

● **Generally Accepted Accounting Principles (GAAP)**

GAAP is developed and maintained by the Financial Accounting Standards Board (FASB) and enforced by regulatory bodies like the SEC for public companies.

The 10 Core GAAP Principles

1. Economic Entity Principle

The business is treated as separate from its owner(s) and other entities.

All transactions are recorded as belonging to the business only.

Example: Sarah Green's personal car is not listed on GreenLeaf Landscapes' balance sheet.

2. Monetary Unit Principle

Only transactions measurable in a stable currency (e.g., USD) are recorded.

Assumes currency's purchasing power remains stable over time (ignores inflation).

3. Time Period Principle

Financial reports are prepared for specific time periods (month, quarter, year).

Example: Income statements prepared monthly for January, February, etc.

4. Cost Principle (Historical Cost)

Assets are recorded at their original cost at the time of purchase, not at market value.

Equipment bought for \$8,000 remains recorded at \$8,000.

5. Full Disclosure Principle

All relevant financial information (lawsuits, debt obligations, contingent liabilities) must be disclosed in financial statements or footnotes.

6. Going Concern Principle

Assumes the business will continue operating indefinitely unless there is evidence to the contrary.

If there are bankruptcy risks, disclosures must be made.

7. Matching Principle

Expenses are recorded in the same period as the revenues they help generate.

If wages relate to January services, they must be recorded in January even if paid in February.

8. Revenue Recognition Principle

Revenue is recognized when earned and realizable — not when cash is received.

Revenue from a service performed in January is recognized in January, even if collected in February.

9. Materiality Principle

Only information that would influence the decision of a reasonable person needs to be disclosed.

A \$10 calculator expense may be recorded as an expense rather than an asset due to immateriality.

10. Conservatism Principle

When in doubt, choose the option that will result in lower net income or asset valuation.

If there's a chance of a loss, report it. If a gain is uncertain, don't record it.

Assumptions Underlying GAAP

Accrual Basis Accounting: Revenues and expenses are recognized when earned/incurred, not when cash is exchanged.

Consistency: Once an accounting method is adopted, it should be used consistently.

Reliability: Information must be verifiable and backed by evidence.

Comparability: Financial statements should be prepared in a way that allows users to compare them across periods and with other entities.

GAAP vs IFRS (International Standards)

GAAP: Rules-based, more detailed

IFRS: Principles-based, used in 100+ countries (not U.S.)

GAAP is mandatory for U.S. public companies, while private companies can choose alternatives (like IFRS or modified cash basis).

● What Is Accounting?

Accounting is the process of recording, summarizing, analyzing, and reporting financial transactions of a business or organization. It helps people understand where money is coming from, where it's going, and whether the business is making a profit.

● Core Purposes of Accounting

Track income and expenses

Understand profits and losses

Prepare financial statements

Ensure legal compliance (e.g. taxes)

Help make business decisions

● Key Concepts You Should Know

Concept Beginner-Friendly Explanation

Transaction Any money-related event (buying, selling, paying, earning)

Assets What the business owns (cash, equipment, inventory)

Liabilities What the business owes (loans, unpaid bills)

Equity The owner's share in the business (Assets – Liabilities)

Revenue Money the business earns from sales or services

Expenses Money the business spends to operate

Profit What's left after expenses are subtracted from revenue

Journal The book (or system) where transactions are first recorded

Ledger Where transactions are grouped by account (like a history for cash, sales, etc.)

Trial Balance A summary that checks if all accounts balance correctly

Financial Statements Reports that show how the business is doing (income statement, balance sheet, etc.)

● Example in Simple Terms

Let's say you start a small gardening business:

You invest \$500 (this is your capital).

You buy tools for \$200 (equipment, an asset).

You earn \$300 from your first customer (revenue).

You pay \$50 for advertising (expense).

Now, accounting helps you see:

How much you earned

What you spent

How much profit you made

What your business is worth

● Income Statement

An Income Statement (also known as the Profit and Loss Statement) shows a company's financial performance over a specific period — typically monthly, quarterly, or annually. It outlines revenues, expenses, and resulting profit or loss.

Sample Income Statement Format

For the Year Ended December 31, 2024

Particulars Amount (PKR)

Revenue:

Sales Revenue 1,200,000
Less: Sales Returns (50,000)
Net Revenue 1,150,000

Cost of Goods Sold (COGS):

Opening Inventory 200,000
Add: Purchases 500,000
Less: Closing Inventory (150,000)
COGS 550,000

Gross Profit 600,000

Operating Expenses:

Selling Expenses 100,000
Administrative Expenses 80,000
Total Operating Expenses 180,000

Operating Profit 420,000

Other Income:

Interest Income 10,000

Other Expenses:

Interest Expense (30,000)

Net Profit Before Tax 400,000
Less: Income Tax (120,000)

Net Profit After Tax 280,000

Key Points:

Gross Profit = Net Revenue - COGS

Operating Profit = Gross Profit - Operating Expenses

Net Profit = Operating Profit + Other Income - Other Expenses - Taxes

● Balance Sheet

Here's a simple Balance Sheet example — it shows a company's financial position on a specific date by listing assets, liabilities, and owner's equity.

Sample Balance Sheet

As of December 31, 2024

Assets Amount (PKR)

Current Assets

Cash and Cash Equivalents 150,000

Accounts Receivable 100,000

Inventory 150,000

Prepaid Expenses 20,000

Total Current Assets 420,000

Non-Current Assets

Property, Plant & Equipment (Net) 600,000

Long-Term Investments 200,000

Total Non-Current Assets 800,000

Total Assets 1,220,000

Liabilities and Equity Amount (PKR)

Current Liabilities

Accounts Payable 80,000

Accrued Expenses 40,000

Short-Term Loans 100,000

Total Current Liabilities 220,000

Non-Current Liabilities

Long-Term Loan 300,000
Total Non-Current Liabilities 300,000

Owner's Equity
Capital 500,000
Retained Earnings 200,000
Total Equity 700,000

Total Liabilities & Equity 1,220,000

Key Accounting Equation:

Assets = Liabilities + Equity

● Linking the Income Statement to the Balance Sheet

Linking the Income Statement to the Balance Sheet primarily involves updating Retained Earnings in Equity.

How Retained Earnings Are Calculated:

$$\text{Retained Earnings (Ending)} = \text{Retained Earnings (Beginning)} + \text{Net Profit After Tax} - \text{Dividends}$$

From our previous Income Statement:

Net Profit After Tax = PKR 280,000

Assume:

Beginning Retained Earnings = PKR 100,000

Dividends Paid = PKR 20,000

Then:

$$\{\text{Ending Retained Earnings}\} = 100,000 + 280,000 - 20,000 = \text{PKR 360,000}$$

Updated Balance Sheet with Income Statement Linkage

As of December 31, 2024

Assets Amount (PKR)

Current Assets

Cash and Cash Equivalents	150,000
Accounts Receivable	100,000
Inventory	150,000
Prepaid Expenses	20,000
Total Current Assets	420,000

Non-Current Assets

Property, Plant & Equipment (Net)	600,000
Long-Term Investments	200,000
Total Non-Current Assets	800,000

Total Assets 1,220,000

Liabilities and Equity Amount (PKR)

Current Liabilities

Accounts Payable	80,000
Accrued Expenses	40,000
Short-Term Loans	100,000
Total Current Liabilities	220,000

Non-Current Liabilities

Long-Term Loan	300,000
Total Non-Current Liabilities	300,000

Owner's Equity

Capital	500,000
Retained Earnings (linked)	360,000
Total Equity	860,000

Total Liabilities & Equity 1,220,000

Now your balance sheet reflects your income statement's profit through retained earnings.

● Cash Flow Statement

Cash Flow Statement, prepared using the Indirect Method, which links with previously shared Income Statement and Balance Sheet.

Cash Flow Statement

For the Year Ended December 31, 2024

Cash Flows from Operating Activities Amount (PKR)

Net Profit After Tax (from Income Statement)	280,000
Adjustments for non-cash items:	
Depreciation Expense	50,000
Increase in Accounts Receivable	(30,000)
Increase in Inventory	(20,000)
Increase in Prepaid Expenses	(5,000)
Increase in Accounts Payable	15,000
Increase in Accrued Expenses	10,000
Net Cash from Operating Activities	300,000

Cash Flows from Investing Activities Amount (PKR)

Purchase of Property, Plant & Equipment	(200,000)
Long-term Investment Made	(100,000)
Net Cash Used in Investing Activities	(300,000)

Cash Flows from Financing Activities Amount (PKR)

Issuance of Capital	200,000
Proceeds from Long-Term Loan	300,000
Dividends Paid	(20,000)
Net Cash from Financing Activities	480,000

Net Increase in Cash and Cash Equivalents	480,000	Opening
Cash Balance	120,000	Closing Cash and Cash
Equivalents (matches balance sheet)	600,000	

Notes:

This shows how cash moved in and out of your business during the year.

Ending cash balance here should match the Cash and Cash Equivalents figure in your Balance Sheet (which we earlier showed as PKR 150,000 — you can now adjust based on this revised figure if needed).

The cash flow statement connects the income statement (via net profit) and the balance sheet (via changes in assets/liabilities).

● Cash Flow Statement using the Direct Method

Cash Flow Statement using the Direct Method — which shows actual cash receipts and payments during the year instead of adjusting net profit like in the indirect method.

Cash Flow Statement (Direct Method)

For the Year Ended December 31, 2024

Cash Flows from Operating Activities Amount (PKR)

Cash received from customers 1,120,000
(Sales revenue – change in accounts receivable) (1,150,000 – 30,000)

Cash paid to suppliers (470,000)
(COGS – change in inventory + change in accounts payable)(550,000 – 20,000 – 60,000)

Cash paid for operating expenses (180,000)
(Selling + administrative expenses, all paid in cash)

Cash paid for prepaid expenses (5,000)
Cash paid for interest (30,000)
Income tax paid (120,000)

Net Cash from Operating Activities 315,000

Cash Flows from Investing Activities Amount (PKR)

Purchase of Property, Plant & Equipment (200,000)
Long-term investments made(100,000)
Net Cash Used in Investing Activities (300,000)

Cash Flows from Financing Activities Amount (PKR)

Issuance of capital 200,000
Proceeds from long-term loan 300,000
Dividends paid(20,000)
Net Cash from Financing Activities 480,000

Net Increase in Cash and Cash Equivalents	495,000	Opening Cash
Balance	105,000	Closing Cash and Cash Equivalents
600,000		

Notes:

Cash received from customers = Sales revenue (from income statement) adjusted for change in receivables.

Cash paid to suppliers = COGS adjusted for inventory & payables.

All items reflect actual cash movements.

The final closing cash aligns with the Balance Sheet cash balance if fully synced.

● Accounting Conventions clearly.

While GAAP principles are formal rules, accounting conventions are more like practical guidelines that have developed over time through common usage. They help accountants handle situations where no specific rule applies and ensure financial statements remain consistent and reliable.

Main Accounting Conventions

1. Convention of Consistency

This means a company should use the same accounting methods and policies from one period to another.

Purpose: To make it easier to compare financial results over time.

Example: If you use the straight-line method of depreciation this year, you should continue with it next year unless a valid reason for change is disclosed.

2. Convention of Full Disclosure

All relevant and material facts must be clearly presented in the financial statements or notes.

Purpose: To give a true and fair view to shareholders, investors, and regulators.

Example: If the company has a pending legal case that could affect its finances, it should be mentioned in the notes to the accounts.

3. Convention of Materiality

Only items that have a significant impact on decision-making need to be disclosed separately. Minor details can be grouped or ignored.

Purpose: To keep financial statements focused and meaningful.

Example: A small expense like office tea can be recorded under "miscellaneous expenses," but a large marketing cost must be shown separately.

4. Convention of Conservatism (or Prudence)

Anticipate no profit, but provide for all possible losses.

Purpose: To avoid overstating income or assets and to protect users from overly optimistic figures.

Example: If there's doubt about recovering a debtor's amount, a provision for bad debts should be created even if the default hasn't happened yet.

Supporting (Minor) Conventions

5. Convention of Objectivity

All accounting entries should be based on verifiable evidence—not personal opinion.

Example: Record machinery at purchase invoice value, not at estimated resale value.

6. Convention of Matching

Expenses should be recorded in the same period as the revenues they help generate.
Example: The cost of raw materials used in producing goods sold this year should be charged against this year's sales income.

7. Convention of Business Entity

A business is treated as separate from its owner(s), even if it's a sole proprietorship.
Example: The owner's personal electricity bill cannot be recorded as a business expense.

8. Convention of Going Concern

It's assumed that the business will continue to operate in the foreseeable future.
Example: Assets are shown at cost less depreciation, not liquidation value, because the business is expected to keep running.

In Simple Words

Principles = formal rules (set by standards).

Conventions = commonly accepted practices (developed through experience).

Together, they make accounting reports true, fair, and comparable.

● depreciation methods

Here's a clear summary of the main depreciation methods along with examples and numericals for practice. You can use these to strengthen your understanding or for exam prep.

1. Straight Line Method (SLM)

Formula:

$$\text{Depreciation per year} = \frac{\text{Cost} - \text{Residual Value}}{\text{Useful Life}}$$

Example:

Cost of machinery = Rs. 100,000

Residual value = Rs. 10,000

Useful life = 5 years

Depreciation per year:

$$(100,000 - 10,000) / 5 = 18,000$$

Book Value at end of each year:

Year	Depreciation	Book Value
1	18,000	82,000
2	18,000	64,000
3	18,000	46,000
4	18,000	28,000
5	18,000	10,000

2. Reducing Balance (Diminishing Balance) Method

Formula:

$\text{Depreciation per year} = \text{Book Value at beginning of year} \times \text{Rate of Depreciation}$

Example:

Cost = Rs. 100,000

Rate = 20% per annum

Year	Opening Book Value	Depreciation (20%)	Closing Book Value
1	100,000	20,000	80,000
2	80,000	16,000	64,000
3	64,000	12,800	51,200
4	51,200	10,240	40,960
5	40,960	8,192	32,768

3. Sum of Years' Digits (SYD) Method

Formula:

$\text{Depreciation} = \frac{\text{Remaining Life}}{\text{Sum of Years' Digits}} \times (\text{Cost} - \text{Residual Value})$

Example:

Cost = Rs. 100,000

Residual Value = Rs. 10,000

Life = 5 years

Sum of years' digits = $1+2+3+4+5 = 15$

Depreciable amount = $100,000 - 10,000 = 90,000$

Year	Remaining Life	Fraction	Depreciation	Book Value
1	5	5/15	30,000	70,000
2	4	4/15	24,000	46,000
3	3	3/15	18,000	28,000

4	2	2/15	12,000	16,000
5	1	1/15	6,000	10,000

4. Units of Production Method

Formula:

$$\text{Depreciation per unit} = \frac{\text{Cost} - \text{Residual Value}}{\text{Estimated Total Units}}$$

Example:

Cost = Rs. 200,000

Residual Value = Rs. 20,000

Estimated units = 90,000

Depreciation per unit = $(200,000 - 20,000) / 90,000 = \text{Rs. 2 per unit}$

Year	Units Produced	Depreciation	Book Value
1	20,000	40,000	160,000
2	25,000	50,000	110,000
3	30,000	60,000	50,000
4	15,000	30,000	20,000

5. Double Declining Balance (DDB) Method

Formula:

$$\text{Depreciation per year} = 2 \times \text{Straight-line rate} \times \text{Book Value at beginning of year}$$

Example:

Cost = Rs. 100,000

Useful life = 5 years
Straight-line rate = $1/5 = 20\%$
DDB rate = $2 \times 20\% = 40\%$

Year	Opening Book Value	Depreciation (40%)	Closing Book Value
1	100,000	40,000	60,000
2	60,000	24,000	36,000
3	36,000	14,400	21,600
4	21,600	8,640	12,960
5	12,960	2,960 (adjust to reach residual)	10,000

Practice Questions

Try solving these on your own:

1. SLM:

Cost = Rs. 80,000; Residual = Rs. 8,000; Life = 4 years.

Find yearly depreciation and closing book value each year.

2. Reducing Balance:

Cost = Rs. 50,000; Rate = 15%.

Calculate depreciation for first 3 years.

3. SYD:

Cost = Rs. 120,000; Residual = Rs. 20,000; Life = 4 years.

Compute depreciation for each year.

4. Units of Production:

Cost = Rs. 150,000; Residual = Rs. 30,000; Total estimated units = 60,000.

Units used per year: 15,000; 20,000; 10,000; 15,000.

Calculate depreciation for each year.

5. DDB:

Cost = Rs. 200,000; Life = 5 years; Residual = Rs. 20,000.

Find depreciation schedule using double declining rate.

● Inventory Valuation Methods

Here's a clear and practical explanation of Inventory Valuation Methods—how they work, where they apply, and examples for each.

Purpose of Inventory Valuation

Inventory valuation helps determine:

Cost of Goods Sold (COGS) — what's expensed in the income statement.

Closing Stock Value — what appears as an asset on the balance sheet.

Different methods affect profit and tax differently, depending on price trends (rising or falling prices).

Main Inventory Valuation Methods

1. FIFO (First In, First Out)

Concept:

Items purchased first are assumed to be sold first.

Closing inventory is from the most recent purchases.

Used When:

Prices are rising and you want to show higher profits (because older, cheaper costs are matched against current revenues).

Example:

Date	Purchase Units	Unit Cost (Rs.)	Total Cost	Units Sold	Issue Cost
Jan 1	100	10	1,000	60	$60 \times 10 = 600$
Jan 5	100	12	1,200	80	$40 \times 10 + 40 \times 12 = 880$

$$\text{COGS} = 600 + 880 = 1,480$$

Closing Stock = Remaining 20 units \times 12 = 240

2. LIFO (Last In, First Out)

Concept:

Items purchased last are assumed to be sold first.

Closing inventory is from the earliest purchases.

Used When:

Prices are rising and you want to reduce profits (and therefore tax), since recent expensive units are charged first to COGS.

(Note: LIFO is not allowed under IFRS but is used in some countries under GAAP.)

Example:

Date	Purchase Units	Unit Cost (Rs.)	Units Sold	Issue Cost (LIFO)
Jan 1	100	10		
Jan 5	100	12	140	$100 \times 12 + 40 \times 10 = 1,600$

COGS = 1,600

Closing Stock = Remaining 60 units \times 10 = 600

3. Weighted Average Cost (WAC)

Concept:

All units are treated as if they cost the same average price.

Formula:

$$\text{Average Cost per Unit} = \frac{\text{Total Cost of Inventory}}{\text{Total Units}}$$

Example:

Date	Purchase Units	Unit Cost (Rs.)	Total Cost
Jan 1	100	10	1,000
Jan 5	100	12	1,200

Average Cost = $(1,000 + 1,200) / 200 = \text{Rs. } 11$ per unit

If 150 units are sold $\rightarrow \text{COGS} = 150 \times 11 = 1,650$

Closing Stock = $50 \times 11 = 550$

4. Specific Identification Method

Concept:

Each item is individually identified with its cost — used when items are unique, high-value, or easily distinguishable.

Example:

A car showroom sells 3 cars purchased at Rs. 2,000,000, Rs. 2,200,000, and Rs. 2,400,000 respectively.

If the Rs. 2,200,000 and Rs. 2,400,000 cars are sold,
then COGS = $2,200,000 + 2,400,000 = 4,600,000$
and Closing Stock = Rs. 2,000,000

5. Moving Average (for perpetual inventory systems)

Concept:

After every purchase, a new average cost is computed.
Used mainly in computerized or perpetual inventory systems.

Example:

Date	Transaction	Units	Unit Cost	Total Cost	Average Cost
Jan 1	Purchase	100	10	1,000	10.00
Jan 3	Purchase	100	12	1,200	$(1,000+1,200)/(200)=11.00$
Jan 5	Sale	60	—	—	Issue @ Rs.11 each

Effect on Financial Results (Rising Prices)

Method	COGS	Ending Inventory	Profit
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FIFO	Lowest	Highest	Highest
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LIFO	Highest	Lowest	Lowest
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Weighted Avg In-between In-between In-between

Practice Questions

Try these to test your understanding:

1. FIFO Practice:

Purchases: 100 units @ Rs. 10, 200 units @ Rs. 12

Sold: 150 units

Find COGS and Closing Stock.

2. LIFO Practice:

Purchases: 100 units @ Rs. 20, 200 units @ Rs. 22, 100 units @ Rs. 25

Sold: 250 units

Calculate COGS and closing inventory.

3. Weighted Average:

Purchases: 50 units @ Rs. 100, 80 units @ Rs. 120, 70 units @ Rs. 110

Sold: 150 units

Compute average cost per unit, COGS, and closing stock.

4. Specific Identification:

Car A = Rs. 3,000,000, Car B = Rs. 3,200,000, Car C = Rs. 2,800,000

Sold A and B. Find closing stock.