**Financial Accounting**

**Introduction**

It is not easy to provide a concise definition of accounting since the word has a broad application within businesses and applications.

The american accounting association define accounting as follows:

*"the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information!.*

This definition is a good place to start. Let's look at the key words in the above definition:

* it suggests that accounting is about providing information to others. Accounting information is economic information - it relates to the financial or economic activities of the business or organisation.
* accounting information needs to be identified and measured. This is done by way of a "set of accounts", based on a system of accounting known as double-entry bookkeeping. The accounting system identifies and records "accounting transactions".
* the "measurement" of accounting information is not a straight-forward process. It involves making judgements about the value of assets owned by a business or liabilities owed by a business. It is also about accurately measuring how much profit or loss has been made by a business in a particular period. As we will see, the measurement of accounting information often requires subjective judgement to come to a conclusion
* the definition identifies the need for accounting information to be communicated. The way in which this communication is achieved may vary. There are several forms of accounting communication (e.g. Annual report and accounts, management accounting reports) each of which serve a slightly different purpose. The communication need is about understanding who needs the accounting information, and what they need to know!
* Accounting information is communicated using "financial statements"

**Accountability**

* Accounting is about accountability.
* Most organizations are externally accountable in some way for their actions and activities. They will produce reports on their activities that will reflect their objectives and the people to whom they are accountable.
* The table below provides examples of different types of organizations and how accountability is linked to their differing organizational objectives:

|  |  |  |
| --- | --- | --- |
| Organisation | Objectives | Accountable to (examples) |
| *Private or public company* (e.g. [Bp](http://www.bp.com/), [tesco](http://www.tesco.com/)) | - making of profit - creation of wealth | - shareholders - other stakeholders (e.g. Employees, customers, suppliers) |
| *Charities* (e.g. [Save the children](http://www.savethechildren.org.uk/)) | - achievement of charitable aims - maximise spending on activities | - charity commissioners - donors |
| [*local authorities*](http://www.lga.gov.uk/) (e.g. [Leeds city council](http://www.leeds.gov.uk/)) | - provision of local services - optimal allocation of spending budget | - local electorate - government departments |
| *Public services (e.g. Transport, health)*  (e.g. [National health service](http://www.nhs.uk/), [prison service](http://www.hmprisonservice.gov.uk/)) | - provision of public service (often required by law) - high quality and reliability of services | - government ministers - consumers |
| [*quasi-governmental agencies*](http://www.cabinet-office.gov.uk/quango/index/qorg.htm) (e.g. [Data protection registrar](http://www.dataprotection.gov.uk/), [scottish arts council](http://www.sac.org.uk/)) | - regulation or instigation of some public action - coordination of public sector investments | - government ministers - consumers |

All of the above organisations have a significant roles to play in society and have multiple stakeholders to whom they are accountable.

All require systems of financial management to enable them to produce accounting information.

**Accounting information helps businesses be accountable**

Accounting is essentially an "information process" that serves several purposes:

* + providing a record of assets owned, amounts owed to others and monies invested;
  + providing reports showing the financial position of an organisation and the profitability of its operations
  + helps management actually manage the organisation
  + provides a way of measuring an organisation's effectiveness (and that of its separate parts and management)
  + helps stakeholders monitor an organisations activities and performance
  + enables potential investors or funders to evaluate an organisation and make decisions

There are many potential users of accounting information, including shareholders, lenders, customers, suppliers, government departments (e.g. Inland revenue), employees and their organisations, and society at large. Anyone with an interest in the performance and activities of an organisation is traditionally called a stakeholder.

For a business or organisation to communicate its results and position to stakeholders, it needs a language that is understood by all in common. Hence, accounting has come to be known as the "language of business"

**There are two broad types of accounting information:**

(1) financial accounts: geared toward external users of accounting information   
(2) management accounts: aimed more at internal users of accounting information

**Difference in financial and management accounts**

Although there is a difference in the type of information presented in financial and management accounts, the underlying objective is the same - to satisfy the information needs of the user. These needs can be described in terms of the following overall information objectives:

|  |  |
| --- | --- |
| **Collection** | Collection in money terms of information relating to transactions that have resulted from business operations |
| **Recording and classifying** | Recording and classifying data into a permanent and logical form. This is usually referred to as "book-keeping" |
| **Summarising** | Summarising data to produce statements and reports that will be useful to the various users of accounting information - both external and internal |
| **Interpreting and communicating** | Interpreting and communicating the performance of the business to the management and its owners |
| **Forecasting and planning** | Forecasting and planning for future operation of the business by providing management with evaluations of the viability of proposed operations. The key forecasting and planning tool is the "budget" |

The process by which accounting information is collected, reported, interpreted and actioned is called "financial management". Taking a commercial business as the most common organisational structure, the **key objectives of financial management are to**:

(1)create wealth for the business  
(2) generate cash, and  
(3) provide an adequate return on investment bearing in mind the risks that the business is taking and the resources invested

In preparing accounting information, care should be taken to ensure that the information presents an accurate and true view of the business performance and position. To impose some order on what is a subjective task, accounting has adopted certain conventions and concepts which should be applied in preparing accounts.

For financial accounts, the regulation or control of what kind of information is prepared and presented goes much further. Uk and international companies are required to comply with a wide range of accounting standards which define the way in which business transactions are disclosed and reported. These are applied by businesses through their accounting policies.

**Comparison of financial and management accounting**

There are two broad types of accounting information:

• financial accounts: geared toward external users of accounting information

• management accounts: aimed more at internal users of accounting information

Although there is a difference in the type of information presented in financial and management accounts, the underlying objective is the same - to satisfy the information needs of the user.

| **Financial accounts** | **Management accounts** |
| --- | --- |
| Financial accounts describe the performance of a business over a specific period and the state of affairs at the end of that period. the specific period is often referred to as the "trading period" and is usually one year long. the period-end date as the "balance sheet date" | Management accounts are used to help management record, plan and control the activities of a business and to assist in the decision-making process. they can be prepared for any period (for example, many retailers prepare daily management information on sales, margins and stock levels). |
| Companies that are incorporated under the companies act 1989 are required by law to prepare and publish financial accounts. the level of detail required in these accounts reflects the size of the business with smaller companies being required to prepare only brief accounts. | There is no legal requirement to prepare management accounts, although few (if any) well-run businesses can survive without them. |
| The format of published financial accounts is determined by several different regulatory elements:   * company law * accounting standards * stock exchange | There is no pre-determined format for management accounts. they can be as detailed or brief as management wish. |
| Financial accounts concentrate on the business as a whole rather than analysing the component parts of the business. for example, sales are aggregated to provide a figure for total sales rather than publish a detailed analysis of sales by product, market etc. | Management accounts can focus on specific areas of a business' activities. for example, they can provide insights into performance of:   * products * separate business locations (e.g. Shops) * departments / divisions |
| Most financial accounting information is of a monetary nature | Management accounts usually include a wide variety of non-financial information. for example, management accounts often include analysis of:  - employees (number, costs, productivity etc.)  - sales volumes (units sold etc.)  - customer transactions (e.g. Number of calls received into a call centre) |
| By definition, financial accounts present a historic perspective on the financial performance of the business | Management accounts largely focus on analysing historical performance. however, they also usually include some forward-looking elements - e.g. A sales budget; cash-flow forecast. |

**Accounting concept and conventions**

In drawing up accounting statements, whether they are external "financial accounts" or internally-focused "management accounts", a clear objective has to be that the accounts fairly reflect the true "substance" of the business and the results of its operation.

The theory of accounting has, therefore, developed the concept of a ***"true and fair view"***. The true and fair view is applied in ensuring and assessing whether accounts do indeed portray accurately the business' activities.

To support the application of the "true and fair view", accounting has adopted certain concepts and conventions which help to ensure that accounting information is presented accurately and consistently.

**Accounting conventions**

The most commonly encountered convention is the **"historical cost convention"**. This requires transactions to be recorded at the price ruling at the time, and for assets to be valued at their original cost.

Under the "historical cost convention", therefore, no account is taken of changing prices in the economy.

The other conventions you will encounter in a set of accounts can be summarised as follows:

|  |  |
| --- | --- |
| **Monetary measurement** | Accountants do not account for items unless they can be quantified in monetary terms. Items that are not accounted for (unless someone is prepared to pay something for them) include things like workforce skill, morale, market leadership, brand recognition, quality of management etc. |
| **Separate entity** | This convention seeks to ensure that private transactions and matters relating to the owners of a business are segregated from transactions that relate to the business. |
| **Realisation** | With this convention, accounts recognise transactions (and any profits arising from them) at the point of sale or transfer of legal ownership - rather than just when cash actually changes hands. For example, a company that makes a sale to a customer can recognise that sale when the transaction is legal - at the point of contract. The actual payment due from the customer may not arise until several weeks (or months) later - if the customer has been granted some credit terms. |
| **Materiality** | An important convention. As we can see from the application of accounting standards and accounting policies, the preparation of accounts involves a high degree of judgement. Where decisions are required about the appropriateness of a particular accounting judgement, the "materiality" convention suggests that this should only be an issue if the judgement is "significant" or "material" to a user of the accounts. The concept of "materiality" is an important issue for auditors of financial accounts. |

**Accounting concepts**

Four important accounting concepts underpin the preparation of any set of accounts:

|  |  |
| --- | --- |
| **Going concern** | Accountants assume, unless there is evidence to the contrary, that a company is not going broke. This has important implications for the valuation of assets and liabilities. |
| **Consistency** | Transactions and valuation methods are treated the same way from year to year, or period to period. Users of accounts can, therefore, make more meaningful comparisons of financial performance from year to year. Where accounting policies are changed, companies are required to disclose this fact and explain the impact of any change. |
| **Prudence** | Profits are not recognised until a sale has been completed. In addition, a cautious view is taken for future problems and costs of the business (the are "provided for" in the accounts" as soon as their is a reasonable chance that such costs will be incurred in the future. |
| **Matching (or "accruals")** | Income should be properly "matched" with the expenses of a given accounting period. |
| **Profit** | *Profit is the amount by which sales revenue (also known as "turnover" or "income") exceeds "expenses" (or "costs") for the period being measured.* |

**Key characteristics of accounting information**

There is general agreement that, before it can be regarded as useful in satisfying the needs of various user groups, accounting information should satisfy the following criteria:

|  |  |
| --- | --- |
| **Criteria** | **What it means for the preparation of accounting information** |
| ***Understandability*** | This implies the expression, with clarity, of accounting information in such a way that it will be understandable to users - who are generally assumed to have a reasonable knowledge of business and economic activities |
| ***Relevance*** | This implies that, to be useful, accounting information must assist a user to form, confirm or maybe revise a view - usually in the context of making a decision (e.g. Should i invest, should i lend money to this business? Should i work for this business?) |
| ***Consistency*** | This implies consistent treatment of similar items and application of accounting policies |
| ***Comparability*** | This implies the ability for users to be able to compare similar companies in the same industry group and to make comparisons of performance over time. Much of the work that goes into setting accounting standards is based around the need for comparability. |
| ***Reliability*** | This implies that the accounting information that is presented is truthful, accurate, complete (nothing significant missed out) and capable of being verified (e.g. By a potential investor). |
| ***Objectivity*** | This implies that accounting information is prepared and reported in a "neutral" way. In other words, it is not biased towards a particular user group or vested interest |

**Underlying Assumptions, Principles, and Conventions**

Financial accounting relies on the following [underlying concepts](http://www.QuickMBA.com/accounting/fin/concepts/):

* Assumptions: Separate entity assumption, going-concern assumption, stable monetary unit assumption, fixed time period assumption.
* Principles: Historical cost principle, matching principle, revenue recognition principle, full disclosure principle.
* Modifying conventions: Materiality, cost-benefit, conservatism convention, industry practices convention.

**Fundamental Accounting Model**

The balance sheet is based on the following fundamental [accounting equation](http://www.QuickMBA.com/accounting/fin/equation/) :

Assets  =  Liabilities  +  Equity

This model has been used since the 18th century. It essentially states that a business owes all of its assets to either creditors or owners, where the assets of a business are its resources, and the creditors and owners are the sources of those resources.   
**Transactions**

To record transactions, one must:

1. Identify an event that affects the entity financially.
2. Measure the event in monetary terms.
3. Determine which accounts the transaction affects.
4. Determine whether the transaction increases or decreases the balances in those accounts.
5. Record the transaction in the ledgers.

Most larger business accounting systems utilize the double entry method. Under double entry, instead of recording a transaction in only a single account, the transaction is recorded in two accounts.

**The Accounting Process**

Once a business transaction occurs, a sequence of activities begins to identify and analyze the transaction, make the journal entries, etc. Because this process repeats over transactions and accounting periods, it is referred to as the [accounting cycle](http://www.QuickMBA.com/accounting/fin/cycle/).

**The Accounting Cycle**

The sequence of activities beginning with the occurrence of a transaction is known as the accounting cycle. This process is shown in the following diagram:

Steps in The Accounting Cycle

|  |  |
| --- | --- |
| |  | | --- | | Identify the Transaction Identify the event as a transaction and generate the source document. | |
| http://www.QuickMBA.com/lib/arrow/270deg-47px-44px-0tail-1head-ddddbb-1.gif |
| |  | | --- | | Analyze the Transaction Determine the transaction amount, which accounts are affected, and in which direction. | |
| http://www.QuickMBA.com/lib/arrow/270deg-47px-44px-0tail-1head-ddddbb-1.gif |
| |  | | --- | | Journal Entries The transaction is recorded in the journal as a debit and a credit. | |
| http://www.QuickMBA.com/lib/arrow/270deg-47px-44px-0tail-1head-ddddbb-1.gif |
| |  | | --- | | Post to Ledger The journal entries are transferred to the appropriate T-accounts in the ledger. | |
| http://www.QuickMBA.com/lib/arrow/270deg-47px-44px-0tail-1head-ddddbb-1.gif |
| |  | | --- | | Trial Balance A trial balance is calculated to verify that the sum of the debits is equal to the sum of the credits. | |
| http://www.QuickMBA.com/lib/arrow/270deg-47px-44px-0tail-1head-ddddbb-1.gif |
| |  | | --- | | Adjusting Entries Adjusting entries are made for accrued and deferred items. The entries are journalized and posted to the T-accounts in the ledger. | |
| http://www.QuickMBA.com/lib/arrow/270deg-47px-44px-0tail-1head-ddddbb-1.gif |
| |  | | --- | | Adjusted Trial Balance A new trial balance is calculated after making the adjusting entries. | |
| http://www.QuickMBA.com/lib/arrow/270deg-47px-44px-0tail-1head-ddddbb-1.gif |
| |  | | --- | | Financial Statements The financial statements are prepared. | |
| http://www.QuickMBA.com/lib/arrow/270deg-47px-44px-0tail-1head-ddddbb-1.gif |
| |  | | --- | | Closing Entries Transfer the balances of the temporary accounts  (e.g. revenues and expenses) to owner's equity. | |
| http://www.QuickMBA.com/lib/arrow/270deg-47px-44px-0tail-1head-ddddbb-1.gif |
| |  | | --- | | After-Closing Trial Balance A final trial balance is calculated after the closing entries are made. | |

The above diagram shows the [financial statements](http://www.QuickMBA.com/accounting/fin/statements/) as being prepared after the adjusting entries and adjusted trial balance. The financial statements also can be prepared before the adjusting entries with the help of a worksheet that calculates the impact of the adjusting entries before they actually are posted.

## Types of Financial accounts

Financial accounts are a historical record of your **business' performance** over a past period - usually one year - for the benefit of external users such as shareholders, employees, suppliers, bankers and authorities.

Financial accounts normally include the following elements:

### Profit and loss account

This measures your business' performance over a given period of time, usually one year.

It compares the income of your business against the cost of goods or services and expenses incurred in earning that revenue

### Balance sheet

This is a snapshot of your business' assets (what you own or are owed) and your liabilities (what you owe) on a particular day - eg the last day of your financial year.

### Cashflow statement

This shows how your business has generated and disposed of cash and liquid funds during the period under review. A cashflow statement is different from a cashflow forecast, which is used to predict the expected rises and falls in cashflow over the coming year.

### Statement of recognised gains and losses

This records all gains and losses since the previous set of accounts. For example, changes caused by currency fluctuations, property revaluation, profits earned by associates and joint ventures not included in the normal accounts.

### Unincorporated businesses

Unincorporated businesses such as sole traders and partnerships are required by HM Revenue & Customs (HMRC) to maintain proper books and records to support annual income tax returns. These must be kept for a minimum of six years. See our guide on how to [set up a basic record-keeping system](http://www.businesslink.gov.uk/bdotg/action/layer?topicId=1073860617&r.s=e&r.l1=1073858790&r.lc=en&r.l3=1073933591&r.l2=1073858944&r.i=1073791253&r.t=RESOURCES).

For more information on what to include in a company's annual accounts, see our guide on how to [file accounts at Companies House](http://www.businesslink.gov.uk/bdotg/action/layer?topicId=1073859917&r.s=e&r.l1=1073858790&r.lc=en&r.l3=1073933591&r.l2=1073858944&r.i=1073791253&r.t=RESOURCES).

**The Four Financial Statements**

Businesses report information in the form of financial statements issued on a periodic basis. the Following are the four financial statements:

* Balance Sheet - statement of financial position at a given point in time.
* Income Statement - revenues minus expenses for a given time period ending at a specified date.
* Statement of Owner's Equity - also known as Statement of Retained Earnings or Equity Statement.
* Statement of Cash Flows - summarizes sources and uses of cash; indicates whether enough cash is available to carry on routine operations.

**Balance Sheet**

The balance sheet is based on the following fundamental accounting model:

Assets  =  Liabilities  +  Equity

Assets can be classed as either current assets or fixed assets. Current assets are assets that quickly and easily can be converted into cash, sometimes at a discount to the purchase price. Current assets include cash, accounts receivable, marketable securities, notes receivable, inventory, and prepaid assets such as prepaid insurance. Fixed assets include land, buildings, and equipment. Such assets are recorded at historical cost, which often is much lower than the market value.

Liabilities represent the portion of a firm's assets that are owed to creditors. Liabilities can be classed as short-term liabilities (current) and long-term (non-current) liabilities. Current liabilities include accounts payable, notes payable, interest payable, wages payable, and taxes payable. Long-term liabilities include mortgages payable and bonds payable. The portion of a mortgage long-term bond that is due within the next 12 months is classed as a current liability, and usually is referred to as the current portion of long-term debt. The creditors of a business are the primary claimants, getting paid before the owners should the business cease to exist.

Equity is referred to as owner's equity in a sole proprietorship or a partnership, and stockholders' equity or shareholders' equity in a corporation. The equity owners of a business are residual claimants, having a right to what remains only after the creditors have been paid. For a sole proprietorship or a partnership, the equity would be listed as the owner or owners' names followed by the word "capital". For example:

|  |  |
| --- | --- |
| *Sole Proprietorship:* | John Doe, Capital |
|  | |
| *Partnership:* | John Doe, Capital |
|  | Josephine Smith, Capital |

In the case of a corporation, equity would be listed as common stock, preferred stock, and retained earnings.

The balance sheet reports the resources of the entity. It is useful when evaluating the ability of the company to meet its long-term obligations. Comparative balance sheets are the most useful; for example, for the years ending December 31, 2000 and December 31, 2001.

**Income Statement**

The income statement presents the results of the entity's operations during a period of time, such as one year. The simplest equation to describe income is:

Net Income  =  Revenue  -  Expenses

Revenue refers to inflows from the delivery or manufacture of a product or from the rendering of a service. Expenses are outflows incurred to produce revenue.

Income from operations can be separated from other forms of income. In this case, the income can be described by:

Net Income  =  Revenue  -  Expenses  +  Gains  -  Losses

where gains refer to items such as capital gains, and losses refer to capital losses, losses from natural disasters, etc.

**Statement of Owners' Equity (Statement of Retained Earnings)**

The equity statement explains the changes in retained earnings. Retained earnings appear on the balance sheet and most commonly are influenced by income and dividends. The Statement of Retained Earnings therefore uses information from the Income Statement and provides information to the Balance Sheet.

The following equation describes the equity statement for a sole proprietorship:

Ending Equity  =  Beginning Equity  +  Investments  -  Withdrawals  +  Income

For a corporation, substitute "Dividends Paid" for "Withdrawals". The stockholders' equity in a corporation is calculated as follows:

|  |
| --- |
| Common Stock (recorded at par value)  +  Premium on Common Stock (issue price minus par value)  +  Preferred Stock (recorded at par value)  +  Premium on Preferred Stock (issue price minus par value)  +  Retained Earnings  ----------------------------------------------------------------  =  Stockholders' Equity |

Note that the premium on the issuance of stock is based on the price at which the corporation actually sold the stock on the market. Afterwards, market trading does not affect this part of the equity calculation. Stockholders' equity does not change when the stock price changes!

**Cash Flow Statement**

The nature of accrual accounting is such that a company may be profitable but nonetheless experience a shortfall in cash. The statement of cash flows is useful in evaluating a company's ability to pay its bills. For a given period, the cash flow statement provides the following information:

* Sources of cash
* Uses of cash
* Change in cash balance

The cash flow statement represents an analysis of all of the transactions of the business, reporting where the firm obtained its cash and what it did with it. It breaks the sources and uses of cash into the following categories:

* Operating activities
* Investing activities
* Financing activities

The information used to construct the cash flow statement comes from the beginning and ending balance sheets for the period and from the income statement for the period.

**Purpose of financial statements**

There are two main purposes of financial statements:

(1) to report on the financial position of an entity (e.g. A business, an organisation);

(2) to show how the entity has performed (financially) over a particularly period of time (an "accounting period").

The most common measurement of "performance" is profit.

It is important to understand that financial statements can be historical or relate to the future.

**Summery**

Businesses have two primary objectives:

* Earn a profit
* Remain solvent

Solvency represents the ability of the business to pay its bills and service its debt.

The four [financial statements](http://www.QuickMBA.com/accounting/fin/statements/) are reports that allow interested parties to evaluate the profitability and solvency of a business. These reports include the following financial statements:

* Balance Sheet
* Income Statement
* Statement of Owner's Equity
* Statement of Cash Flows

These four financial statements are the final product of the accountant's analysis of the transactions of a business. A large amount of effort goes into the preparation of the financial statements. The process begins with bookkeeping, which is just one step in the accounting process. Bookkeeping is the actual recording of the company's transactions, without any analysis of the information. Accountants evaluate and analyze the information, making sense out of the numbers.

For the reports to be useful, they must be:

* Understandable
* Timely
* Relevant
* Fair and Objective (free from bias)

**BOOKKEEPING**

**Single entry bookkeeping**

Single **entry** **bookkeeping** means that all transactions are entered only once on to the accounts system. For instance, buying a vehicle for £15,000 would be entered as a payment in a cashbook.

Single **entry** **bookkeeping** can be used to account for cash (and bank) based systems. It has the advantage of being simple, and intuitive to use. However, it will not account for “non-cash” (or “non-bank”) transactions. These are transactions that will have a significant effect on the accounts, but do not immediately cause a change on the cash or bank accounts.

An example of a non-cash transaction is ordering a vehicle for £15,000. The vehicle might take a month to arrive. During that month, a single **entry** system would not record the transaction on the formal accounts. This would mean that the accounts showed you as having £15,000 more than you do: a dangerous situation.

**Double entry bookkeeping**

Double entry bookkeeping means that all transactions are entered twice on to the accounts system. For instance, buying a vehicle for £15,000 would be entered as a decrease in the cash account, and as an increase in the ‘vehicle’ account. (The decrease in the cash account would be shown as an entry in a cashbook, like in a single entry system.)

A double entry system will have a separate ‘account’ for each budget line. The system also uses a few accounts that are not found on the budget. These are the accounts that allow you to track non-cash expenditure, and which make the double entry system so powerful.

For instance, you might have an account called ‘Goods ordered’. Then, if the vehicle above was ordered, the cash account would decrease by £15,000, and the ‘Goods ordered’ account would increase by £15,000. This is just a transfer in the accounts: no real money would have moved.

But it would show you that you have put aside £15,000 for something. When the vehicle arrives, and you have to pay the bill for it, then the double entry that you make would be to decrease the ‘Goods ordered’ account by £15,000, and increase the ‘vehicles’ account by £15,000.

So, the advantage of a double entry system is that it is comprehensive. It will give you an accurate picture of your true financial position, not just your cash position. As non-cash transactions can be huge, this is extremely important for robust financial management.

For example, in the 1994/95 response to the Rwanda crisis, a major international NGO flew a very large amount of relief equipment into Central Africa. When the response was completed, the NGO drew up its accounts, from its single entry, cash-based accounting system, and submitted them to its donor. The donor paid up, and the project was closed.

Unfortunately, some time later, a bill for freight insurance was received. It came to over £50,000. The donor said that they could not pay more, after the accounts had been settled, and the NGO had to meet the bill out of its own resources. If a full double entry accounts system had been used, then this sort of vicious surprise would have been almost impossible.

However, the disadvantage of double entry bookkeeping is that it is complicated, and not always easy to use. It generally needs a qualified accountant to run it for the entire life of the project. On large international projects, it may need two or three. This may not always be possible for an NGO.

**Double Entry Bookkeeping**

A business transaction involves an exchange between two accounts. For example, for every asset there exists a claim on that asset, either by those who own the business or those who loan money to the business. Similarly, the sale of a product affects both the amount of cash (or cash receivable) held by the business and the inventory held.

Recognizing this fundamental dual nature of transactions, merchants in medieval Venice began using a double-entry bookkeeping system that records each transaction in the two accounts affected by the exchange. In the late 1400's, Franciscan monk and mathematician Luca Pacioli documented the procedure for double-entry bookkeeping as part of his famous *Summa* work, which described a significant portion of the [accounting cycle](http://www.QuickMBA.com/accounting/fin/cycle/). Double-entry bookkeeping spread throughout Europe and became the foundation of modern accounting.

Two notable characteristics of double-entry systems are that 1) each transaction is recorded in two accounts, and 2) each account has two columns.

In a double-entry system, two entries are made for each transaction - one entry as a debit in one account and the other entry as a credit in another account. The two entries keep the [accounting equation](http://www.QuickMBA.com/accounting/fin/equation/) in balance so that:

Assets    =    Liabilities   +   Owners' Equity

To illustrate, consider a repair shop with a transaction involving repair service performed on Jan 4 for a cash payment of $275.00. In a [single-entry bookkeeping](http://www.QuickMBA.com/accounting/fin/single-entry/)system, the transaction would be recorded as follows:

Single Entry Example

|  |  |  |  |
| --- | --- | --- | --- |
| Date | Description | Revenues | Expenses |
| Jan 4 | Performed repair service | 275.00 |  |

In a double-entry system, the transaction would be recorded as follows:

Double Entry Example

|  |  |  |  |
| --- | --- | --- | --- |
| Date | Accounts | Debit | Credit |
| Jan 4 | Cash | 275.00 |  |
|  | Revenue |  | 275.00 |

A notation may be added to this journal entry to indicate that the revenue was from repair services.

Note that two accounts (revenue and cash) are affected by the transaction. If the customer did not pay cash but instead was extended credit, then "accounts receivable" would have been used instead of "cash."

In this system, the double entries take the form of [debits and credits](http://www.QuickMBA.com/accounting/fin/debits-credits/), with debits in the left column and credits in the right. For each debit there is an equal and opposite credit and the sum of all debits therefore must equal the sum of all credits. This principle is useful for identifying errors in the transaction recording process.

Double-entry accounting has the following advantages over single-entry:

* Accurate calculation of profit and loss in complex organizations
* Inclusion of assets and liabilities in the bookkeeping accounts.
* Preparation of financial statements directly from the accounts
* Easier detection of errors and fraud

To appreciate the importance of double-entry bookkeeping, it is interesting to note that the industrial revolution might not have been possible without it. At that time, businesses increased in size and complexity. Accurate bookkeeping was required for managers to understand the financial status of their businesses in order to keep them solvent and offer a degree of transparency to investors. While a single-entry system can be adapted by a skilled bookkeeper to meet some of these needs, only a double-entry system provides the required detail systematically and by design.

**Journal Entries**

After a transaction occurs and a source document is generated, the transaction is analyzed and entries are made in the general journal. A journal is a chronological listing of the firm's transactions, including the amounts, accounts that are affected, and in which direction the accounts are affected. A journal entry takes the following format:

Format of a General Journal Entry

|  |  |  |  |
| --- | --- | --- | --- |
| Date | Accounts | Debit | Credit |
| *mm/dd* | *account to be debited* | *xxxx.xx* |  |
|  | *account to be credited* |  | *xxxx.xx* |

In addition to this information, a journal entry may include a short notation that describes the transaction. There also may be a column for a reference number so that the transaction can be tracked through the accounting system.

The above format shows the journal entry for a single transaction. Additional transactions would be recorded in the same format directly below the first one, resulting in a time-ordered record. The journal format provides the benefit that all of the transactions are listed in chronological order, and all parts ([debits and credits](http://www.QuickMBA.com/accounting/fin/debits-credits/)) of each transaction are listed together.

Because the journal is where the information from the source document first enters the accounting system, it is known as the *book of original entry*.

**Compound Journal Entries**

The format shown above has a single entry for the debit and a single entry for the credit. This type of entry is known as a simple journal entry. Sometimes, more than two accounts are affected by a transaction so more than two lines are required. Such a journal entry is know as a compound journal entry and takes the following format:

Format of a Compound General Journal Entry

|  |  |  |  |
| --- | --- | --- | --- |
| Date | Accounts | Debit | Credit |
| *mm/dd* | *account to be debited* | *xxxx.xx* |  |
|  | *account to be credited* |  | *xxxx.xx* |
|  | *account to be credited* |  | *xxxx.xx* |

For example, if an expense is incurred in which part of the expense is paid with cash and the remainder placed in accounts payable, then two lines would be used for the credit - one for the cash portion and one for the accounts payable portion. The total of the two credits must be equal to the debit amount.

As many accounts as are necessary can be used in this manner, and multiple accounts also can be used for the debit side if needed.

**Special Journals**

The general journal is the main journal for a wide range of transactions. Of these, a business usually finds itself performing some types much more frequently than others. By grouping specific types of transactions into their own special journal, the efficiency and organization of the accounting system can be improved.

Some commonly-used special journals:

* sales journal
* purchases journal
* cash receipts journal
* cash disbursements journal

While a special journal may be organized differently from the general journal, it still provides the core transaction information such as date, debits and credits, and the relevant accounts.

**Trial Balance**

A basic rule of double-entry accounting is that for every credit there must be an equal debit amount. From this concept, one can say that the sum of all debits must equal the sum of all credits in the accounting system. If debits do not equal credits, then an error has been made. The **trial balance** is a tool for detecting such errors.

The trial balance is calculated by summing the balances of all the ledger accounts. The account balances are used because the balance summarizes the net effect of all of the debits and credits in an account. To calculate the trial balance, construct a table in the following format:

**Trial Balance Calculation**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  |  | | --- | --- | --- | | **Account** | **Debits** | **Credits** | | *Account 1* | *xxxx.xx* |  | | *Account 2* | *xxxx.xx* |  | | *Account 3* | *xxxx.xx* |  | | **. . .** |  |  | | *Account 4* |  | *xxxx.xx* | | *Account 5* |  | *xxxx.xx* | | *Account 6* |  | *xxxx.xx* | |  |  | **. . .** | |  | \_\_\_\_\_\_\_\_ | \_\_\_\_\_\_\_\_ | | **Totals:** | ***xxxx.xx*** | ***xxxx.xx*** | |

In the above trial balance, the balances of Accounts 1, 2, and 3 are net debits, and the balances of Accounts 4, 5, and 6 are net credits. The totals of the debits and credits should be equal; if they are not, then an error was made somewhere in the accounting process. Some common errors include the following:

1. **Error in totaling the columns** - make sure that the trial balance columns were summed properly.
2. **Error in transferring account balances to proper trial balance columns** - make sure that debit and credit account balances are in the appropriate debit and credit columns of the trial balance calculation. Check for reversed digits and misplaced decimal points.
3. **Omission of an account** - an account may be missing in the trial balance calculation.
4. **Error in account balance** - an error may have been made in the calculation of a ledger account balance.
5. **Error in posting a journal entry** - a journal entry may not have been posted properly to the general ledger.
6. **Error in recording a transaction in the journal** - for example, making an error in a debit or credit, or failing to enter a debit or credit.

In general, the most effective way to isolate an error is to work backward from the trial balance itself to the initial journal entry, as outlined in the above list.

Note that a balanced trial balance does not guarantee that there are no errors. An error of omission could have been made in which a transaction was not recorded, a journal entry could have been posted to the wrong ledger account, or a debit and credit could have been transposed. Such errors are not caught by the trial balance.

**How To Prepare and Analyze a Balance Sheet**

Examine the concepts of assets, liabilities, and net worth in a way that will help you relate them to your business. Learn how to create a balance sheet for your company and how to use it to analyze your business's liquidity and leverage.

[What You Should Know Before Getting Started](http://www.esmalloffice.com/SBR_template.cfm?DocNumber=PL12_0200.htm#whatknow)

* The Purpose of Financial Statements
* Why Create a Balance Sheet?

[How to Prepare a Balance Sheet](http://www.esmalloffice.com/SBR_template.cfm?DocNumber=PL12_0200.htm#prepbal)

* Assets
* Liabilities
* Net Worth
* Sample Worksheet

|  |
| --- |
|  |
| **What To Expect**  This Business Builder will introduce you to accounting terminology and examine the concepts of assets, liabilities and net worth in a way that will help you relate them to your business. It will guide you through a step-by-step process to create a balance sheet for your company and explain how to use a balance sheet to analyze your business' liquidity and leverage.  **What You Should Know Before Getting Started** [[top](http://www.esmalloffice.com/SBR_template.cfm?DocNumber=PL12_0200.htm#top)]  **The Purpose Of Financial Statements**  The purpose of financial statements is to communicate. Financial statements tell you and others the state of your business. The three most commonly prepared financial statements for a small business are a *balance sheet,*an *income statement,* and a*cash flow statement.*  **A balance sheet (also known as a statement of financial position) is a formal document that follows a standard accounting format showing the same categories of assets and liabilities regardless of the size or nature of the business.** The balance sheet you prepare will be in the same format as IBM's or General Motors'. Accounting is considered the language of business because its concepts are time-tested and standardized. Even if you do not utilize the services of a certified public accountant, you or your bookkeeper can adopt certain generally accepted accounting principles (GAAP) to develop financial statements.  The strength of GAAP is the reliability of company data from one accounting period to another and the ability to compare the financial statements of different companies. The standardization introduced by commonly defined terms is responsible for this reliability. To help you get a grip on accounting terminology, terms are defined as they are introduced and a glossary is included for reference.   |  | | --- | | ***Watch Out For…*** Accounting jargon overload. The vocabulary of accounting is foreign and may be confusing. However, after you begin using the accounting concepts defined in this Business Builder and associating them with your business, a familiarity with them is sure to develop. |   **Garbage-in, garbage-out.**The integrity of any financial statement is directly related to the information that goes into its construction. You may want to consider revamping of your record-keeping, if necessary, before you begin compiling financial statements.  This Business Builder will explain what data is necessary for accurate financial statements, but answering the following questions might be a good place to start.   * Are the financial records for all (or most) of the company's assets (equipment, inventory, furniture) and liabilities (personal loans, bank loans) in one place? * Is there a record of the amounts and sources of cash expended to begin the business and acquire inventory? * Do you know what is currently owed to the bank, creditors, or others? * Do you know how much of what is owed is due in the next 12 months? * Can you estimate what percentage of accounts receivable may not be received?   **Why Create A Balance Sheet?**  A balance sheet provides a snapshot of a business' health at a point in time. It is a summary of what the business owns (assets) and owes (liabilities). Balance sheets are usually prepared at the close of an accounting period such as month-end, quarter-end, or year-end. New business owners should not wait until the end of 12 months or the end of an operating cycle to complete a balance sheet. Savvy business owners see a balance sheet as an important decision-making tool.  Over time, a comparison of balance sheets can give a good picture of the financial health of a business. In conjunction with other financial statements, it forms the basis for more sophisticated analysis of the business. The balance sheet is also a tool to evaluate a company's flexibility and liquidity.  **How To Prepare A Balance Sheet** [[top](http://www.esmalloffice.com/SBR_template.cfm?DocNumber=PL12_0200.htm#top)]  A balance sheet is a summary of a firm's assets, liabilities and net worth. The key to understanding a balance sheet is the simple formula:  **Assets = Liabilities + Net Worth**  **All balance sheets follow the same format:** If it is in two columns, assets are on the left, liabilities are on the right, and net worth is beneath liabilities. If it is in one column, assets are listed first, followed by liabilities and net worth.  Here is a sample balance sheet for the Doodads Company.  **Doodads Co. Balance Sheet as of Dec 31, 200x**   |  |  | | --- | --- | | **Assets** | **$$** | | Current Assets |  | | Cash On Hand | $ 300 | | Cash in Bank | $ 2,200 | | Accounts Receivable | $ 1,600 | | Merchandise Inventory | $ 5,500 | | Prepaid Expenses |  | | Rent | $ 1,200 | | Total Current Assets | $10,800 | | **Fixed assets** |  | | Equipment and Fixtures      (less Depreciation) | $ 1,200 | | Total Assets | $12,000 | |  |  | | **Liabilities** | **$$** | | Current Liabilities |  | | Accounts Payable | $ 1,100 | | Notes Payable, Bank | $ 2,200 | | Accrued Payroll Expenses | $ 500 | | Total Current Liabilities | $ 3,800 | | **Long-term liabilities** | $ | | Notes Payable, 1998 | $ 5,500 | | Total Liabilities | $ 9,300 | | Net Worth\* | $ 2,700 | | Total Liabilities and Net Worth | $12,000 |  |  | | --- | | \*Net Worth = Assets - Liabilities |   **Assets**  In this section, each type of asset is explained. A worksheet is provided for your use in assembling a balance sheet for your business at the end of this section.  All balance sheets show the same categories of assets: *current assets*, *long-term (fixed) assets*, and *other assets*. Assets are arranged in order of how quickly they can be turned into cash. Turning assets into cash is called liquidity.  **Current assets include cash, stocks and bonds, accounts receivable, inventory, prepaid expenses and anything else that can be converted into cash within one year or during the normal course of business.**These are the categories you will use to group your current assets. This Business Builder focuses on the current assets most commonly used by small businesses: cash, accounts receivable, inventory, and prepaid expenses.  Cash is relatively easy to figure out. It includes cash on hand, in the bank and in petty cash.  Accounts receivable is what you are owed by customers. The easy availability of this information is important. Fast action on slow paying accounts may be the difference between success and failure for a small business. To make this number more realistic, you should deduct an amount from accounts receivable as an allowance for bad debts.  Inventory may be your largest current asset. On a balance sheet, the value of inventory is the cost to replace it. If your inventory were destroyed, lost or damaged, how much would it cost you to replace or reproduce it? Inventory includes goods ready for sale, as well as raw material and partially completed products that will be for sale when they are completed.  Prepaid expenses are listed as a current asset because they represent an item or service that has been paid for but has not been used or consumed. An example of a prepaid expense is the last month of rent of a lease that you may have prepaid as a security deposit. It will be carried as an asset until it is used. Prepaid insurance premiums are another example of a prepaid expense. Sometimes, prepaid expenses are also referred to as unexpired expenses.  On a balance sheet, current assets are totaled and this total is shown as the line item: Total Current Assets.  ***Step 1: Complete The Current Asset Section Of The Worksheet.***  Fixed Assets are also known as Long-term assets. Fixed assets are the assets that produce revenues. They are distinguished from current assets by their longevity. They are not for resale. Many small businesses may not own a large amount of fixed assets. This is because most small businesses are started with a minimum of capital. Of course, fixed assets will vary considerably and depend on the business type (such as service or manufacturing), size and market.  Fixed assets include furniture and fixtures, motor vehicles, buildings, land, building improvements (or leasehold improvements, if you rent), production machinery, equipment and any other items with an expected business life that can be measured in years.  All fixed assets (except land) are shown on the balance sheet at original (or historic) cost less any depreciation.**Subtracting depreciation is a conservative accounting practice to reduce the possibility of overvaluation.**Depreciation subtracts a specified amount from the original purchase price for the wear and tear on the asset. It is important to remember that original cost may be more than the asset's invoice price. It can include shipping, installation, and any associated expenses necessary for readying the asset for service.  This Business Builder assumes that you are familiar with depreciation and have already selected a depreciation method and are comfortable with its application. If you are not familiar with depreciation, you can still prepare a balance sheet. It will provide you with similar benefits, but it will not be in conformance with GAAP.  This section concentrates on the categories of fixed assets common to most small businesses: furniture and fixtures, motor vehicles, and machinery and equipment.   * Furniture and fixtures is a line item that includes office furniture, display shelves, counters, work tables, storage bins and other similar items. On the balance sheet, these items are listed at cost (plus related expenses) minus depreciation. * Motor vehicles is a line item to list the original value (less depreciation) of any motor vehicle, such as a delivery truck, that is owned by your business. * Machinery and equipment are vital to many businesses. If you are a manufacturing firm, this could be your largest fixed asset. Like the other fixed assets on the balance sheet, machinery and equipment will be valued at the original cost minus depreciation. * Other assets is a third category of fixed assets. Other assets are generally intangible assets—such as patents, royalty arrangements and copyrights.   ***Step 2: Complete The Fixed Asset Section And The Other Asset Section Of The Worksheet And Compute The Total Assets Of Your Business.***  **Liabilities**  In this section, two types of liabilities will be explained. You will continue to use the worksheet and at the end of this section. Liabilities are claims of creditors against the assets of the business. They are debts owed by the business.  There are two types of liabilities: **Current Liabilities** and **Long-Term Liabilities**. Liabilities are arranged on the balance sheet in order of how soon they must be repaid. For example, accounts payable will appear first as they are generally paid within 30 days. Notes payable are generally due within 90 days and are the second liability to appear on the balance sheet.  **Current Liabilities** are accounts payable, notes payable to banks (or others), accrued expenses (such as wages and salaries), taxes payable, the current—due within one year—portion of long-term debt and any other obligations to creditors due within one year from the date of the balance sheet. The current liabilities of most small businesses include accounts payable, notes payable to banks, and accrued payroll taxes.  Accounts payable is the amount you may owe any suppliers or other creditors for services or goods that you have received but not yet paid for.  Notes payable refers to any money due on a loan during the next 12 months.  Accrued payroll taxes would be any compensation to employees who have worked, but have not been paid, at the time the balance sheet is created.  **Long-Term Liabilities** are any debts that must be repaid by your business more than 1 year from the date of the balance sheet. This may include startup financing from relatives, banks, finance companies or others.  ***Step 3: Complete The Liabilities Section Of The Worksheet. Compute Total Liabilities.***  **Net Worth**  **The formula that defines the balance sheet:**  **Assets = Liabilities + Net Worth**  can be transposed to yield a definition of net worth  **Net Worth = Assets - Liabilities**  Net worth is what is left over after liabilities have been subtracted from the assets of the business. In a sole proprietorship, it is also known as owner's equity. This equity is the investment by the owner plus any profits or minus any losses that have accumulated in the business.  ***Step 4: Complete The Net Worth Section Of The Worksheet. When This Is Done, You Should Have A Completed Balance Sheet For Your Business.***  In the next section, 4 simple formulas will be introduced to enhance the information contained on the balance sheet.  The information in the preceding section will help you develop a balance sheet of your own.  **How To Analyze A Balance Sheet** [[top](http://www.esmalloffice.com/SBR_template.cfm?DocNumber=PL12_0200.htm#top)]  Now that you have created a balance sheet for your business, there are some easy calculations that you can perform that will give you a better understanding of your company. Using data from your balance sheet, you can calculate liquidity and leverage ratios.  These financial ratios turn the raw financial data from the balance sheet into information that will help you manage your business and make knowledgeable decisions. A ratio shows the relationship between two numbers. It is defined as the relative size of two quantities expressed as the quotient of one divided by the other. Financial ratio analysis is important because it is one method loan officers use to evaluate the creditworthiness of potential borrowers. Ratio analysis is a tool to uncover trends in a business as well as allow the comparison between one business and another.  In the following section, four financial ratios that can be computed from a balance sheet are examined:   * Current Ratio * Quick Ratio * Working Capital * Debt/Worth Ratio   **Current Ratio**  The *current ratio* (or liquidity ratio) is a measure of financial strength. The number of times current assets exceed current liabilities is a valuable expression of a business' solvency. Here is the formula to compute the current ratio:   |  |  | | --- | --- | | **Current Ratio =** | **Total Current Assets**  **Total Current Liabilities** |   **The current ratio answers the question, "Does my business have enough current assets to meet the payment schedule of current liabilities with a margin of safety?"**A rule-of-thumb puts a strong current ratio at two. Of course, the adequacy of a current ratio will depend on the nature of the small business and the character of the current assets and current liabilities. While there is usually little doubt about debts that are due, there can be considerable doubt about the quality of accounts receivable or the cash value of inventory.  A current ratio can be improved by either increasing current assets or decreasing current liabilities. This can take the form of the following:   * Paying down debt. * Acquiring a loan (payable in more than 1 year's time.) * Selling a fixed asset. * Putting profits back into the business.   A high current ratio may mean that cash is not being utilized in an optimal way. That is, the cash might better be invested in equipment.  **Quick Ratio**  The *quick ratio* is also called the "acid test" ratio. It is a measure of a company's liquidity. The quick ratio looks only at a company's most liquid assets and divides them by current liabilities. Here is the formula for the quick ratio:   |  |  | | --- | --- | | **Quick Ratio =** | **Current Assets - Inventory**  **Total Current Liabilities** |   The assets considered to be "quick" assets are cash, stocks and bonds, and accounts receivable (all of the current assets on the balance sheet except inventory). The quick ratio is an acid test of whether or not a business can meet its obligations if adverse conditions occur. Generally, quick ratios between .50 and 1 are considered satisfactory—as long as the collection of receivables is not expected to slow.  **Working Capital**  *Working capital* should always be a positive number. It is used by lenders to evaluate a company's ability to weather hard times. Often, loan agreements specify a level of working capital that the borrower must maintain. The current ratio, quick ratio and working capital are all measures of a company's liquidity. In general, the higher these ratios are, the better for the business and the higher degree of liquidity.  **Working Capital = Total Current Assets - Total Current**  **Liabilities**  **Debt/Worth Ratio**  The [*debt/worth ratio*](http://www.esmalloffice.com/SBR_template.cfm?DocNumber=PL12_0200.htm#Debt/Worth Ratio.) (or leverage ratio) is an indicator of a business' solvency. It is a measure of how dependent a company is on debt financing (or borrowings) as compared to owner's equity. It shows how much of a business is owned and how much is owed. The debt/worth ratio is computed as follows:   |  |  | | --- | --- | | **Debt/Worth Ratio =** | **Total Liabilities**  **Net Worth** |   ***Step 5: Compute The Current Ratio, Quick Ratio, Working Capital, And Debt/Worth Ratio For Your Company.***  **Conclusion**  Since balance sheets present the health of a company as of one point in time, valuable information will be lost if managers do not take the opportunity to compare the progress and trend of a business by regularly evaluating and comparing balance sheets of past time periods. Information is power. The information that can be gleaned from the preparation and analysis of a balance sheet is one financial management tool that may mean the difference between success and failure.  **Checklist** [[top](http://www.esmalloffice.com/SBR_template.cfm?DocNumber=PL12_0200.htm#top)]  **Assets**  \_\_\_\_ Have you included all current assets on the worksheet?  \_\_\_\_ Did you adjust accounts receivable for bad debts?  \_\_\_\_ Is inventory valued at replacement cost?  \_\_\_\_ Did you include all appropriate prepaid expenses?  \_\_\_\_ Did you include any installation or delivery costs for fixed assets?  **Liabilities and Net Worth**  \_\_\_\_ Have all liabilities, both current and long term, been included on the balance sheet?  \_\_\_\_ Did you include all startup expenses payable in more than one year in long-term liabilities?  \_\_\_\_ On the worksheet, do assets minus liabilities equal net worth?  **Financial Ratio Analysis**  \_\_\_\_ Did you compute a current ratio, quick ratio, working capital and debt/worth ratio for your business?  \_\_\_\_ Is your current ratio greater than or equal to two? If not, do you know what adjustments might be made?  **Glossary** [[top](http://www.esmalloffice.com/SBR_template.cfm?DocNumber=PL12_0200.htm#top)]  **Allowance For Bad Debts -**Amount of estimated debt to the business that is not expected to be repaid and is subtracted from accounts receivable on the balance sheet. Also known as an allowance for doubtful accounts.  **Assets -**Anything that a business owns that has monetary value.  **Accounts Payable -**Debts of the business, often to suppliers, and generally payable within 30 days.  **Accounts Receivable -**An amount owed to the business, usually by one of its customers, as result of the extension of credit.  **Accrued Payroll Taxes -**Taxes payable for employee services received, but for which payment has not yet been made.  **Balance Sheet -**A financial statement showing the assets, liabilities, and net worth of a business as of a specific date.  **Current Assets -**Cash and other assets readily converted into cash. Includes accounts receivable, inventory, and prepaid expenses.  **Current Liabilities -**The debts of a company which are due and payable within the next 12 months.  **Current Ratio -**Current assets divided by current liabilities.  **Debt/Worth Ratio -**Total Liabilities divided by Net Worth.  **Depreciation -**An accounting convention to take into account the physical deterioration of an asset. It is a systematic method to allocate the historical cost of the asset over its useful life.  **Fixed Assets -**Also called long-term assets with a relatively long life that are used in the production of goods and services, rather than being for resale.  **Gaap -**Abbreviation of Generally Accepted Accounting Principles. Conventions, rules, and procedures that define accepted accounting practice.  **Inventory -**Goods held for sale, raw material and partially finished products which will be sold when they are finished.  **Liabilities -**Debts of the business.  **Liquidity -**The ability to produce cash from assets in a short period of time.  **Long-Term Liabilities -**Debts of a company due after a period of 12 months or longer.  **Net Worth -**The business owner's equity in a company as represented by the difference between assets and liabilities.  **Owners' Equity -**See Net Worth.  **Quick Ratio -**Current Assets minus Inventory, divided by Current Liabilities. Also known as the acid test.  **Working Capital -**Current Assets minus Current Liabilities. |

# Balance sheet - accounting for fixed assets

**Introduction**

An important distinction is made in accounting between "current assets" and " "fixed assets".

**Current assets** are those that form part of the circulating capital of a business. They are replaced frequently or converted into cash during the course of trading. The most common current assets are stocks, trade debtors, and cash.

Compare current assets with fixed assets. A **fixed asset** is an asset of a business **intended for continuing use**, rather than a short-term, temporary asset such as stocks.

Fixed assets must be classified in a company's balance sheet as **intangible, tangible, or investments.** Examples of intangible assets include goodwill, patents, and trademarks. Examples of tangible fixed assets include land and buildings, plant and machinery, fixtures and fittings, motor vehicles and it equipment.

**How should the changing value of a fixed asset be reflected in a company's accounts?**

The benefits that a business obtains from a fixed asset extend over several years. For example, a company may use the same piece of production machinery for many years, whereas a company-owned motor car used by a salesman probably has a shorter useful life.

By accepting that the life of a fixed asset is limited, the accounts of a business need to recognise the benefits of the fixed asset as it is "consumed" over several years.

This consumption of a fixed asset is referred to as **depreciation**.

**Definition of depreciation**

Financial reporting standard 15 (covering the accounting for tangible fixed assets) defines depreciation as follows:

"the wearing out, using up, or other reduction in the useful economic life of a tangible fixed asset whether arising from use, effluxion of time or obsolescence through either changes in technology or demand for goods and services produced by the asset.'

A portion of the benefits of the fixed asset will be used up or consumed in each accounting period of its life in order to generate revenue. To calculate profit for a period, it is necessary to match expenses with the revenues they help earn.

In determining the expenses for a period, it is therefore important to include an amount to represent the consumption of fixed assets during that period (that is, depreciation).

In essence, depreciation involves allocating the cost of the fixed asset (less any residual value) over its useful life. To calculate the depreciation charge for an accounting period, the following factors are relevant:

- the cost of the fixed asset;

- the (estimated) useful life of the asset;

- the (estimated) residual value of the asset.

**What is the relevant cost of a fixed asset?**

The cost of a fixed asset includes all amounts incurred to acquire the asset and any amounts that can be directly attributable to bringing the asset into working condition.

Directly attributable costs may include:

- delivery costs

- costs associated with acquiring the asset such as stamp duty and import duties

- costs of preparing the site for installation of the asset

- professional fees, such as legal fees and architects' fees

Note that general overhead costs or administration costs would not be included as part of the total  
costs of a fixed asset (e.g. The costs of the factory building in which the asset is kept, or the cost of the maintenance team who keep the asset in good working condition)

The cost of subsequent expenditure on a fixed asset will be added to the cost of the asset provided that this expenditure enhances the benefits of the fixed asset or restores any benefits consumed.

This means that major improvements or a major overhaul may be capitalised and included as part of the cost of the asset in the accounts.

However, the costs of repairs or overhauls that are carried out simply to maintain existing performance will be treated as expenses of the accounting period in which the work is done, and charged in full as an expense in that period.

**What is the useful life of a fixed asset?**

An asset may be seen as having a physical life and an economic life.

Most fixed assets suffer physical deterioration through usage and the passage of time. Although care and maintenance may succeed in extending the physical life of an asset, typically it will, eventually, reach a condition where the benefits have been exhausted.

However, a business may not wish to keep an asset until the end of its physical life. There may be a point when it becomes uneconomic to continue to use the asset even though there is still some physical life left.

The economic life of the asset will be determined by such factors as technological progress and changes in demand. For purposes of calculating depreciation, it is the estimated economic life rather than the potential physical life of the fixed asset that is used.

**What about the residual value of a fixed asset?**

At the end of the useful life of a fixed asset the business will dispose of it and any amounts received from the disposal will represent its residual value. This, again, may be difficult to estimate in practice. However, an estimate has to be made. If it is unlikely to be a significant amount, a residual value of zero will be assumed.

The cost of a fixed asset less its estimated residual value represents the total amount to be depreciated over its estimated useful life.

**ADVANTAGES OF ACCOUNTING**

Accounting replaces human memory

Accounting helps in knowing profit

Accounting helps in knowing financial position of organisation

Accounting helps in knowing list of creditors and debtors   
accounting helps in paying taxes

Accounting helps in raising more funds by supplying information to investors and creditors

Accounting helps in planning for expansion

Accounting helps in getting bank loans

## Uses of management accounting

Management accounts will enable you to:

* compare your accounts with original budgets or forecasts
* manage your resources better
* identify trends in your business
* highlight variations in your income or spending which may require attention

They should be used for the following:

**Record keeping**

* recording business transactions
* measuring results of financial changes
* projecting financial effects of future transactions
* preparing internal reports in a user-friendly format

**Planning and control**

* collecting cash
* controlling stocks
* controlling expenses
* co-ordination and monitoring of strategy/performance
* monitoring gross margins

**Decision making**

* using cost information for pricing, capital investment and marketing
* evaluating market and product profitability
* evaluating the financial effect of strategies and plans