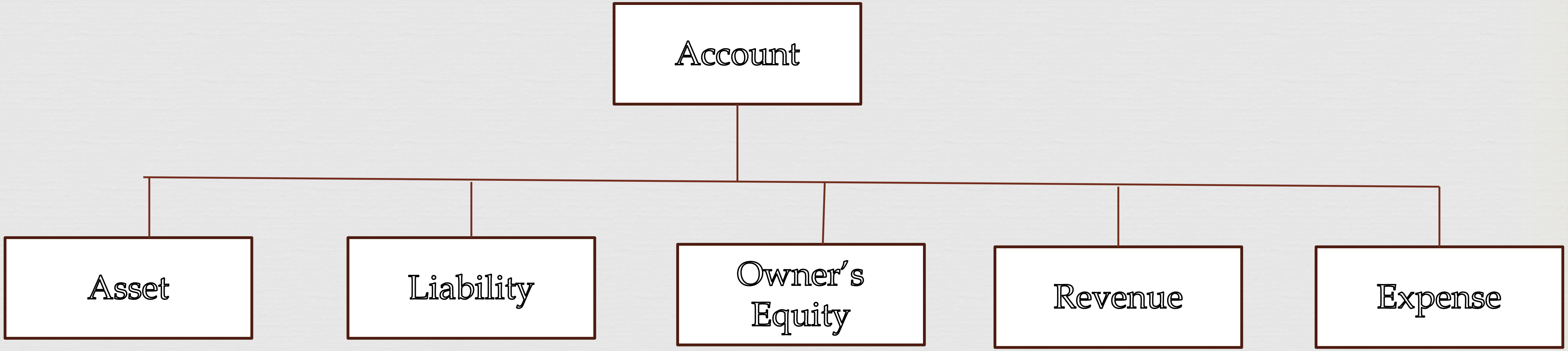
Financial and Cost Accounting

CT-258

Lecture 6

Classification of accounts

On a basic level there are five heads of accounts



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.

4^{th} 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

Balance Sheet

- Though preparation of financial statements is the final step in the Financial accounting process, we would start the process of learning Financial accounting by looking into the Balance sheet as the starting logical point. By acquiring a clear understanding of the nature and content of this financial statement, students would be in a better position to appreciate the objectives of the earlier steps of recording and classifying business transactions.

- The purpose of balance sheet is to show the financial position of a given business entity by summarizing its assets, liabilities and owner's equity, at a specific date.

GAAP relating to the valuation of assets

- GAAP: (Generally accepted Accounting Principles) are the accounting concepts, measurement techniques and standards of presentation used in various financial statements.

- FASB(Financial Accounting Standard Board is an independent group that conducts research into accounting problems and issues authoritative pronouncement of GAAP.

GAAP relating to valuation of Assets(Balance Sheet)

The evaluation of various assets of a business, according to GAAP at present is done at cost rather than at appraised market value.(a matter of controversy).

- The Cost Principle: states that the assets (such as land, building, merchandise and equipment) should be recorded at cost. This means that an asset is shown in the balance sheet at original cost(historical cost) to the business entity (Which may be very different from the assets market value).

GAAP relating to valuation of Assets(Balance Sheet)

- Business Entity

Each business has an identity separate from its owners. The financial statements report only the activities, resources and obligations of the business.

- The going concern assumption:

An assumption by accountants that a business will operate indefinitely, until an evidence to the contrary exists, such as an impending bankruptcy.

GAAP relating to valuation of Assets(Balance Sheet)

Stable-Dollar(Monetary Currency) Assumption:

Business entities measure economic events and transactions in monetary units

An assumption by the accountants that the dollar maintains a relatively stable value over long periods in time. (in countries with high inflation this assumption may not be valid)

GAAP relating to valuation of Assets(in Balance Sheet)

- Objectivity Principle: Accountants use the term objective to describe valuations that are factual and can be verified by independent experts.

Objectivity Principle applies to all financial statements as well as other financial data used in accounting.

GAAP

- Bear in mind there is no comprehensive list if GAAP – new accounting Principles emerge continuously as business organizations enter into new form of business activities