Financial and Cost Accounting

CT-258

Lecture 4

Accounting

- The Language of business’

- The primary objective of setting up a business is to earn profit or to make money

In order to understand and run a business effectively, it imperative to know its language which is ‘Accounting’

Example Company
Balance Sheet
December 31, 2019

ASSETS		LIABILITIES	
Current assets		Current liabilities	
Cash	$ 2,100	Notes payable	$ 5,000
Petty cash	100	Accounts payable	35,900
Temporary investments	10,000	Wages payable	8,500
Accounts receivable - net	40,500	Interest payable	2,900
Inventory	31,000	Taxes payable	6,100
Supplies	3,800	Warranty liability	1,100
Prepaid insurance	1,500	Unearned revenues	1,500
Total current assets	89,000	Total current liabilities	61,000
Investments	36,000	Long-term liabilities	
		Notes payable	20,000
Property, plant & equipment		Bonds payable	400,000
Land	5,500	Total long-term liabilities	420,000
Land improvements	6,500		
Buildings	180,000		
Equipment	201,000	Total liabilities	481,000
Less: accum depreciation	(56,000)		
Prop, plant & equip - net	337,000		
Intangible assets		STOCKHOLDERS' EQUITY	
Goodwill	105,000	Common stock	110,000
Trade names	200,000	Retained earnings	220,000
Total intangible assets	305,000	Accum other comprehensive income	9,000
		Less: Treasury stock	(50,000)
Other assets	3,000	Total stockholders' equity	289,000
Total assets	$ 770,000	Total liabilities & stockholders' equity	$ 770,000

The notes to the sample balance sheet have been omitted.

Stocks & Shares

A stock is a collection of shares

Whereas

A share is the transferable ownership of a business stock

How do stockholder's make money?

What is an Annual Report

Annual Report: Annual report contains non-financial information about the company’s objectives, products and operations.

It is a document released by companies at the end of fiscal year.

Fiscal year (Financial Year) is a twelve months period, that a company uses for accounting purposes and preparing financial statements.

And in addition included in these annual reports are audited financial statements for each of the past several years.

Audit: in an investigation of a company’s financial statements, to establish fairness of these statements.(simply means that an authority(CPA firm) has checked and found this information to be correct) and that these conform to GAAP.

How do you get the annual report.

By law business entities formulated as a corporation, are required to publish and provide their annual report to investors and other interested parties.

In the past, corporations used to send a printed copy of the annual report. Later on they use to send electronic copy on a cd or make these available on the internet.

Users of Annual Report

Internal as well as external Users who are people interested in the annual reports but its mostly prepared for external users.

- Company Owner's
- Investors
- Creditors
- Bankers
- Government
- Economist
- Trade Unions or Associations
- Suppliers
- Management
- Debtors
- Money lenders
- General public
- Tax collectors
- Researchers
- Labor Unions

and others

What is an account?

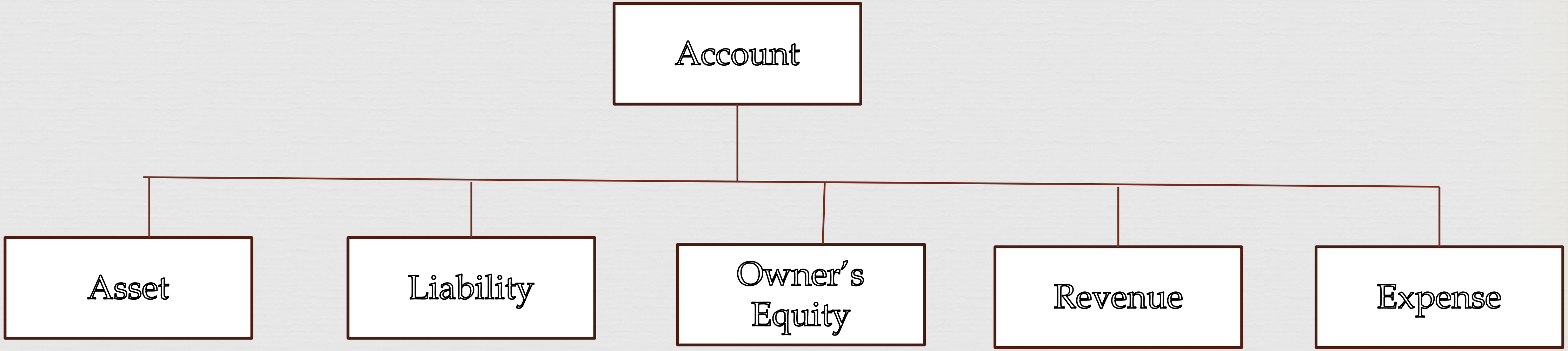
We can define an account as

An account is a summary of relevant transactions at a place relating to a particular head. It is a record of the amount of transaction and its direction and effect.

So basically, in a bookkeeping system, a record of all the transaction relating to particular person or item is called an 'account'

Classification of accounts

On a basic level there are five heads of accounts



1st head of Account 'assets'

Assets are all the economic resources that a business owns, which are expected to generate revenue from future operations of the business.

- Resources
- What a business owns
- Assets

all mean the same

Classification of assets on the basis of physical existence

1. Tangible Assets: Assets that exist physically.

For example: Land, building, factory, plant etc.

2. Intangible Assets: Assets that do not exist physically

e.g. copyrights, licenses, franchise, trademarks, patent rights etc.

Classification of assets on the basis of Liquidity

Liquidity means how fast an asset can be converted into cash without interfering or hampering normal business operations

Or

How widely an asset is acceptable in the market against cash.

Classification of Assets

On the basis of liquidity, assets can be classified as Current Asset and Non-Current Assets

Current Assets (more liquid assets) are those assets which are expected to be realized in cash or sold or consumed within a year of normal operations of the business.

e.g.
- Cash in hand
- Cash in bank
- Notes Receivables
- Accounts Receivables
- Prepaid expense
- Unexpired insurance

Current assets

Notes Receivable and Account Receivable arises when a business organization sells goods and/or services on credit or on account.

When the agreement is written i.e there is a promissory note, then its called notes receivable and if it's a verbal agreement then it is considered as account receivable,

Inventory: Those goods which are purchased for sale (not for personal use)

Office Supplies: those stationary items which are used in the office.

Prepaid Expenses: A Prepaid expense is recorded as an asset on the balance sheet which results from advance payments for goods and/or services to be received in the future.

Non-Current assets

Non-Current Assets (relatively less liquid assets) Those assets which take relatively longer period of time to convert to cash, usually more than a year.

For example

- Office equipment (Computers, scanners, printers, fax machines etc.)
- Fixtures and Furniture etc.
- Buildings, plant, factory etc.

These assets are considered long life assets, whose benefits are spread over more than one accounting period usually more than a year.

(also called Fixed Assets)

Fixed assets are tangible, long life assets which take relatively longer period of time to convert into cash.

2nd head of Account ‘Liabilities’

Liability means all the financial debts and obligations that are incurred as a result of business transactions on credit or on account.

- Obligations
- Debts
- What a business owes to others

and

- Liabilities of a Business all mean the same that is ‘Liabilities’

Classification of ‘Liabilities’ on the basis of maturity

On the basis of maturity liabilities can be classified as current and non current liabilities.

Current Liabilities:

Also called short term liabilities

Non-current Liabilities:

Also called the long term liabilities

Classification of Liabilities

On the basis a maturity

Current or short-term Liabilities: all financial debts and obligations that a business organization has to pay within one accounting period(usually within a year.

Examples: Notes payable, accounts payable, Salaries payable, wages payable, interest payable, unearned revenue.

Current liabilities

Current Liabilities

Notes payable and Accounts payable: arises when an organization purchases goods and/or services on credit or on account.

Salaries Payable and Wages Payable: salaries and wages that a business owes to its employees and labor (wage earners).

Current Liabilities

Unearned Revenue: it's the income which is not earned but some amount of money is received in advance and goods will be supplied and/or services will be rendered in some future time period.

Remember

when you to receive advance → it's a Liability
(for goods or services not yet provided)

when you give advance → it's an asset
(for goods or services not yet provided)

Non-current Liabilities

Non-current Liabilities (also known as long term liabilities) are the liabilities that a business has to pay after a relatively longer period of time.(usually after a year). This time generally in more than one accounting period.

Example: Long term loans
Mortgage payable (lien)
Bonds payable

3rd head of Account 'equity'

Owner's Equity represents the owner's claim to the assets of the business. As the creditor's have legal priority claims of the owner, so basically the Owner's Equity is the residual amount of the assets in the business.

Increase in Owner's Equity in a business comes from two sources

1. Investment by the Owner
2. Earnings from the profitable operations of the business

Equity

Conversely, decrease in owner's equity is also caused in two ways

1. Withdrawal of cash or any other asset by the owner (in case of a corporation these withdrawals are in the form of 'dividends'
2. Losses from unprofitable operations of the business.

Equity(in Corporate form of business)

Equity in Corporate form of business comprises of Stockholder's equity and Retained Earnings.

Stockholder's Equity(share holders equity): is the investment into the business or corporation by the owner's that is the stockholder's

Retained Earnings: of an organization or portion of owner's equity in a corporation that has accumulated as a result of profitable business operations and is reinvested into the business, rather than being distributed amongst the stock holders.

4th head of Account 'Revenue'

Revenue: The price of goods sold and/or services rendered during an accounting period.

Example: Sales Revenue, (Any)-Service Revenue, Commission Revenue, fees revenue, rent revenue, ticket revenue etc.

5th head of Account 'Expense'

Expense: is the cost of goods and/or services used up in the process of earning revenue.

Example: Electricity expense, Utility expense, Fuel expense, Depreciation expense, Salaries expense, Insurance expense, Interest expense

Accounting Equation

Assets = Liabilities + Owner's Equity

Remember this equation always remains in balance

By the same token we can define Liabilities as

Assets – Owner's Equity = Liabilities
Or
Assets - Liabilities = Owner's Equity