Basics of Accounting

A] Accounting concepts

(1) Going concern concept:

It is assumed that the business will continue to exist for a long period in the future. There is no intention to shut down the business in near future.

(2) Consistency concept

This concept states that accounting principles and methods should remain consistent for years after years. These should not be changed from year to year. This enable comparison of profits every year. If the firm adopts different accounting principles in different accounting periods then the figures become uncomparable. HOWEVER accounting methods can be changed if it is going to lead in better disclosure of income or profits or financial position or if it required to be changed due to change in an Accounting Standard or any law.

(3) Accrual concept

It refers to **all expenses are recorded in the financial year in which they assist in earning revenues whether** paid or not. Also, revenue is to be recorded in the financial year in which goods & services are sold irrespective of whether they amount is received in cash or not. Thus all expenses/ incomes relating the accounting period are to be recorded whether actual cash has been paid or received or not.

(4) Business Entity Concept

Under this concept, business is different from the owner for accounting purpose. Business transactions shall be recorded in a different set of books. Thus under this concept Capital is considered as a liability for the business

(5) Money measurement concept

Only those transactions events are recorded in the books which could be measured in terms of money.

(6) Accounting period principle

life of the business entity is divided into the time intervals of 12 months known as an accounting period so that profit can be found out and corrective measures can be taken on time.

(7) Cost Concept: This is applied to the Fixed Assets

All fixed assets are recorded at the **acquisition cost** i.e. the cost at which FA was acquired & related expenses. Subsequent increase/ decrease in the market value of buildings will not be recorded. Fixed assets are the assets which are not meant for sale and are purchased with the intention to use it in the business for generating revenue hence, market price is not relevant.

(8) <u>Dual aspect concept:</u>

According to this concept, every business transaction affects at least two accounts. If one account is debited, then the other account needs to be credited.This system of recording transactions is known as **'Double Enrty System of Book keeping.'**

(9) <u>Revenue recognition concept:</u>

Revenue earned by the business by selling goods or by rendering services. Revenue is deemed to be realised when the title or ownership of goods is transferred to the purchaser & has nothing to do with receipt of actual cash.

(10) <u>Matching concept:</u>

According to this concept, all costs/ expenses which assist in earning the revenue for a particular period shall be charged against the revenue. First, revenue needs to be recognised and then costs shall be matched with the revenue.

(11) <u>Prudence principle:</u>

According to this concept, ALL ANTICIPATED LOSSES shall be recorded in the books of accounts but all anticipated gains are to be ignored.
For example - Making provision for bad and doubtful debts in addition to the actual bad debts. Closing stock is valued at cost or market price, whichever is lower.

(12) <u>Materiality concept:</u>

Material means something which is of utmost importance and the knowledge of which would affect the decision making of the user. Items having an insignificant effect or being irrelevant to the user need not be disclosed. The main question that the materiality concept addresses is does the financial information make a difference to financial statement users. If not, the company doesn't have to worry about including it in their financial statements because it is immaterial.

(13) <u>Full disclosure principle</u>

All significant information relating to the economin affairs of the enterprise should be completely disclosed. For example Contingent liabilities are disclosed a s a footnote . A contingent liability is a liability that may occur depending on the outcome of an uncertain future event.

B] Financial statements:

<u>Following are the main Financial statements:</u>

a) Profit and loss account/ Income statement.
   (Manufacturing A/c and Trading A/c is prepared by Manufacturingand Trading concerns respectively)
b) Balance sheet
c) Cash flow statement
d) Statement of Equity

a) **Income statement/ Profit and loss A/c-** tells us whether the business has earned a profit or incurred losses
b) **Balance sheet**- states the position of assets and liabilities of the business entity on the year end.
c) **Cash flow statement**- summarizes cash and cash equivalents coming into and going out of business from three major activities of business i. e. operating, investing and financial activities.
d) **Statement of shareholders' equity**- it is a part of its balance sheet highlighting the changes in value to shareholders equity & measures changes from the beginning of the year through the year end.

The importance of financial statements - to different parties (Called as stakeholders) such as management, shareholders, government, tax authorities, competitors, creditors, banks, and financial institutions, public, etc.

<u>Importance to management:</u>

Financial statements help the management to understand the financial position, progress, and prospects of business as well as industry.

Financial statements are necessary to formulate appropriate business policies and future actions.

<u>Importance to the shareholders:</u>

In case of corporate entities, Management is separated from the shareholders. Although Shareholders cannot directly participate into day-to-day activities of business, Financial Statements are to be reported to them at AGM (Annual General meeting). This enables them to know the efficiency and effectiveness with which the management is functioning.

Also, published annual reports are the main source of information to the prospective investors.

<u>Importance to lenders/ creditors / Bankers & Financial institutions</u>

The financial statements is a useful guide for suppliers and lenders of company so that they can judge the credit worthiness of the company and decidewhether to grant credit or not and also to judge the repayment capacity of the company.

<u>Importance to employees:</u> bonus to workers & salary increments depend upon the size of profits disclosed by the audited financial statements.

<u>Importance to competitors:</u>

Financial statements enable the comparison with the companies belonging to thesame industry for finding out their market standing as compared to their competitors.

<u>Importance to government and taxation authorities:</u>

To government and taxation authorities to ensure the accuracy of taxes and additional duties declared and paid by the company.

<u>Importance to the Public:</u>

Business is a social entity. Business borrows resources from the public at large. V

C] ACCOUNTING TERMINOLOGY

TYPES OF RECEIPTS:

a) REVENUE RECEIPT - Revenue receipt is money obtainedfrom Sale of goods or sell of services. Interest and dividend received on investments. Recurring in nature & is income which is credited to Trading and Profit & Loss account.

b) **CAPITAL RECEIPT** is money obtained from Sale of a fixed asset or investments, capital contribution, loans taken. Non-recurring in nature. It goes to Balance sheet liability side.

TYPES OF EXPENDITURE

REVENUE EXPENDITURE – this is incurred for day to day running of the business. Recurring in nature & yields benefit over a short period. Debited to Trading and P&L A/c

CAPITAL EXPENDITURE –

(i) is incurred for buying or acquisition of a fixed asset. Suppose a Machinery is purchased for Rs 25 Lakhs. Transportation cost is Rs. 1 Lakh & installation charges are Rs. 1.5 lakhs. In this example the cost of machinery will be not just Rs 25 Lakhs but all expenses to bring that machinery into operations will become part of it. i.e. 25+1+1.5= 27.5 Lakhs
(ii) Non-recurring in nature.
(iii) increases the earning capacity of the fixed asset / increases the life span of the fixed asset
(iv) yields benefit over a long period
(v) Capital expenditure goes to balance sheet as fixed assets.

Examples:

1. Wages paid – Revenue Exp
2. Wages paid for installation of machinery- capital exp
3. Repairs done to machinery -Revenue Exp
4. Wages paid for construction of a building- capital exp
5. Upgradation of computer software- capital exp
6. Repairs done to a second-hand car purchased- capital Exp
7. Payment of rent- Revenue Exp
8. Purchase of goods- Revenue Exp

CAPITAL

Every business requires funds. Capital is an investment by the owner in the business. It is either in cash Or Kind i. e. goods or assets.

As per the **'Business Entity Concept'**, the owner and business are treated as two separate entities. Therefore capital is considered as a permanent liability for the business enterprise.

DRAWING:

Any cash or goods withdrawn by the owner from the Business for **personal use** or for household expenses are called as drawings. **Business Entity concept** is applied over here as well.

ASSETS:

properties AND anything which is in possession of a business enterprise including amount / money receivable from others. Assets are of 2 types

Sr. No.	NON-CURRENT ASSETS I. E. FIXED ASSETS	CURRENT ASSETS I.E. Liquid Assets
1.	These are used for continued use in the business for production of goods & services. These assets generate revenue for business.	These Assets are expected to be realised in cash OR sold OR get consumed during the normal operating cycle of the business.
2.	called as Fixed / Permanent assets.	Called as 'floating assets'
3.	They cannot be easily converted into cash.	can be easily converted into cash within a short period. (Less than a year)
4.	**3 types of non-current assets:** **Tangible assets-** Assets in physical existence. – Land, building, machinery, Furniture and fittings, Office equipment, Computer, Vehicle etc. **Intangible assets-** Assets which do not have a physicalexistence such as Patents, Trademarks,Copyrights, Computer software, etc. **Non-current investments i.e. Long term investments** Both Tangible as well as Intangible assetsare valuable assets	Egs: Stock, bank balance, debtors, short terminvestments, prepaid expenses, etc.

INTERNAL AND EXTERNAL LIABILITIES:

Internal liability-
Money owed by the business entity to its owners. i.e. Capital

External liability-
Money owed by the business entity to its outsiders such as loans, creditors etc.

Another classification of liabilities:

NON-CURRENT AND CURRENT LIABILTIES

Non-current liabilities these are due for payment **after one year and also called as** Long Term Liabilities'. Such as Capital, Long-term loans etc

Current Liabilities are the liabilities which become due for payment **within a period of one year also** called as 'Short term Liabilities' such as Creditors for purchases & expenses outstanding expenses, etc.

DEPRECIATION:

Why asset depreciates?

- Wear and tear of the fixed asset
- Passage of time
- Obsolescence/ fixed asset becomes outdated

Other features of Depreciation:

- Depreciation is a gradual and permanent fall in the value of a fixed asset.
- Charging depreciation reduces the value of a fixed asset
- Depreciation is a non-cash expense. i. e. there is no cash outgo / outflow.
- Depreciation is a revenue expenditure & is charged on all the fixed assets at the end of eachyear.

Rates of depreciation are taken from the Income Tax Act or the Companies Act
The two commonly followed methods of charging depreciation are:

a) Straight Line method/ Original Cost method (SLM)
b) Written down value method/ reducing value method/ diminishing balance method (WDV)

GOODS/ MERCHANDISE- A commodity in which the business deals into are known as goods. Goods are commodities purchased for resale. electric kettles, switch boards will be goods for electric goods dealer.

PURCHASES: This term is used **only for the purchase of goods** in which the business deals into. Purchase of a fixed asset is not referred to as 'Purchases'.

PURCHASE RETURNS/ RETURN OUTWARDS:

When purchased goods are returned to the creditor/ supplier it is known as purchase returns. Purchase returns is a gain to the entity as we will be paying less to the extent of goods returned to the creditor.

SALES:
Revenue earned by selling goods or rendering the services is known as sales.

SALES RETURNS/ RETURN INWARDS:

When our customer/ debtor returns the goods to us due to reasons like wrong order supplied, goods supplied were defective or not as per the specifications.
Sales returns is considered as a loss for the entity.

BAD DEBTS:
Money irrecoverable from the debtors is known as bad debts.
In simple words, bad debts is debt gone bad. It is a loss for the entity.

BILL OF EXCHANGE:

A bill of exchange is a negotiable instrument. It is drawn by the seller of goods on the buyer. Bill of exchange is drawn in case of credit sale of goods only.

B/E has three parties:

A drawer-The one who draws the bill (seller)

A drawee- The one on whom the bill is drawn/ acceptor of the bill (buyer)

A payee- A person who receives money against the bill on the due date.

Every B/E has a due date which is mentioned on the bill. (due date: the maturity date of the bill on which the drawee needs to pay money to the drawer).

The same bill is referred to as 'Bills receivable' by the drawer and 'Bills payable' by the drawee.

TRADE RECEIVABLES = DEBTORS + BILL RECEIVABLE

TRADE PAYABLES= CREDITORS + BILLS PAYABLES

Closing stock- Stock of goods remaining unsold at the end of the accounting period in knownas Closing stock.

Discount- Rebate/ concession/ reduction in the selling price of a product is called as a discount.

TYPES OF DISCOUNTS

A) TRADE DISCOUNT:	**B) CASH DISCOUNT**
given on **bulk purchases / sales.**	allowed **for prompt payment.**
given by the wholesaler to the retailer	usually given by the retailer to the end user.
allowed as a fixed percentageon the list price or the catalogue price of the goods.	The rate of cash discount is on case to case basis
quantity-based discount.	**time-based discount**. Earlieryou pay, higher is the rate of discount.
it's pre decided at the time of purchases / sales, **NOTrecorded in the books of accounts.** It is deducted directly from the Purchase /sales price directly.	Since this is allowed at the time of payment and rate is not predecided, it is recorded in the books of accounts.