

Financial and Cost Accounting



CT-258

Lecture 7,8,9

Summary



End of Lecture 6, of week 2.

last week we learnt the following

1. What are Annual Reports, Users of Annual Reports
2. What is account, five heads of accounts

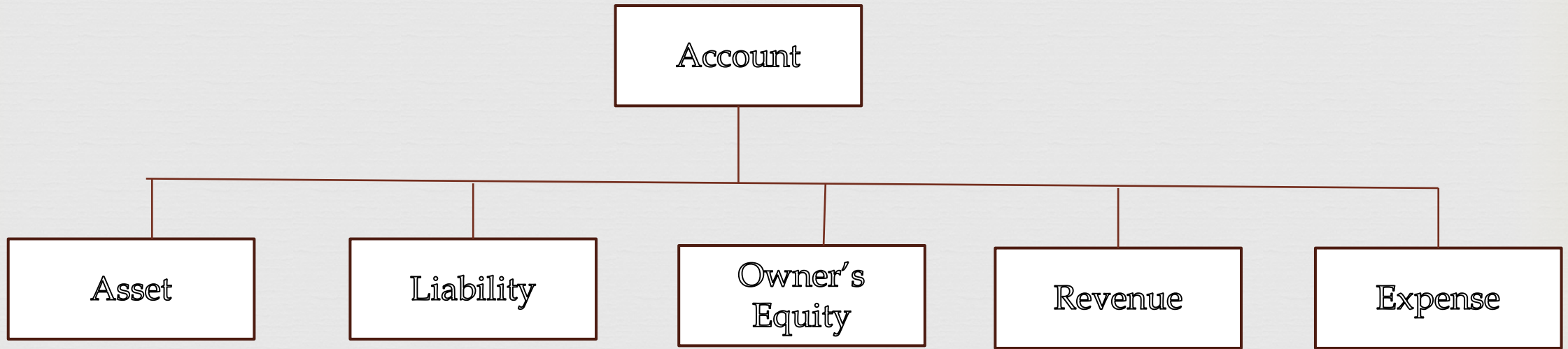
That is

- What are Assets, classification of assets
 - What are Liabilities, classification of liabilities
 - What is Equity
 - What is Revenue
 - What are expenses
- lastly we talked about the accounting equation which provides the basic ground for preparation of Financial information through financial accounting.

Classification of accounts



On a basic level there are five heads of accounts



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

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

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 of GAAP – new accounting Principles emerge continuously as business organizations enter into new form of business activities

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 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.

Balance Sheet



Balance Sheet : a balance sheet shows at a specific date the **financial position** of a company by indicating the resources that it owns, the debt that it owes and the amount of owner's equity(investment) in the business.

Owe, obligations, debt and liabilities are terms used interchangeably .
These all mean the same that is 'liability',

Balance Sheet



There are two forms of Balance Sheet generally used

Account form : (Horizontal format) the three types of accounts found on a balance sheet namely Assets, Liabilities and Owner's equity are listed on two sides that is all assets are listed on the left hand side with their total as total assets and the liabilities and owner's equity accounts on the right hand side of the balance sheet along with the total of liabilities and owner's equity at the end. The balancing of the two sides and equality of the two amounts Total Assets and Total of liabilities and Owner's equity, is the reason why its called a balance sheet.

and

Report Form : in Report format assets are listed first and then the total of assets, then liabilities and their total. Next Owner's equity and finally the total of liabilities and Owner's equity. This is the vertical listing of the component accounts of the balance sheet.

Students generally prefer horizontal or side by side format but generally report or vertical format is more widely used.

Case Study for sole proprietorship

- ✧ Business Entity Mr. Ahmed Ali, an experienced Auto mechanic by profession decided to start his own automotive repair business called
- ✧ 'Overnight Auto Repair Services'

Distinctive features

- all repair work will be done at night this would give customer's the convenience of dropping off their cars/ vehicles in the evening and picking up the following morning.
- Operating at night also enables the business to minimize it's labor cost. Instead of hiring full time employees, overnight will offer part-time work to experienced mechanics who might hold day time jobs as well. This would also eliminate the need for costly employee training programs and other fringe benefits such as health insurance and employee pension plans.

For the time being Mr. Ahmed Ali plans to maintain his accounting books himself. Later on Mr. Ahmed Ali would like to expand his business and perhaps open other such garages. He would like to attract investment from investors and creditors.

Double Entry accounting System



❧ Double Entry accounting system is system of recording each business transaction with equal monetary amounts of increase and decrease entries. As a result the accounting equation always remains in balance. In addition, this system makes it possible to measure income and use of error detection devices such as the trial balance.

Effect of Transactions on the balance sheet

❧ **The company's first Transaction** Ahmed Ali started this business on June 01, 2020.

On June 01, 2020, Ahmed Ali Deposited Rs.800,000 in bank account of 'Overnight Repair Services (Ahmed Ali opened a bank account in the name of the business on the same date)

This transaction provides Overnight with its first asset 'Cash' at the same time this transaction created the initial owner's equity in the business. A balance sheet showing the company's financial position after this initial transaction looks like

Effects of transactions on the balance sheet

Overnight Auto Repair Services Balance Sheet June 01, 2020

Assets

Cash.....Rs.800,000

Owner's Equity

Ahmed Ali, capital.....Rs.800,000

Effect of Transactions on the balance sheet

- ❧ **Purchase of an asset for cash:** On June 03, 2020 Mr. Ahmed Ali bought the land from KDA for Rs520,000. This transaction had two immediate effects on the company's financial position
- ❧ 1. the company's cash was reduced by Rs.520,000
 - ❧ 2. the company acquired a new asset – land

Effects of transactions on the balance sheet

Overnight Auto Repair Services Balance Sheet June 03, 2020

Assets

Cash.....	Rs280,000
Land.....	520,000
Total Assets	<u>Rs800,000</u>

Owner's Equity

Ahmed Ali, capital.....	Rs800,000
Total Owner's Equity.....	<u>Rs800,000</u>

Effect of Transactions on the balance sheet

- ❧ **Purchase of an asset and financing part of the cost** On June 05, 2020 Ahmed Ali purchased the old garage building from CDGK for Rs. 360,000. Overnight made a cash down payment of Rs.60,000 and issued a 90 day non-interest bearing Notes payable for the remaining Rs.300,000 owed.
- ❧ As a result of this transaction

This transaction provides Overnight with its first asset 'Cash' at the same time this transaction created the initial owner's equity in the business. A balance sheet showing the company's financial position after this initial transaction looks like

Effects of transactions on the balance sheet

Overnight Auto Repair Services Balance Sheet June 05, 2020

Assets

Cash.....	Rs220,000
Land.....	520,000
Building.....	360,000
Total Assets	<u>Rs1,100,000</u>

Liabilities & Owner's Equity

Liabilities:	
Notes Payable.....	Rs300,000
Owner's Equity	
Ahmed Ali, capital.....	Rs800,000
Total Liabilities & Owner's Equity.....	<u>Rs1,100,000</u>

Effect of Transactions on the balance sheet

- ❧ **Purchase of an asset on account** On June 17, 2020 Ahmed Ali purchased the old garage building from CDGK for Rs. 360,000. Overnight made a cash down payment of Rs.60,000 and issued a 90 day non-interest bearing Notes payable for the remaining Rs.300,000 owed.
- ❧ As a result of this transaction

This transaction provides Overnight with its first asset 'Cash' at the same time this transaction created the initial owner's equity in the business. A balance sheet showing the company's financial position after this initial transaction looks like

Effects of transactions on the balance sheet

Overnight Auto Repair Services Balance Sheet June 17, 2020

Assets	Liabilities & Owner's Equity
Cash.....Rs220,000	Liabilities:
Land..... 520,000	Notes Payable.....Rs300,000
Building..... 360,000	Accounts Payable... ..Rs138,000
Tools and Equipment138,000	Total Liabilities.....Rs438,000
	Owner's Equity
	Ahmed Ali, capital.....Rs800,000
Total AssetsRs1, <u>238,000</u>	Total Liabilities & Owner's Equity.....Rs <u>1,238,000</u>

Effect of Transactions on the balance sheet

- ❧ **Sale of an asset** After taking delivery of the new tools and equipment, Overnight found that it has purchased more than it needed. Ace towing a neighboring business, offered to buy the excess of tools & equipment. On June 20, 2020 Overnight some of its new tools to Ace-towing worth Rs18,000, a price equal to Overnight's cost. Ace-towing made no down payment, but agreed to pay the amount due within 45 days.
- ❧ As a result of this transaction

One asset converted into another. In other words tools and equipment decreased and Account Receivable increased by Rs18,000.

Effects of transactions on the balance sheet

Overnight Auto Repair Services Balance Sheet June 20, 2020

Assets	Liabilities & Owner's Equity
Cash.....Rs220,000	Liabilities:
Accounts Receivable..... 18,000	Notes Payable.....Rs300,000
Land..... 520,000	Accounts Payable... ..Rs138,000
Building..... 360,000	Total Liabilities..... <u>Rs438,000</u>
Tools and Equipment138,000	Owner's Equity
	Ahmed Ali, capital.....Rs800,000
Total Assets <u>Rs1,238,000</u>	Total Liabilities & Owner's Equity..... <u>Rs1,238,000</u>

Effect of Transactions on the balance sheet

- ❧ **Sale of an asset** After taking delivery of the new tools and equipment, Overnight found that it has purchased more than it needed. Ace towing a neighboring business, offered to buy the excess of tools & equipment. On June 20, 2020 Overnight some of its new tools to Ace-towing worth Rs18,000, a price equal to Overnight's cost. Ace-towing made no down payment, but agreed to pay the amount due within 45 days.
- ❧ As a result of this transaction

One asset converted into another. In other words tools and equipment decreased and Account Receivable increased by Rs18,000.

Effects of transactions on the balance sheet

Overnight Auto Repair Services Balance Sheet June 25, 2020

Assets	Liabilities & Owner's Equity
Cash.....Rs226,000	Liabilities:
Accounts Receivable..... 12,000	Notes Payable.....Rs300,000
Land..... 520,000	Accounts Payable... ..Rs138,000
Building..... 360,000	Total Liabilities..... <u>Rs438,000</u>
Tools and Equipment120,000	Owner's Equity
	Ahmed Ali, capital.....Rs800,000
Total Assets <u>Rs1,238,000</u>	Total Liabilities & Owner's Equity..... <u>Rs1,238,000</u>

Effect of Transactions on the balance sheet

- ❧ Payment of a Liability on June 30, Overnight made a partial payment of Rs68,000 on its accounts payable to Snap-on-tools
- ❧ This transaction reduced Overnights's cash and accounts payable by the same amount. Leaving total assets and total of liabilities and owner's equity in balance.
- ❧ Now lets see what change this transaction brought to the balance sheet.

Effects of transactions on the balance sheet

Overnight Auto Repair Services Balance Sheet June 30, 2020

Assets	Liabilities & Owner's Equity
Cash.....Rs158,000	Liabilities:
Accounts Receivable..... 12,000	Notes Payable.....Rs300,000
Land..... 520,000	Accounts Payable... .. Rs70,000
Building..... 360,000	Total Liabilities..... <u>Rs370,000</u>
Tools and Equipment120,000	Owner's Equity
	Ahmed Ali, capital.....Rs800,000
Total Assets <u>Rs1,170,000</u>	Total Liabilities & Owner's Equity..... <u>Rs1,170,000</u>

Double Entry accounting System



- ❧ Double Entry accounting system is system of recording each business transaction with equal monetary amounts of increase and decrease entries. As a result the accounting equation always remains in balance. In addition, this system makes it possible to measure income and use of error detection devices such as the trial balance.
- ❧ Now we will see how as a result of double entry accounting system, the accounting equation always remains in balance.

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

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