(8) 法定资本等于发行股本的票面价值或设定价值。

(9) 库藏股票是公司发行后又购回,但不予注销的股票。

## 3. Translate the following passage into Chinese.

Most businesses use the straight-line method of depreciation in their financial statements and accelerated methods in their income tax returns. The reasons for these choices are easy to understand.

Accelerated depreciation methods result in higher charges to depreciation expense and, therefore, lower reported net income than straight-line depreciation. Most publicly owned companies want to appear as profitable as possible—certainly as profitable as their competitors. Therefore, the overwhelming majority of publicly owned companies use straight-line depreciation in their financial statements.

For income tax purposes, it's a different story. Management usually wants to report the lowest possible taxable income in the company's income tax returns. Accelerated depreciation methods can substantially reduce both taxable income and tax payments for a period of years.

### *Reading Material*

## Marketable Securities, Inventory and Fixed Assets

Marketable securities can include government bonds and notes, commercial paper,

and/or stock and bond investments in public corporations. They shall be accounted for according to historical cost as obtained. Income received or receivable from marketable securities in current period and the difference between the receipt obtained from securities sold and book cost shall be all accounted for as current profit or loss. Marketable securities are usually listed at cost or market price, whichever is lower. Accountants will frequently list securities at cost with a footnote indicating market price on the balance sheet date. (When marketable securities appear on a statement, it frequently indicates investment of excess cash.) They should be shown in LCM (lower of cost or market) in accounting statement.

Inventory includes different items depending on whether a business is a manufacturer, wholesaler or retailer. Retailers and wholesalers will show goods that are sold "as is" with no further processing or supplies required in shipping. Raw materials are considered the most valuable part of inventory as they could be resold in the event of liquidation. Work-in-process has the least value because it requires additional labor and a sales effort to get rid of it if liquidation should occur. Finished goods are ready for resale. Finished goods value varies greatly according to circumstances. If they are popular products in good condition that can be easily sold, the value shown might be justified. If the goods are questionable in salability, the value may be carried too high. The manufacturer's cost of labor employed in the production of finished goods and goods in process, as well as factory expenses is included in the value. Inventory is normally shown on the balance sheet at cost or market value, whichever is lower. On the other hand, many manufacturers will show three different classes of inventory: raw materials, work-in-progress and finished goods. As a company's sales volume increases, larger inventories are required; however, problems can arise in financing their purchase unless turnover (number of times a year goods are bought and sold) is kept in balance with sales. A sales decline could be accompanied by a decrease in inventory in order to maintain a healthy condition. If a business has a sizable inventory, it may have partially completed or finished goods that are obsolete, or it could reflect a change in merchandising conditions.

Fixed assets are materials, goods, services and land used in the production of a company's goods. Examples include real estate, buildings, plant equipment, tools and machinery, furniture, fixtures, office or store equipment and transportation equipment. All of these would be used in producing products for a company's customers. Land, equipment or buildings not used in the production of customer goods



would be listed as other non-current assets of investments. Fixed assets are carried on the company's accounting books at the price they cost at the time of purchase. All fixed assets, except land, are regularly depreciated since they eventually wear out. Depreciation is an accounting practice that reduces the fixed assets, carrying value on an annual basis. The reductions are considered a cost of doing business and are called depreciation expense. Normally, the accounting procedure is to list the fixed asset cost on the balance sheet less accumulated depreciation. Not all companies are comparable on this item as some rent their equipment and premises. If a company rents equipment or building, its fixed asset total will be smaller compared with other balance sheet items.