Accounting

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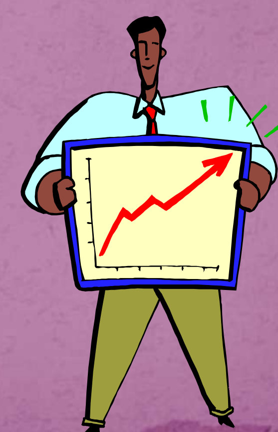
Accounting Activities

❶ Identifying Business Activities

❷ Recording Business Activities

❸ Communicating Business Activities



Generally Accepted Accounting Principles

Financial accounting practice is governed by concepts and rules known as generally accepted accounting principles (GAAP).

Relevant Information	**Affects the decision of its users.**
Reliable Information	**Is trusted by users.**
Comparable Information	**Used in comparisons across years & companies.**

Activities covered under Accounting

- **Identifying the transaction and events** – e.g. purchase of raw material, use of raw material for production, sale of goods etc.
- **Measuring the identified transactions and events** in the terms of common measurement unit, that is the ruling currency of a country

Activities covered under Accounting

- **Summarizing -** the classified transactions in a manner useful to the users. This function involves the preparation of Financial Statements such as Income Statement, Balance Sheet, Statements of Changes in Financial Position, Statement of Cash Flow etc.
- **Analyzing -** the data derived from Income Statement and or Balance Sheet for the purpose of identifying the financial Strengths and weaknesses of the enterprise

Activities covered under Accounting

- **Interpreting** – It is concerned with explaining the meaning and significance of the relationship so established by the analysis. Nowadays, the first six functions are performed by electronic data processing devices and the accountant has to concentrate mainly on the interpretation aspect of accounting

Interpreting

- The accountants should interpret the statements in a manner useful to the users, so as to enable the users to make reasoned decisions out of alternative course of action.
- The accountant should explain –
- not only what has happened but also
- why it happened, and
- what is likely to happen under specified conditions.

Activities covered under Accounting

- **Communicating** the summarized, analyzed and interpreted information to the users to enable them to make reasoned decisions.

Primary Objectives of Accounting

To maintain Accounting Records	To calculate the results of operations	To ascertain the financial position	To communicate the information to the users

BASIC ACCOUNTING TERMINOLOGY

- **Entity / enterprise / organization –** means an economic unit that performs economic activities e.g. Birla Industries, Reliance Industries, Bajaj Auto.
- **Event** – An event is a happening of consequences to an entity. For example – use of raw material in production

- **Transaction –** is an exchange in which each participant receives or sacrifices value. It involves exchange of goods or services on cash or credit basis. It is an event involving transfer of money or money’s worth.
- **Voucher –** is a document which serves as an evidence of a transaction. i.e. cash purchases – cash memos, credit purchases – purchase invoice. The vouchers are source documents for recording business transactions in the books of accounts.

- **Entry –** is the record made in the books of accounts in respect of a transaction or event. An entry is passed on the basis of vouchers.

- **Assets –** refer to tangible objects or intangible rights of an enterprise which carry probable future benefits

- **Current Assets** – Cash, Stock of - Raw Materials (R/M), Work-in-Progress (WIP), Finished Goods, Debtors (Drs), Bills Receivables (B/R).
- **Fixed Assets** – are the assets held for purpose of producing goods or providing services and those are not held for resale in the normal course of business. Fixed assets classified into

- (i) **Tangible fixed assets** which can be seen and touched e.g. Land and Building, Plant and Machinery, Furniture and fixture
- (ii) **Intangible fixed assets** – which cannot be seen and touched. E.g. Goodwill, Patent, Trademark, Copyrights etc

- **Liabilities** – refer to financial obligations of an enterprise other than owner's funds/equity.
- (a) **Current liabilities –** refer to those liabilities which fall due for payment in a relatively short period (normally not more than 12 months from the date of B/S). e.g. Bills Payable (B/P), Trade Creditors, outstanding expenses, bank overdraft etc.
- (b) **Long –term liabilities** – refer to those liabilities which do not fall due for payment in a relatively short period. E.g. Long term loans, Debentures etc.

- **Capital** – is the excess of assets over external liabilities. It refers to the amount invested in an enterprise by the owners. This amount is increased by the amounts earned and amount of additional capital introduced and is decreased by the amount of losses incurred and the amount withdrawn. It is owner’s claim / equity/net assets/net worth.

- **Drawings –** an amount of cash or goods withdrawn by the proprietor / partner for personal use.
- **Purchases –** the total amount of goods obtained by an enterprise for resale or for use in the production of goods or rendering of services in the normal course of business.
- **Sales –** The term 'sales' refer to the amount for which the goods are sold or services are rendered.

- **Stock / Inventory-** The term ‘stock’ refers to tangible property held for sale in the ordinary course of business or for consumption in the production of goods or services for sale.

- **Trade Debtors –** The term ‘Trade Debtors’ refers to the person from whom the amounts are due for goods sold or services rendered on credit basis

Trade Creditors – are the persons to whom the amounts are due for goods purchased or services rendered on credit basis.

Receivables – include both the trade debtors and Bills Receivable.

Bill of Exchange

- is an unconditional order in writing given by the creditor to the debtor to pay on demand or at a fixed or determinable future time, a certain sum of money to or to the order of a specified person or to bearer. This bill of exchange is known as Bills Receivable for creditor.

Payables

- The term ‘Payable’ include both the trade creditors and Bills Payable. The Bills of Exchange is known as Bills Payable for the debtors.

Expenditure

- Expenditure are the costs incurred in acquiring an asset or service in the form of outflow or depletion of assets or incurrence of liability. Cost is the measure of expenditure. It may be expired or unexpired.
- (a) Expired Cost (or Expense) – Expense is that portion of the expenditure which

- has been consumed during the current accounting period. It decreases equity. Expired cost is of following two types:
- (i) Utilized Cost – is that portion of expired cost which benefits the enterprise in producing revenue and includes cost of merchandise sold or services rendered. E.g. commission on Sales, Advt. Expenses.

- (ii) Lost Cost – is that portion of expired cost which does not contribute to revenue and is regarded as loss. E.g. Loss of uninsured asset due to fire.
- (b) Unexpired Cost (or Asset) – is that portion of the expenditure which has not been consumed till the end of current accounting period. It does not reduce equity.

Income

- Income is increase in economic benefits during an accounting period in the form of
  - (a) inflow of assets, or
  - (b) decrease of liabilities, that result in increase in internal equity.

Expenses

- Expenses are decrease in economic benefits during an accounting period in the form of (a) outflow or depletion of assets or (b) incurrence of liabilities, that result in decrease in internal equity.

- Gains - are increase in equity.
- Losses - are decrease in equity.
- Revenue – refers to the amount charged for the goods sold or services rendered.
- Net Profit – means the excess of revenue over expenses.
- Net Loss – means the excess of expenses and losses over revenue.

Principles and Assumptions of Accounting

Measurement principle (also called cost principle) means that accounting information is based on actual cost.

Revenue recognition principle provides guidance on when a company must recognize revenue.

Matching principle (expense recognition) prescribes that a company must record its expenses incurred to generate the revenue.

Full disclosure principle requires a company to report the details behind financial statements that would impact users' decisions.

Going-concern assumption means that accounting information reflects a presumption the business will continue operating.

Monetary unit assumption means we can express transactions in money.

Time period assumption presumes that the life of a company can be divided into time periods, such as months and years.

Business entity assumption means that a business is accounted for separately from its owner or other business entities.

Accounting Concepts

- Business entity
- Money Measurement/stable monetary unit
- Going Concern
- Historical Cost
- Prudence/conservatism
- Materiality
- Objectivity
- Consistency
- Accruals/matching
- Realization
- Uniformity
- Disclosure
- Relevance

Business Entity

- Meaning
  - The business and its owner(s) are two separate existence entity
  - Any private and personal incomes and expenses of the owner(s) should not be treated as the incomes and expenses of the business

Business Entity

- Examples
  - Insurance premiums for the owner's house should be excluded from the expense of the business
  - The owner's property should not be included in the premises account of the business
  - Any payments for the owner's personal expenses by the business will be treated as drawings and reduced the owner's capital contribution in the business

Money Measurement

Money Measurement

- Meaning
  - All transactions of the business are recorded in terms of money
  - It provides a common unit of measurement
- Examples
  - Market conditions, technological changes and the efficiency of management would not be disclosed in the accounts

Going Concern

Going Concern

- Meaning
  - The business will continue in operational existence for the foreseeable future
  - Financial statements should be prepared on a going concern basis unless management either intends to liquidate the enterprise or to cease trading, or has no realistic alternative but to do so

- Example
  - Possible losses form the closure of business will not be anticipated in the accounts
  - Prepayments, depreciation provisions may be carried forward in the expectation of proper matching against the revenues of future periods
  - Fixed assets are recorded at historical cost

Historical Cost

Historical Cost

- Meaning
  - Assets should be shown on the balance sheet at the cost of purchase instead of current value
- Example
  - The cost of fixed assets is recorded at the date of acquisition cost. The acquisition cost includes all expenditure made to prepare the asset for its intended use. It included the invoice price of the assets, freight charges, insurance or installation costs

Prudence/Conservatism

Prudence/Conservatism

- Meaning
  - Revenues and profits are not anticipated. Only realized profits with reasonable certainty are recognized in the profit and loss account
  - However, provision is made for all known expenses and losses whether the amount is known for certain or just an estimation
  - This treatment minimizes the reported profits and the valuation of assets

- Example
  - Stock valuation sticks to rule of the lower of cost and net realizable value
  - The provision for doubtful debts should be made
  - Fixed assets must be depreciated over their useful economic lives

Materiality

Materiality

- Meaning
  - Immaterial amounts may be aggregated with the amounts of a similar nature or function and need not be presented separately
  - Materiality depends on the size and nature of the item

- Example
  - Small payments such as postage, stationery and cleaning expenses should not be disclosed separately. They should be grouped together as sundry expenses
  - The cost of small-valued assets such as pencil sharpeners and paper clips should be written off to the profit and loss account as revenue expenditures, although they can last for more than one accounting period

Objectivity

Objectivity

- Meaning
  - The accounting information should be free from bias and capable of independent verification
  - The information should be based upon verifiable evidence such as invoices or contracts

- Example
  - The recognition of revenue should be based on verifiable evidence such as the delivery of goods or the issue of invoices

Consistency

Consistency

- Meaning
  - Companies should choose the most suitable accounting methods and treatments, and consistently apply them in every period
  - Changes are permitted only when the new method is considered better and can reflect the true and fair view of the financial position of the company
  - The change and its effect on profits should be disclosed in the financial statements

- Examples
  - If a company adopts straight line method and should not be changed to adopt reducing balance method in other period
  - If a company adopts weight-average method as stock valuation and should not be changed to other method e.g. first-in-first-out method

Accruals/Matching

Accruals/Matching

- Meaning
  - Revenues are recognized when they are earned, but not when cash is received
  - Expenses are recognized as they are incurred, but not when cash is paid
  - The net income for the period is determined by subtracting expenses incurred from revenues earned

- Example
  - Expenses incurred but not yet paid in current period should be treated as accrual/accrued expenses under current liabilities
  - Expenses incurred in the following period but paid for in advance should be treated as prepayment expenses under current asset
  - Depreciation should be charged as part of the cost of a fixed asset consumed during the period of use

Problems in the recognition of expenses

- Normally, expenses represents resources consumed during the current period. Some costs may benefit several accounting periods, for example, development expenditures, depreciation on fixed assets.

Recognition criteria for expenses

- Association between cause and effect
  - Expenses are recognized on the basis of a direct association between the expenses incurred on the basis of a direct association between the expenses incurred and revenues earned
  - For example, the sales commissions should be accounted for in the period when the products are sold, not when they are paid

- Systematic allocation of costs
  - When the cost benefit several accounting periods, they should be recognized on the basis of a systematic and rational allocation method
  - For example, a provision for depreciation should be made over the estimated useful life of a fixed asset
- Immediate recognition
  - If the expenses are expected to have no certain future benefit or are even without future benefit, they should be written off in the current accounting period, for example, stock losses, advertising expenses and research costs

Realization

Realization

- Revenues should be recognized when the major economic activities have been completed
- Sales are recognized when the goods are sold and delivered to customers or services are rendered

Recognition of revenue

- The realization concept develops rules for the recognition of revenue
- The concept provides that revenues are recognized when it is earned, and not when money is received
- A receipt in advance for the supply of goods should be treated as prepaid income under current liabilities
- Since revenue is a principal component in the measurement of profit, the timing of its recognition has a direct effect on the profit

Recognition criteria for revenues

- The uncertain profits should not be estimated, whereas reported profits must be verifiable
- Revenue is recognized when
  1. The major earning process has substantially been completed
  2. Further cost for the completion of the earning process are very slight or can be accurately ascertained, and
  3. The buyer has admitted his liability to pay for the goods or services provided and the ultimate collection is relatively certain

- Example
  - Goods sent to our customers on sale or return basis
  - This means the customer do not pay for the goods until they confirm to buy. If they do not buy, those goods will return to us
  - Goods on the 'sale or return' basis will not be treated as normal sales and should be included in the closing stock unless the sales have been confirmed by customers

Problems in the recognition of revenue

- Normally, revenue is recognized when there is a sale
- The point of sales in the earning process is selected as the most appropriated time to record revenues
- However, if revenue is earned in a long and continuous process, it is difficult to determine the portion of revenue which is earned at each stage
- Therefore, revenue is permitted to be recorded other than at the point of sales

Exceptions to rule of sales recognition

1. Long-term contracts
   – Owning to the long duration of long-term contracts, part of the total profit estimated to have been arisen from the accounting period should be included in the profit and loss account
2. Hire Purchase Sale
   – Hire purchase sales have long collection period. Revenue should be recognized when cash received rather than when the sale (transfer of ownership) is made
   – The interest charged on a hire purchase sale constitutes the profit of transaction

3. Receipts from subscriptions

- A publisher receives subscriptions before it sends newspapers or magazines to its customers
- It is proper to defer revenue recognition until the service is rendered.
- However, part of subscription income can be recognized as it is received in order to match against the advertising expenses incurred

Disclosure

Disclosure

- Meaning
  - Financial statements should be prepared to reflect a true and fair view of the financial position and performance of the enterprise
  - All material and relevant information must be disclosed in the financial statements

Uniformity

Uniformity

- Meaning
  - Different companies within the same industry should adopt the same accounting methods and treatments for like transactions
  - The practice enables inter-company comparisons of their financial positions

Relevance

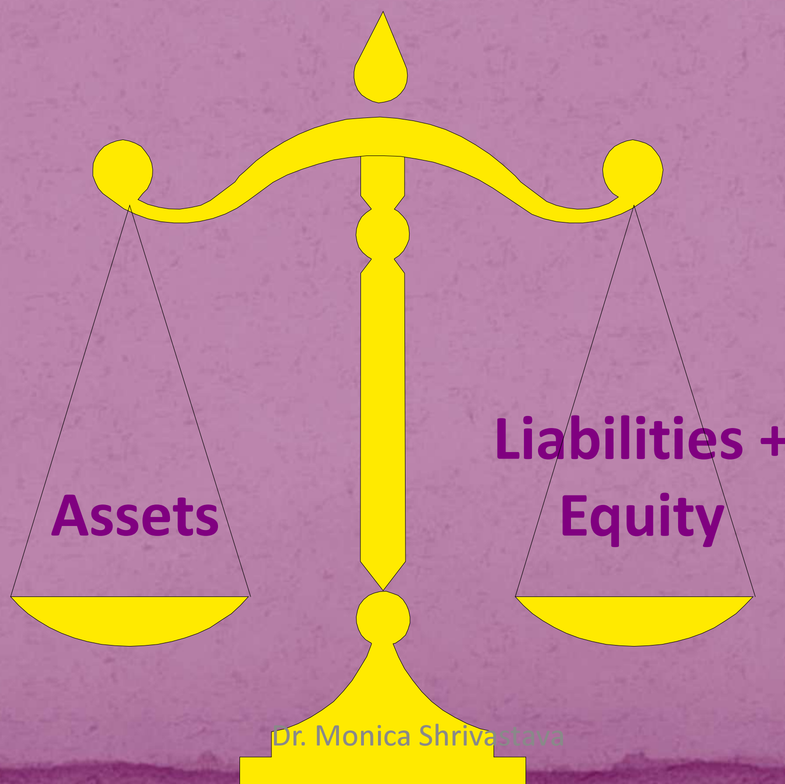
Relevance

- Meaning
  - Financial statements should be prepared to meet the objectives of the users
  - Relevant information which can satisfy the needs of most users is selected and recorded in the financial statement

A1

Accounting Equation

Assets = Liabilities + Equity



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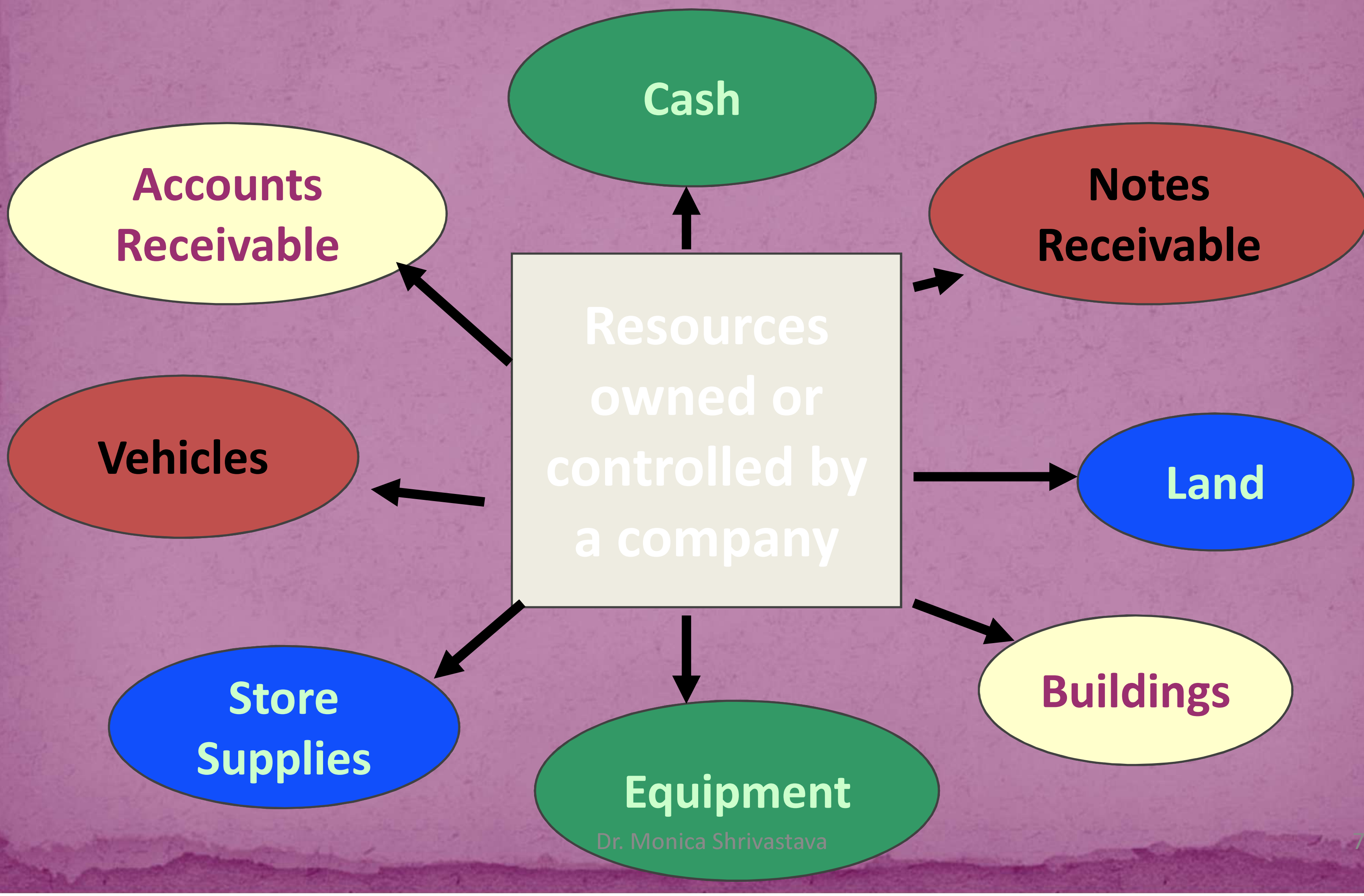
Assets


Cash
Accounts Receivable
Notes Receivable
Resources owned or controlled by a company
Vehicles
Land
Store Supplies
Equipment
Buildings

A1

Liabilities

Accounts Payable

Notes Payable

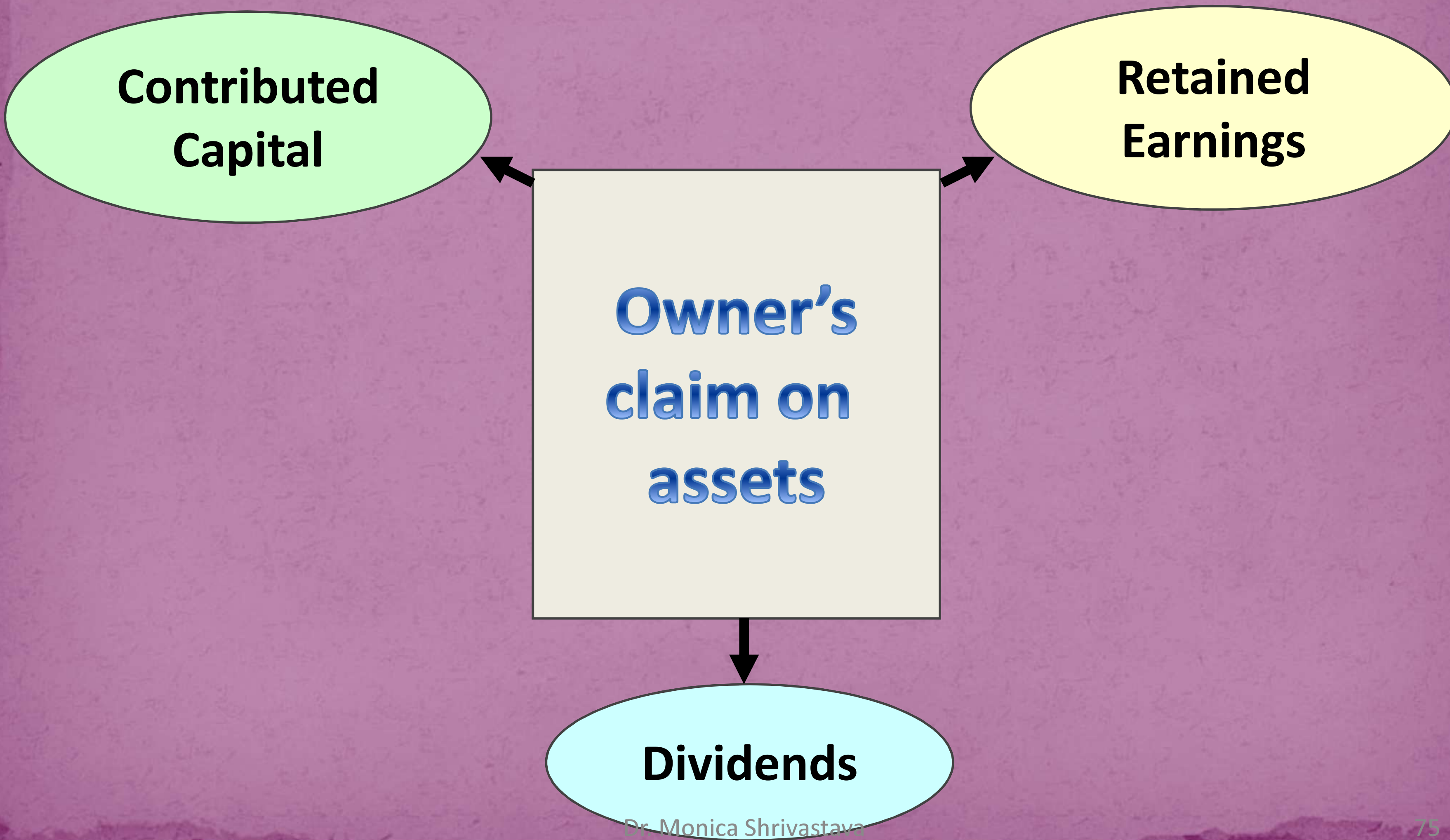
Creditors' claims on assets

Taxes Payable

Wages Payable

A1

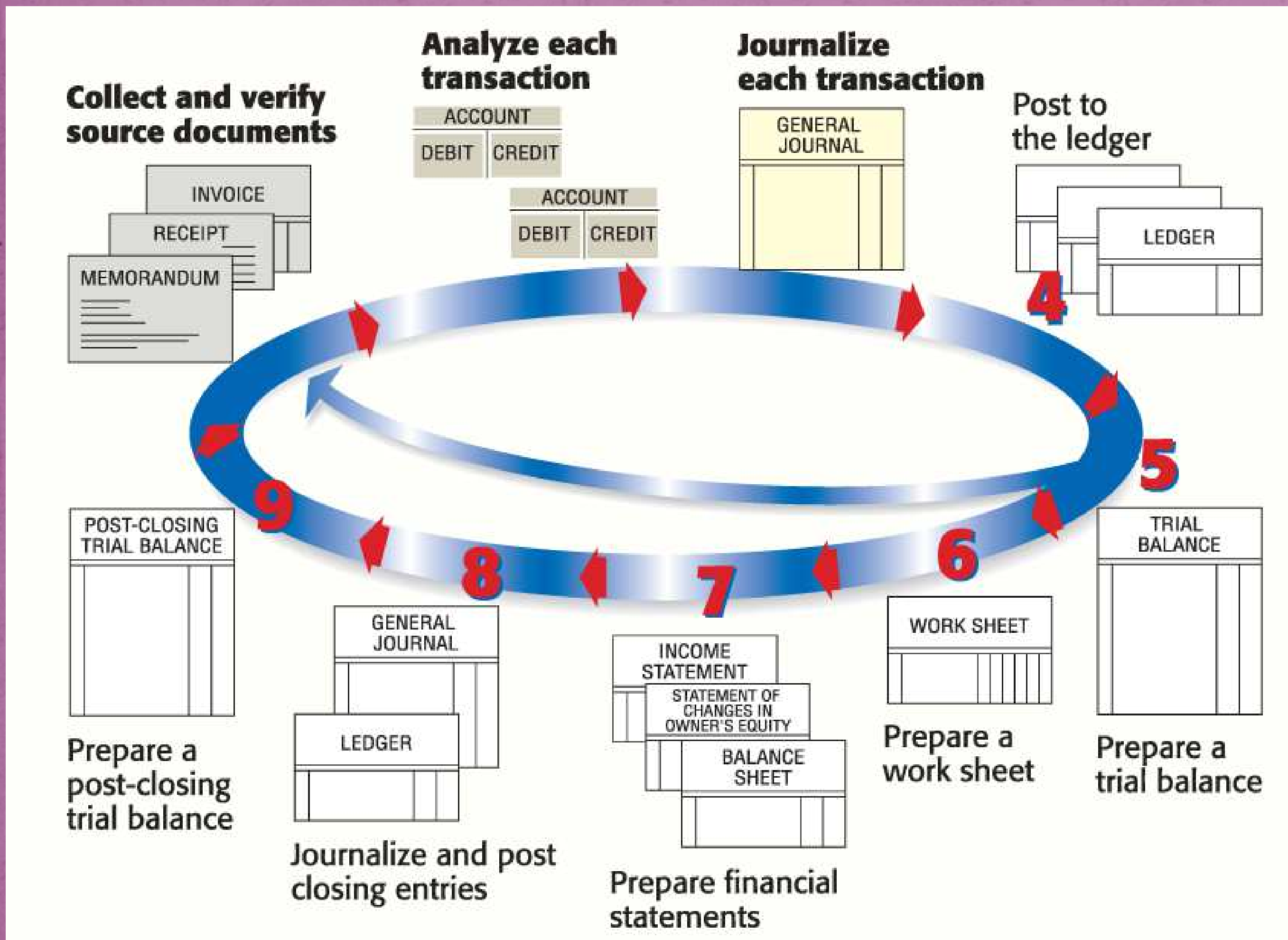
Equity


Contributed Capital
Retained Earnings
Owner's claim on assets
Dividends

Accounting Cycle

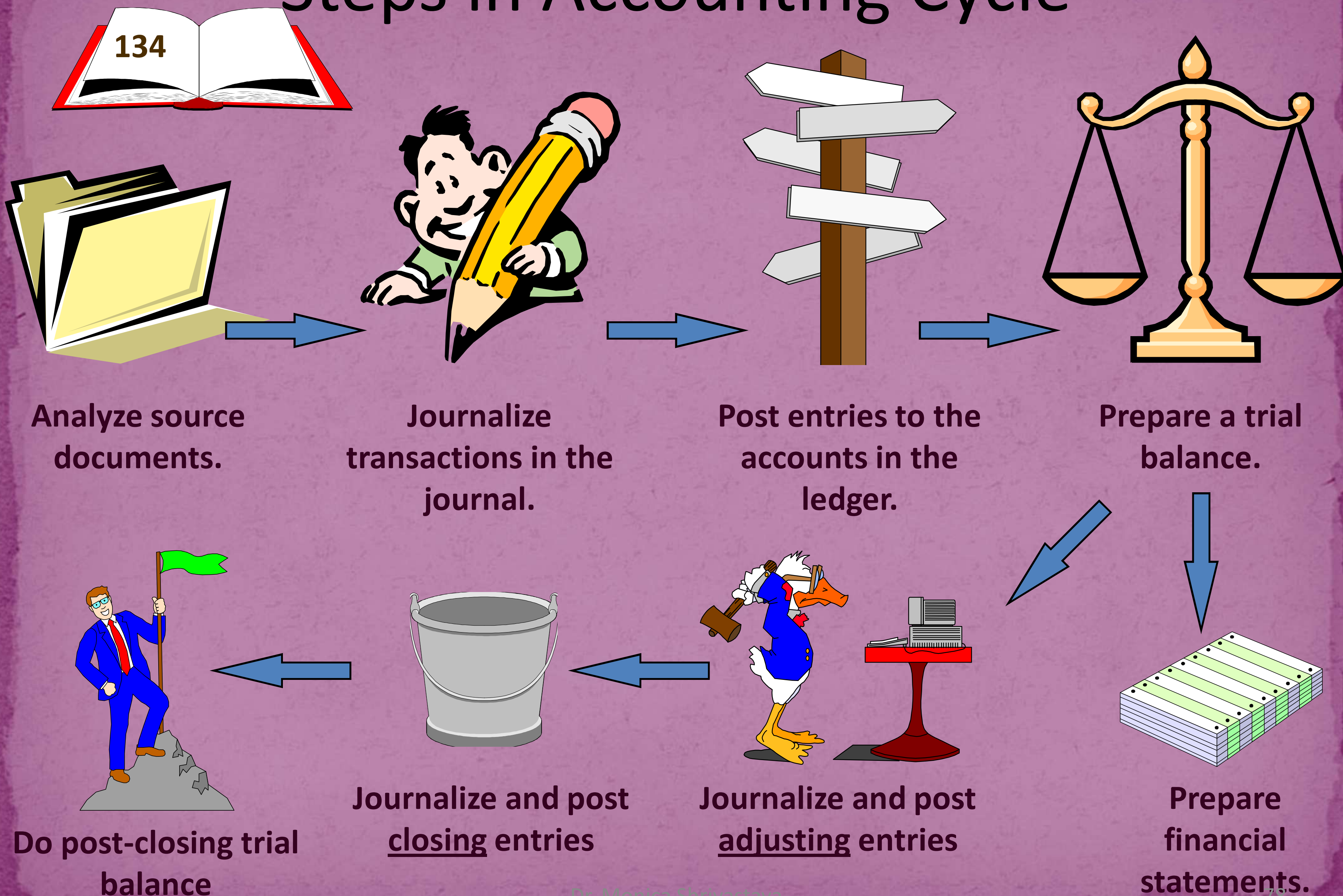
The accounting cycle is a series of steps done in each accounting period to keep records in an orderly fashion. You can use the general journal to record all of the transactions of a business.

Accounting Cycle



accounting cycle
Activities performed in an accounting period that help the business keep its records in an orderly fashion.

Steps in Accounting Cycle



1. Identifying and Analyzing Business Transactions

The accounting process starts with identifying and analyzing business transactions and events. Not all transactions and events are entered into the accounting system. Only those that pertain to the business entity are included in the process.

For example, a loan made by the owner in his name that does not have anything to do with the entity is not accounted for.

The transactions identified are then analyzed to determine the accounts affected and the amounts to be recorded.

The first step includes the preparation of business documents, or *source documents*. A business document serves as basis for recording a transaction

2. Recording in the Journals

A journal is a book – paper or electronic – in which transactions are recorded. Business transactions are recorded using the double-entry bookkeeping system. They are recorded in journal entries containing *at least* two accounts (one debited and one credited).

To simplify the recording process, special journals are often used for transactions that recur frequently such as sales, purchases, cash receipts, and cash disbursements. A general journal is used to record those that cannot be entered in the special books.

Transactions are recorded in chronological order and as they occur. Hence, journals are also known as *Books of Original Entry*.

3. Posting to the Ledger

Also known as *Books of Final Entry*, a ledger is a collection of accounts that shows the changes made to each account as a result of past transactions, and their current balances. This is the core of the classifying phase.

After the posting process, the balances of each account can now be determined.

For example, all journal entries made to Cash would be transferred into the Cash account in the ledger. Increases and decreases in cash will be entered into one ledger account. Thus, the ending balance of Cash can be determined.

4. Unadjusted Trial Balance

A trial balance is prepared to test the equality of the debits and credits. All account balances are extracted from the ledger and arranged in one report. Afterwards, all debit balances are added. All credit balances are also added. Total debits should be equal to total credits.

When errors are discovered, *correcting entries* are made to rectify them or reverse their effect. Take note however that the purpose of a trial balance is only test the equality of total debits and total credits and not to determine the correctness of accounting records.

Some errors could exist even if debits are equal to credits, such as double posting or failure to record a transaction.

5. Adjusting Entries

Adjusting entries are prepared as an application of the *accrual basis of accounting*. At the end of the accounting period, some expenses may have been incurred but not yet recorded in the journals. Some income may have been earned but not entered in the books.

Adjusting entries are prepared to have the accounts updated before they are summarized into the financial statements.

Adjusting entries are made for accrual of income, accrual of expenses, deferrals *(income method or liability method)*, prepayments *(asset method or expense method)*, depreciation, and allowances.

6. Adjusted Trial Balance

An *adjusted trial balance* may be prepared after adjusting entries are made and before the financial statements are prepared. This is to test if the debits are equal to credits after adjusting entries are made.

7. Financial Statements

When the accounts are already up-to-date and equality between the debits and credits have been tested, the financial statements can now be prepared. The financial statements are the end-products of an accounting system.

A complete set of financial statements is made up of: (1) Statement of Comprehensive Income *(Income Statement and Other Comprehensive Income)*, (2) Statement of Changes in Equity, (3) Statement of Financial Position or *Balance Sheet,* (4) Statement of Cash Flows, and (5) Notes to Financial Statements.

8. Closing Entries

Temporary or nominal accounts, i.e. income statement accounts, are closed to prepare the system for the next accounting period. Temporary accounts include *income, expense, and withdrawal* accounts. These items are measured periodically.

The accounts are closed to a summary account (often, Income Summary) and then closed further to the appropriate capital account. Take note that closing entries are made only for temporary accounts. Real or permanent accounts, i.e. balance sheet accounts, are not closed.

9. Post-Closing Trial Balance

In the accounting cycle, the last step is to prepare a post-closing trial balance. It is prepared to test the equality of debits and credits after closing entries are made. Since temporary accounts are already closed at this point, the post-closing trial balance contains real accounts *only*.