Carsten Berkau

Basics of Accounting

Introduction to International Bookkeeping and Financial Accounting

6th Edition

UVK

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Further books: Financial Statements / Bilanzen / Management Accounting.

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Introduction to International Bookkeeping and Financial Accounting

6th, revised and extended Edition

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I Contents

II Introduction

We published the 1st edition of Basics of Accounting in 2013. It was an online preparatory course for Financial Accounting classes in Osnabrück. We want to prepare our readers for studying Accounting.
After working through this textbook, you can record Bookkeeping entries for standard cases in the academic environment. You will be fit to study Accounting following German law (HGB) and International Accounting Standards IFRSs in English.

The focus of the *Basics of Accounting* lays on Bookkeeping aspects and standard Accounting procedures, like recording acquisitions, discounts, depreciations, disposals etc. The *Basics of Accounting* has three parts:

(A) Introduction to Accounting (self-study) in chapters (1) – (5)
(B) First Steps in Bookkeeping (self-study) in chapters (6) – (15)
(C) Special Considerations in Financial Accounting in chapters (16) – (39)

The *Basics of Accounting* teach you the fundamental knowledge of Accounting. References to Standards or to national GAAPs (Generally Accepted Accounting Principles) are kept to a minimum. We teach Accounting for commercial financial statements. This is the same syllabus most international Accounting Schools follow. You can use our textbook to get fit for studies abroad.

Basics of Accounting is a textbook for beginners. No Accounting knowledge is expected from you as our readers, but you should bring a good sense for and interest in business.
Our approach is teaching with case studies. Almost 70% of the textbook consists of case studies. Therefore, you learn by "observing" Accounting.

For the 6th edition, we revised the wording and simplified some case studies. Furthermore, we adjusted the appearance of all accounts to the format used in the textbooks *Bilanzen/Financial Statements* and *Management Accounting*. New is, that now all chapters end with 5 multiple-choice questions. You can check your knowledge and prepare yourself for oral exams (if necessary). We started producing Accounting tutorial videos which are available on Youtube. They cover our case studies in the self-study parts.

We author this textbook as an international team (Germany and South Africa). Most of the case studies are derived from Carsten's lessons in Osnabrück, Cape Town and Kuantan. Keabetswe is an Accountant and native speaker; she edited the text to make it easily understandable.

Thanks to Dr. Jürgen Schechler from UVK-Verlag in Munich, who is our lector. He supports our book projects and always gives us a very nice and friendly atmosphere for our writing. He also manages to keep the textbooks affordable for our students by controlling the printing costs.

At www.uvk.digital/9783739831831, we uploaded further study materials for our readers.

Feel free to follow us on twitter, under: '@CBerkau' and/or to email us: BOOKS@Prof-Berkau.de. Let us know about your experience in Accounting and give us feedback, so we can improve our books and study materials to your needs!

Enjoy the new Basics 6e!

Cape Town, in July 2021

Keabetswe and Carsten Berkau

1 Conventions

The below listed conventions apply merely to simplify the case studies. They are about legal forms, tax rates, formats etc. They apply for this textbook, for our textbooks *Bilanzen*, *Financial Statements* and *Management Accounting* and for all online study materials.
At this stage of reading, you might not understand the conventions completely. We only place them at the beginning of the textbook for you to find them upfront.

1.1 Accounting Periods

Accounting periods start on 1.01.20XX and end on 31.12.20XX. Furthermore, to keep the examples transferable to later years, we write the decades with an X, as in 20X4. X is followed by Y, then Z.

1.2 Accounting Technical Terms

At the end of every chapter, we explain new technical terms. They help you to easily understand the content. These are simple explanations if you are beginners in Accounting. The Accounting technical terms are not as formal and precise as the definitions provided by the IASB.

1.3 Account Names

All account names are written in capital letters, like 'Cash/Bank account'. However, an account not subjected to our recordings is written in small letters. Assume there is a bank account with Deutsche Bank, and we refer thereto. The writing is in small letters: bank account. We do not make Bookkeeping entries therein, but Deutsche Bank AG does. Only the Cash/Bank account applicable to calculate the item cash/bank on the balance sheet is part of our Accounting work.

1.4 Alphabetic Order

For all lists, we apply an alphabetic order.

1.5 Basics

Our Basics refers to the textbook *Berkau: Basics of Accounting*. You must read our basics before you start reading our *Financial Statements*. It introduces you to Bookkeeping and major Accounting concepts without consideration of International Accounting standards IFRSs. We frequently quote the *Basics*.

1.6 Bookkeeping Entries

All Bookkeeping entries are printed in bold and cover a whole page's width.

1.7 Bookkeeping Entry Format

We write debit entries and credit entries. DR stands for debit recorded and CR for credit recorded.
See, e.g., a Bookkeeping entry for the acquisition of a motor vehicle:

```
DR Motor Vehicle................    20,000.00 EUR
DR VAT..........................     4,000.00 EUR
CR Cash/Bank....................    24,000.00 EUR
```

The identifier for Bookkeeping entries in the text, like "Bookkeeping entry (1)" can be found in the accounts as "(1)", as well.

1.8 Calculations

For calculations, we only show the units with the results. E.g., 10 + 20.50 = **30.50 EUR**. Furthermore, the figures in calculations come without digits after the decimal point in case they equal zero. Results are printed in bold to find them easily in the text.
All calculations are exact to the EUR-cent or any other currency as 1/100-amounts.

1.9 Case Studies (C/S)

We keep case studies in this textbook as easy as possible even as they might look unrealistic. Teaching Accounting is our priority.

1.10 Case Study Text

We write case studies in a different text format than the normal text (Italic fonts).

1.11 Cash Flow Separation

Interest payments in this textbook are always considered to be financing cash flows, even as IAS 7.33 allows their recognition as operating as well as financing cash flows. This applies for all case studies.

1.12 Companies

For the textbook, the legal form of companies does not matter. Legal forms are not part of our Accounting syllabus. We only assure that companies prepare financial statements.
In contrast to IFRSs, we do not refer to companies as "entities". Once you read the expression entity in the standards, remember they refer to companies. We apply the technical terms "business", "firm" and "company". Most companies are limited companies in this textbook, like GmbH, AG, Pty Ltd., PLC, Inc. etc.

1.13 Cost-Expense-Congruence

By default, costs are expenses and vice versa.

1.14 Country

All case studies of the Basics take place in Germany or in countries where IFRSs apply for single-entity financial statements. We do not focus on national law as the German Handelsgesetzbuch HGB.

1.15 Currency Unit

For all examples, the reporting currency is based on the country of the case study. We use the common 3 letter codes for abbreviations, like ZAR for South African Rand or GBP for British Pound Sterling.

1.16 Data Format in Tables
In tables, negative figures are shown in brackets. E.g., (7.50) equals -7.50 EUR.

1.17 Prepayments of Income Taxes
We assume, that no provisional income tax payments are made to the national revenue service in our case studies. Taxes are calculated at the end of the year and added to short-term liabilities, mostly to the Income Tax Liabilities account. For German companies, § 249 HGB applies, and income taxes are shown as provisions.

1.18 How it is Done

(1) You find How-it-is Done sections in this textbook.
(2) They offer you very short and clear instructions for your Accounting work.

1.19 Income Taxes
For our textbooks and the IFRSs, a simplified income tax model applies. Income taxes amount to 30 % of the pre-tax profit (EBT).

1.20 Financial Statements for Taxation
We do not cover tax calculations. Tax statements are relevant for us to determine income taxes (simplified calculation) and deferred taxes.

1.21 Names
We name companies and mark them with capital letters. E.g., SCHULZE-BRAMMELKAMP Ltd. No links to actual existing persons or companies are intended. The names work as identifiers, so you can use them for your communication with your classmates.

1.22 Language
This textbook is written in South African English. Only our textbook *Bilanzen* is in German; it is a accurate translation of *Financial Statements 5e*.

1.23 Learning Objectives and Summaries
All chapters start with the learning objectives and end with a summary. We also give you a short overview by our *What-is-in-the-Chapter?*-paragraphs.

1.24 Legal Forms of a Business
For this textbook, we use Ltd., (Pty) Ltd., Sdn. Bhd., Bhd., AG, GmbH, UG, PLC, Inc. etc. If no legal form is mentioned, assume the company is privately-owned, such as SANDPIPER BOOKS for a privately-owned bookstore.

1.25 Length of a Month/Year
1 month = 21.5 days = 4.3 weeks.
1 year = 12 evenly long months = 365 days = 52 weeks.

1.26 Level of Precision
We work accurate to 2 digits after the decimal point. Results from workings are rounded to the nearest cent, too. We calculate mostly in MS-Excel; hence, calculations in the background are more precise than they appear.

1.27 Literature

The main source of preparing financial statements are the standards issued by the International Accounting Standard Board IASB. At the end of the textbook, we recommend further readings for you.

1.28 Non-existing Items

In case something has not been mentioned it does not exist.

1.29 Online Materials

The online materials are at the time of printing this textbook 354 exam tasks with solutions. Their names refer to the chapter and contain a counting figure, like Task_B29.7-LUEDGENFELDE, which is linked to the Basics (B), chapter 29 and is the 7th exam task. As higher the count, as newer the task is.

1.30 Payment Terms

In this textbook, payments/receipts for taxation and for dividends are due in the next following Accounting period.

1.31 Presentation of Accounts

Accounts are displayed in the T-format. They have a 3-letter indicator column used for Bookkeeping entry identification or contra-entry references. Nominal accounts show the Accounting periods as a suffix, like Depreciation-20X4. See the accounts for the car acquisition with the Bookkeeping entry (1) therein:

D	**Property, plant, equipment PPE**		C
(1)	20,000.00		

D	**Value added tax VAT**		C
(1)	4,000.00		

D	**Cash/Bank C/B**		C
		(1)	24,000.00

Figure 1.1: Accounts

1.32 Proportional Calculation of Depreciation and Interest

Although given as annual rates, depreciation and interest are calculated on a proportional basis - accurate to full months. Monthly depreciation is calculated as annual depreciation divided by 12. In case a company owns an asset for a shorter period than a full year, a month will count for depreciation if the asset is owned for the major duration thereof. Interest rates are given per annum (/a) and compounded annually (no compounded interest calculation within a year). For loans taken for shorter periods than a full year, interest is calculated per rate accurate to the month, too. For a bank loan of 100,000.00 EUR taken on 9.06.20X4 with an annual rate of interest of 10 %/a, the interest paid at the end of the year is: 7 × 100,000 × 10%/12 = **5,833.33 EUR**.

If dates are not at the beginning or end of the Accounting period, the month is underlined to direct your attention thereto, as in 11.06.20X4.

By default, pay-off payments take place at the end of the Accounting period.

Interest is only calculated for debts, like bank loans, bonds etc. Overdrafts of bank accounts are ignored. An exception is chapter (37) in our *Basics*.

1.33 Question Bank

At the end of each chapter, you find 5 multiple choice questions and their solution to check your learning progress. Expect them to be "tricky".

1.34 Quotation of Law Texts/Standards

Law texts/standards are quoted like '§ 266 HGB' or 'IAS 1.68'. We use the original law names. Note, that IFRS paragraphs can be subjected to changes.

1.35 Sequence of Bookkeeping Entries

The sequence of Bookkeeping entries comes along the logical process defined by the text. Bookkeeping identifiers, like "(1), (2), (3) …" do not indicate nor prescribe a sequence of recording.

1.36 Tax on Capital Returns (Dividend Tax)

The tax on capital returns is an income tax. The rate on capital returns is 25 % based on the capital gain for this textbook. Note, the tax on capital returns is no company tax, although it is owed by the company. It is a withholding tax in most countries levied from persons (not companies).

1.37 Transaction Costs

We ignore transaction costs, like costs for selling goods/services, taking or repaying bank loans, issuing shares or bonds etc.

1.38 Value Added Tax, Goods and Service Tax

VAT stands for value added tax and GST for Goods and Service Tax. Except in, e.g., United Arabic Emirates or some U.S. states like Delaware, Alaska etc., consumers pay VAT – or sometimes referred to as sales tax - for buying goods or services. In this textbook, we apply one single VAT account for input-VAT and output-VAT. The VAT rate in our textbooks is 20 %. We ignore reduced VAT rates as levied in many countries for food, books etc.

1.39 VAT Reduction

It is assumed that every company discussed in this textbook is registered for VAT reduction. They get refunded for input-VAT and collect output-VAT from their customers.

1.40 Working Definition(s)

At the end of each chapter, you find short and easily understandable definitions for new Accounting terms. They are merely a glossary and should support your understanding. For enforceable and more precise definitions, study the IFRSs!

1.41 Work-in-Process Account

We apply the Work-in-Process account as reconciliation account for all job orders and name it Work-in-Process WIP. We also apply a Work-in-Process account for single job orders but then add the job order's ID thereto, like "Work-in-Process 4711" for a job order 4711.

1.42 Writing Management Terms

We write academic disciplines, like Accounting, Marketing, Management etc., in capital letters.

1.43 WWW

We provide you with a lot of exercises and further materials. Pls., check the website:

www. uvk.digital/9783739831831.

Most of the exercises are exam tasks from Hochschule Osnabrück or its partner universities, in South Africa, China, South Korea and Malaysia.

1.44 Youtube Videos

On our Youtube channel (Carsten Berkau) we published video tutorials which are based on the case studies in this textbook. Find their links on Twitter and on the UVK website.

1.45 10-20-30 Rule

In this textbook, a 10-20-30 rule applies. If not mentioned otherwise, the interest rate is 10 %/a, the VAT rate is 20 % and the total income tax rate is 30 %/a.

2 Cafeteria Example and what is on the Balance Sheet

2.1 What is in the Chapter?

In this chapter, you will achieve a basic understanding of the Accounting work linked to financial statements (balance sheet and income statement). We introduce the Accounting equation.

After an explanation what a balance sheet and an income statement are, we read the financial statements of the Australian car rental – case study NEWINGTON Ltd. Later we prepare financial statements for a cafeteria business by studying its operations activity-by-activity. In this chapter, we focus on the major Accounting purpose, to report about the financial position and the performance of a company. We also show how a statement of cash flows and of changes in equity look like.

2.2 Learning Objective

After studying this chapter, you have developed a sound understanding of Accounting principles and what Accounting can tell you about a company. Reading financial statements of NEWINGTON Ltd. gives you an idea of what the items on the financial statements are. Preparing financial statements shows you, how business activities change items on the balance sheet, the income statement, the statement of cash flows and the statement of changes in equity.

2.3 Statement of Financial Position

A balance sheet (= statement of financial position) shows two lists; one thereof contains the assets and the other one capital and liabilities. Both sides must equal, meaning: the total value of assets equals the total value of equity funds and liabilities. **An asset is any resource of a company that meets the recognition criteria (existence of economic benefit and reliable measurement)**. Equity funding refers to funds owned by the company. It is either money paid in at the time of incorporation or gained from further share issues, or it comes from accumulating profits. It is also called capital: **Capital is the amount of funds assigned to the owners of the company**.

In contrast, liabilities are funds the company owes someone: we call these parties creditors, like a bank a company is borrowing from. **A liability represents funds coming from other parties than from the owners of the business**.

For understanding the company's financial position, a balance sheet compares the value of all assets to the funds' value. As assets are either bought from own money or financed with liabilities, the totals on the two balance sheet's sides are always the same. Often beginners in Accounting try to connect particular assets to certain items of equity or liabilities. This is not necessary and only works out in the first Accounting lessons. Do not try! Focus on the equality of both sides regarding the totals of values.

2.4 Our first Balance Sheet

At the commencement of a company's life, its owners prepare a(n opening) balance sheet which is an addendum to the memorandum of incorporation (MoI). **The memorandum of incorporation is a contract set up when a company is established**. In some countries this contract is named "the Articles" or in German: "Gründungsvertrag". It is a contract between the owners and their company. Most probably, the MOI requires a notary signing the agreement as a witness. Look at the German company Tulbagh GmbH:

TULBAGH GmbH is established with owners' capital of 100,000.00 EUR, which is deposited in TULBAGH GmbH's bank account with Deutsche Bank. When preparing the opening balance sheet, the Accountant discloses only two figures: one is on the asset side and refers to the money paid in: 100,000.00 EUR. We name the item on the balance sheet cash/bank. The other one is the source of funds which is the owners' capital of 100,000.00 EUR. It is called issued capital or Stammkapital for a German Gesellschaft mit beschränkter Haftung GmbH. The reader of its balance sheet can see that TULBAGH GmbH is established based on 100,000.00 EUR in the bank account which comes from its proprietors.
We prepare our first balance sheet as shown in Figure 2.1:

Tulbagh GmbH
STATEMENT of FINANCIAL POSITION
as at 1.01.20X1

A		C, L	
Non-current assets	[EUR]	*Equity*	[EUR]
P, P, E		Share capital	100,000.00
Intangibles		Reserves	
Financial assets		Retained earnings	
Current assets		*Liabilities*	
Inventory		Interest bear liab	
Accounts receivables		Accounts payables	
Prepaid expenses		Provisions	
Cash/Bank	100,000.00	Tax liabilities	
Total assets	100,000.00	***Total equity and liab.***	100,000.00

Figure 2.1: TULBAGH GmbH's opening balance sheet

TULBAGH GmbH's balance sheet shows the company's name, the day for which the balance sheet is set up, the reporting currency EURO and the items on the asset side and the items on the credit side.

2.5 Accounting Equation

The balance sheet or - following International Financial Reporting Standards IFRSs referred to as the statement of financial position - represents the **Accounting equation: The total of the assets' value is the total of the value of capital and liabilities**. The totals on both sides always must be equal.

$$\sum_{i=1}^{n} Asset_i = \sum_{j=1}^{m} Capital_j + \sum_{k=1}^{l} Liability_k$$

(with: i = index for assets, i = 1 … n, j = index for capital, j = 1 …m,
k = index for liabilities, k = 1 … l)

We write in a less formal way:

∑Assets = ∑Capital + ∑Liabilities

The equality of assets and equity plus liabilities is easily understandable because every asset is either financed with owners' equity of by the creditors. A creditor is someone who lends the company money, like a bank, a supplier (who did not receive its money yet), customers (who prepaid some goods/services, bond holders, the national revenue service etc.

2.6 Income Statement

The income statement is the second statement to be introduced: It compares revenue earned by the business to the expenses. **Revenue is the total of receipts from customers for goods/services sold**. It does not matter whether money for the revenue is received of a note receivable is recorded. **Expenses is the value of consumed resources, such as materials, labour, depreciation etc**. Whether a payment is made during an Accounting period is not relevant for the recognition of expenses. Payments also can take place in preceding or later Accounting periods. It is only relevant, for which Accounting period expenses count. There are even expenses without any payments, like depreciation. **Depreciation is the loss in value that occurs when assets are deployed**.

In case the total revenue exceeds the sum of the expenses in an Accounting period, a company earns a profit. Income taxes must be paid based on the income tax rate – study the national tax law for details. We regularly calculate income taxes as earnings before taxes EBT × income tax rate. To keep examples in this textbook as simple as possible, we assume the total income tax rate is 30 %. In the real business world you must replace the 30 % by what the tax professionals calculate. We do not worry about income tax calculations for Accounting and are confident calculating taxes by our simple formula as the IFRSs do.

Financial statements are prepared at every end of an Accounting period. In this textbook, all Accounting periods end on the 31.12. To develop a feeling about what the items of the balance sheet tell us, we study the case of NEWINGTON Ltd.