Accounting Fundamentals

201 ACCO

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CHAPTER – 1

INTRODUCTION TO ACCOUNTING

Learning Objectives

After studying this Chapter, you will be able to:

Understand the Need, Meaning, Definition, Objectives and Advantages of Book-Keeping.

Know the Need, Definition, Objectives and Process of Accounting.

Distinguish between Book-Keeping and Accounting.

Identify the Users of Accounting Information and their Need.

Know the Basic Accounting Terms.

"Accounting is as old as money itself". Since in early ages commercial activities were based on barter system, record keeping was not a necessity. The Industrial Revolution of 19th century along with rapid rise in population, paved way for the development of commercial activities, mass production and credit terms. Thus recording of business transaction has become an important feature. In recent years with the change of technologies and marketing along with stiff competition, accounting system has undergone remarkable changes.

Need and Importance of Accounting

When a person starts a business, whether large or small, his main aim is to earn profit. He receives money from certain sources like sale of goods, interest on bank deposits etc. He has to spend money on certain items like purchase of goods, salary, rent, etc.

These activities take place during the normal course of his business.

He would naturally be anxious at the year end, to know the progress of his business. Business transactions are numerous, that it is not possible to recall his memory as to how the money had been earned and spent. At the same time, if he had noted down his incomes and expenditures, he can readily get the required information. Hence, the details of the business transactions have *to be recorded in a clear and systematic manner to get answers easily and accurately for the following questions at any time he likes.*

i. What has happened to his investment?

ii. What is the result of the business transactions?

iii. What are the earnings and expenses?

iv. How much amount is receivable from customers to whom goods have been sold on credit?

v. How much amount is payable to suppliers on account of credit purchases?

vi. What are the nature and value of assets possessed by the business concern?

vii. What are the nature and value of liabilities of the business concern?

These and several other questions are answered with the help of accounting. The need for recording business transactions in a clear and systematic manner is the basis which gives rise to Book-keeping.

Book-keeping

Book-keeping is that branch of knowledge which tells us how to keep a record of business transactions. It is often routine and clerical in nature. It is important to note that only those transactions related to business which can be expressed in terms of money are recorded. The activities of book-keeping include recording in the journal, posting to the ledger and balancing of accounts.

Definition

R.N. Carter *says, "Book-keeping is the science and art of correctly recording in the books of account all those business transactions that result in the transfer of money or money's worth".*

Objectives

The objectives of book-keeping are

i. To have permanent record of all the business transactions.

ii. To keep records of income and expenses in such a way that the net profit or net loss may be calculated.

iii. To keep records of assets and liabilities in such a way that the financial position of the business may be ascertained.

iv. To keep control on expenses with a view to minimize the same in order to maximize profit.

v. To know the names of the customers and the amount due from them.

vi. To know the names of suppliers and the amount due to them.

vii. To have important information for legal and tax purposes.

Advantages

From the above objectives of book-keeping, the following advantages can be noted

i. Permanent and Reliable Record: *Book-keeping provides permanent record for all business transactions, replacing the memory which fails to remember everything.*

ii. Arithmetical Accuracy of the Accounts: *With the help of book keeping trial balance can be easily prepared. This is used to check the arithmetical accuracy of accounts.*

iii. Net Result of Business Operations: *The result (Profit or Loss) of business can be correctly calculated.*

iv. Ascertainment of Financial Position: *It is not enough to know the profit or loss; the proprietor should have a full picture of his financial position in business. Once the full picture (say for a year) is known, this helps him to plan for the next year's business.*

v. Ascertainment of the Progress of Business: *When a proprietor prepares financial statements every year, he will be in a position to compare the statements. This will enable him to ascertain the growth of his business. Thus book keeping enables a long range planning of business activities besides satisfying the short term objective of calculation of annual profits or losses.*

vi. Calculation of Dues: *For certain transactions payments may be made later. Therefore, the businessman has to know how much he has to pay others.*

vii. Control over Assets: *In the course of business, the proprietor acquires various assets like building, machines, furniture, etc. He has to keep a check over them and find out their values year after year.*

viii. Control over Borrowings: *Many businessmen borrow from banks and other sources. These loans are repayable. Just as he must have a control over assets, he should have control over liabilities.*

ix. Identifying Do's and Don'ts: *Book keeping enables the proprietor to make an intelligent and periodic analysis of various aspects of the business such as purchases, sales, expenditures and incomes. From such analysis, it will be possible to focus his attention on what should be done and what should not be done to enhance his profit earning capacity.*

x. Fixing the Selling Price: *In fixing the selling price, the businessmen have to consider many aspects of accounting information such as cost of production, cost of purchases and other expenses. Accounting information is essential in determining selling prices.*

xi. Taxation: *Businessmen pay sales tax, income tax, etc. The tax authorities require them to submit their accounts. For this purpose, they have to maintain a record of all their business transactions.*

xii. Management Decision-making: *Planning, reviewing, revising, controlling and decision-making functions of the management are well aided by book-keeping records and reports.*

xiii. Legal Requirements: *Claims against and for the firm in relation to outsiders can be confirmed and established by producing the records as evidence in the court.*

Accounting

Book-keeping does not present a clear financial picture of the state of affairs of a business. When one has to make a judgement regarding the financial position of the firm, the information contained in these books of accounts has to be analyzed and interpreted. It is with the purpose of giving such information that accounting came into being.

Accounting is considered as a system which collects and processes financial information of a business. These information are reported to the users to enable them to make appropriate decisions.

Definition

American Accounting Association *defines accounting as "the process of identifying, measuring and communicating economic information to permit informed judgments and decision by users of the information".*

Objectives

The main objectives of accounting are

i. To maintain accounting records.

ii. To calculate the result of operations.

iii. To ascertain the financial position.

iv. To communicate the information to users.

Process

The process of accounting as per the above definition is given below:

Input		***Process***		***Output***
Business Transactions (monetary value)		*Identifying Recording Classifying Summarizing Analyzing Interpreting Communicating*		*Information To Users*

In order to accomplish its main objective of communicating information to the users, accounting embraces the following functions.

i. Identifying: *Identifying the business transactions from the source documents.*

ii. Recording: *The next function of accounting is to keep a systematic record of all business transactions, which are identified in an orderly manner, soon after their occurrence in the journal or subsidiary books.*

iii. Classifying: *This is concerned with the classification of the recorded business transactions so as to group the transactions of similar type at one place. i.e., in ledger accounts. In order to verify the arithmetical accuracy of the accounts, trial balance is prepared.*

iv. Summarizing: *The classified information available from the trial balance are used to prepare profit and loss account and balance sheet in a manner useful to the users of accounting information.*

v. Analyzing: *It establishes the relationship between the items of the profit and loss account and the balance sheet. The purpose of analyzing is to identify the financial strength and weakness of the business. It provides the basis for interpretation.*

vi. Interpreting: *It is concerned with explaining the meaning and significance of the relationship so established by the analysis.*

Interpretation should be useful to the users, so as to enable them to take correct decisions.

vii. Communicating: *The results obtained from the summarized, analyzed and interpreted information are communicated to the interested parties.*

Accountancy, Accounting and Book-keeping

Accountancy *refers to a systematic knowledge of accounting.*

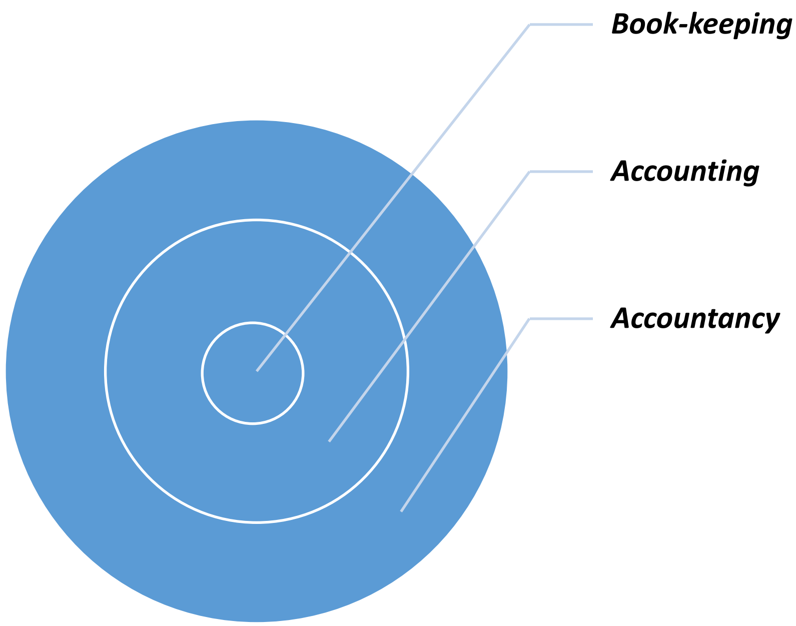
It explains "why to do" and "how to do" of various aspects of accounting. It tells us why and how to prepare the books of accounts and how to summarize the accounting information and communicate it to the interested parties.

Accounting *refers to the actual process of preparing and presenting the accounts. In other words, it is the art of putting the academic knowledge of accountancy into practice.*

Book-keeping *is a part of accounting and is concerned with record keeping or maintenance of books of accounts. It is often routine and clerical in nature.*

***Relationship* between Accountancy, Accounting and Book-keeping**

Book-keeping provides the basis for accounting and it is complementary to accounting process. Accounting begins where book-keeping ends. Accountancy includes accounting and book-keeping. The terms Accounting and Accountancy are used synonymously. This relationship can be easily understood with the help of the following diagram.



Users of Accounting Information

The basic objective of accounting is to provide information which is useful for persons and groups inside and outside the organization.

I. Internal users: *Internal users are those individuals or groups who are within the organization like owners, management, employees and trade unions.*

II. External users: *External users are those individuals or groups who are outside the organization like creditors, investors, banks and other lending institutions, present and potential investors, Government, tax authorities, regulatory agencies and researchers.*

The users and their need for information are as follows:

Users	***Need for Information***
Internal	
i. Owners	*To know the profitability and financial soundness of the business.*
ii Management	*To take prompt decisions to manage the business efficiently.*
iii. Employees and Trade unions	*To form judgment about the earning capacity of the business since their remuneration and bonus depend on it.*
External	
i. Creditors, banks and other lending institutions	*To determine whether the principal and the interest thereof will be paid in when due.*
ii. Present investors	*To know the position, progress and prosperity of the business in order to ensure the safety of their investment.*
iii Potential investors	*To decide whether to invest in the business or not.*
iv. Government and Tax authorities	*To know the earnings in order to assess the tax liabilities of the business.*
v. Regulatory agencies	*To evaluate the business operation under the regulatory legislation.*
vi. Researchers	*To use in their research work.*

Basic Accounting Terms VERY IMPORNTANT (مهمة جداً)

The understanding of the subject becomes easy when one has the knowledge of a few important terms of accounting. Some of the mare explained below.

***Transactions** are those activities of a business, which involve transfer of money or goods or services between two persons or two accounts. For example, purchase of goods, sale of goods, borrowing from bank, lending of money, salaries paid, rent paid, commission received and dividend received. Transactions are of two types, namely, cash and credit transactions.*

***Cash Transaction** is one where cash receipt or payment is involved in the transaction. For example, When Saad buys goods from Ahmed paying the price of goods by cash immediately, it is a cash transaction.*

***Credit Transaction** is one where cash is not involved immediately but will be paid or received later. In the above example, if Saad, does not pay cash immediately but promises to pay later, it is credit transaction.*

***Proprietor:** A person who owns a business is called its proprietor. He contributes capital to the business with the intention of earning profit.*

***Capital:** It is the amount invested by the proprietor/s in the business. This amount is increased by the amount of profits earned and the amount of additional capital introduced. It is decreased by the amount of losses incurred and the amounts withdrawn. For example, if Mr. Ahmad starts business with Sr.5, 00,000, his capital would be Sr.5, 00,000.*

Assets

Assets are the properties of every description belonging to the business. Cash in hand, plant and machinery, furniture and fittings, bank balance, debtors, bills receivable, stock of goods, investments, Goodwill are examples for assets. Assets can be classified into tangible and intangible.

Tangible Assets: *These assets are those having physical existence. It can be seen and touched. For example, plant & machinery, cash, etc.*

Intangible Assets: *Intangible assets are those assets having no physical existence but their possession gives rise to some rights and benefits to the owner. It cannot be seen and touched. Goodwill, patents, trademarks are some of the examples.*

Current Asset*: A current asset is cash or any asset that can be reasonably converted to cash within one year.*
Current assets typically include categories such as cash, marketable securities, short-term investments, accounts receivable , prepaid expenses, and inventory.

Liabilities
Liabilities refer to the financial obligations of a business. These denote the amounts which a business owes to others, e.g., loans from banks or other persons, creditors for goods supplied, bills payable, outstanding expenses, bank overdraft etc.

Drawings
It is the amount of cash or value of goods withdrawn from the business by the proprietor for his personal use. It is deducted from the capital.

Income
Income is the difference between revenue and expense.

Debtors
A person (individual or firm) who receives a benefit without giving money or money's worth immediately, but liable to pay in future or in due course of time is a debtor. The debtors are shown as an asset in the balance sheet. For example, Mr. Anwar bought goods on credit from Mr. Babur for Sr.10, 000. Mr. Anwar is a debtor to Mr. Babur till he pays the value of the goods.

Creditors
A person who gives a benefit without receiving money or money's worth immediately but to claim in future, is a creditor. The creditors are shown as a liability in the balance sheet. In the above example Mr. Babur is a creditor to Mr. Anwar till he receive the value of the goods.

Purchases
Purchases refers to the amount of goods bought by a business for resale or for use in the production. Goods purchased for cash are called ***cash purchases****. If it is purchased on credit, it is called as* ***credit purchases****. Total purchases include both cash and credit purchases.*

Purchases Return or Returns Outward

When goods are returned to the suppliers due to defective quality or not as per the terms of purchase, it is called as purchases return. To find net purchases, purchases return is deducted from the total purchases.

Sales

Sales refers to the amount of goods sold that are already bought or manufactured by the business. When goods are sold for cash, they are ***cash sales*** *but if goods are sold and payment is not received at the time of sale, it is* ***credit sales****. Total sales includes both cash and credit sales.*

Sales Return or Returns Inward

When goods are returned from the customers due to defective quality or not as per the terms of sale, it is called sales return or returns inward. To find out net sales, sales return is deducted from total sales.

Stock / Inventory

Stock includes goods unsold on a particular date. Stock may be opening and closing stock. The term opening stock means goods unsold in the beginning of the accounting period. Whereas the term closing stock includes goods unsold at the end of the accounting period. For example, if 4,000 units purchased @ Sr. 20 per unit remain unsold, the closing stock is Sr...80,000. This will be opening stock of the subsequent year.

Revenue

Revenue means the amount receivable or realized from sale of goods and earnings from interest, dividend, commission, etc.

Expense

It is the amount spent in order to produce and sell the goods and services. For example, purchase of raw materials, payment of salaries, wages, etc.

Voucher: *It is a written document in support of a transaction. It is a proof that a particular transaction has taken place for the value stated in the voucher. It may be in the form of cash receipt, invoice, cash memo, bank pay-in-slip etc. Voucher is necessary to audit the accounts.*

Invoice *is a business document which is prepared when one sell goods to another. The statement is prepared by the seller of goods. It contains the information relating to name and address of the seller and the buyer, the date of sale and the clear description of goods with quantity and price.*

Receipt *is an acknowledgement for cash received. It is issued to the party paying cash. Receipts form the basis for entries in cashbook.*

Account is *a summary of relevant business transactions at one place relating to a person, asset, expense or revenue named in the heading. An account is a brief history of financial transactions of a particular person or item. An account has two sides called debit side and credit side.*

QUESTIONS

A) Fill in the blanks:

1. The amount which the proprietor has invested in the business is _______________.

2. Book-keeping is an art of recording ____________ in the book of accounts.

3. ____________ is a written document in support of a transaction.

4. Accounting begins where _______ ends.

5. Liabilities refer to the ____________ obligations of a business.

6. Owner of the business is called ___________.

7. A/an ____________ is a summary of relevant business transactions at one place relating to a person, assets, expense or revenue named in the heading.

8. Receipt is an acknowledgement for ___________.

9. Income is the difference between revenue and ________.

B) Choose the correct answer:

1. The debts owing to others by the business is known as a) liabilities b) expenses c) debtors

2. Assets minus liabilities is a) drawings b) capital c) credit

3. A written document in support of a transaction is called a) receipt b) credit note c) voucher

4. Business transactions may be classified into a) three b) two c) one

5. Amount spent in order to produce and sell the goods and services is called a) expense b) income c) revenue

CHAPTER – 2

BRANCHES OF ACCOUNTING

Learning Objectives

After studying this Chapter, you will be able to:

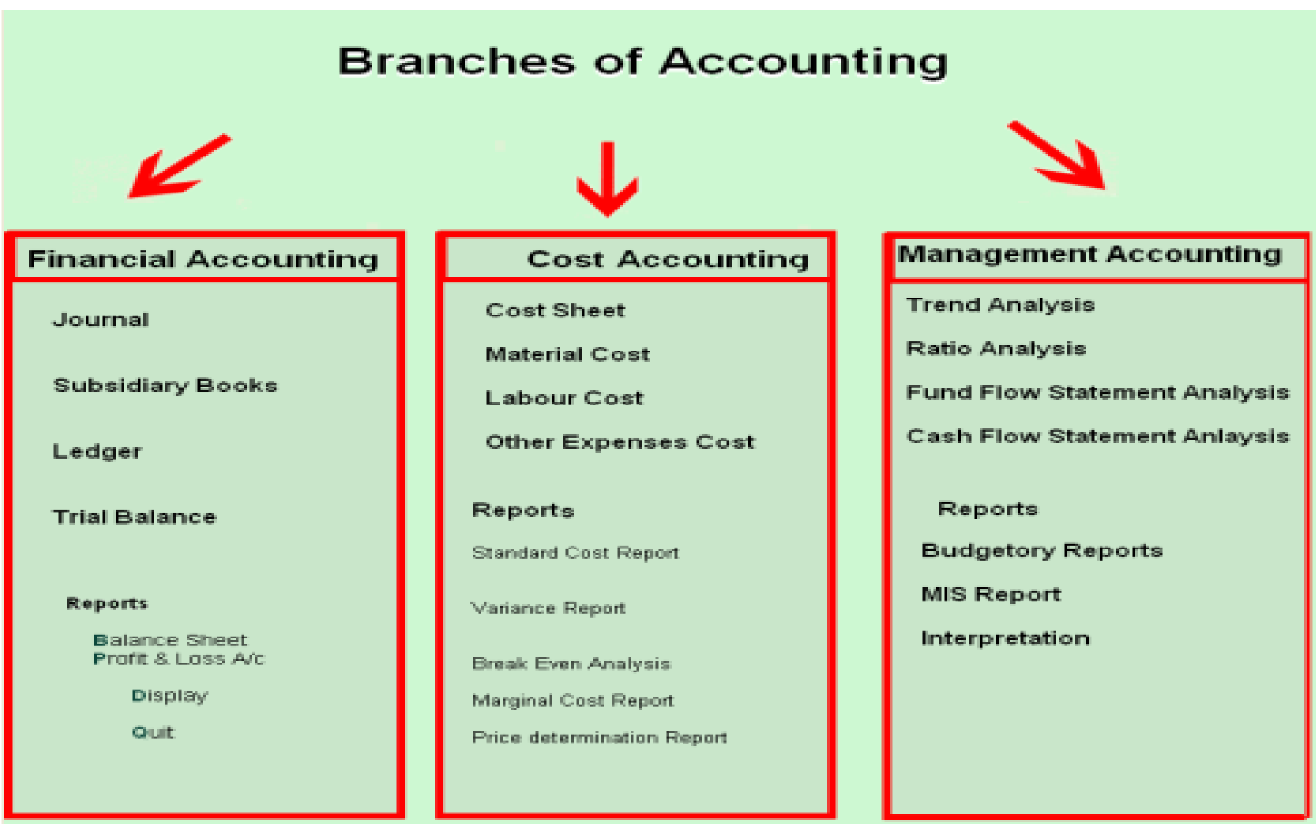
Understand the different branches of accounting and their needs.

Know the Basic Assumptions of Accounting,

Understand the Basic Accounting Concepts.

Know the Modifying Principles of Accounting.

Different branches of accounting came into existence keeping in view various types of accounting information needed by a different class of people viz. owners, shareholders, management, suppliers, creditors, taxation authorities and various government agencies, etc. There are three main branches of accounting which include financial accounting, cost accounting and management accounting.



Financial Accounting

Financial Accounting is based on a systematic method of recording transactions of any business according to the accounting principles. It is the original form of the accounting process. The main purpose of financial accounting is ***to calculate the profit or loss*** *of a business during a period and to provide an accurate picture of the financial position of the business as on a particular date. The Trial Balances, Profit & Loss Accounts and Balance Sheets of a company are based on an application of financial accounting. These are used by* ***creditors, banks and financial institutions to assess the financial status of the company. Further, taxation authorities are able to calculate the tax based on these records only.***

Cost Accounting

Cost accounting deals with evaluating the cost of a product or service offered. It ***calculates the cost by considering all factors that contribute to the production of the output, both manufacturing and administrative factors****. The objective of cost accounting is to help the management in fixing the prices and controlling the cost of production. It also pin points any wastages, leakages and defects during manufacturing and marketing processes.*

Management Accounting

This branch of accounting ***provides information to management*** *for better administration of the business. It helps in making important decisions and controlling of various activities of the business. The management is able to take decisions efficiently with the help of various Management Information Systems such as Budgets, Projected Cash Flow and Fund Flow Statements, Variance Analysis reports, Cost-Volume-Profit Analysis reports, Break-Even-Point calculation, etc.*

Management accounting and financial accounting *are not to be confused with each other. Both are different. Management accounting serves the needs of the management in decision makings regarding minimization of the cost factor and enhancing of profit making. Financial accounting serves the needs of shareholders, creditors and financial institutions for ascertaining* *the financial position of the company.* Management accounting *records are kept secret for the use of management only. They are not made public.*

<u>Accounting is the language of business</u>*. It records business transactions taking place during the accounting period. Accounting communicates the result of the business transactions in the form of final accounts. With a view to make the accounting results understood in the same sense by all interested parties, certain accounting assumptions, concepts and principles have been developed over a course of period.*

<u>*Basic Accounting Assumptions, concepts and Principles*</u>

These basics of accounting are like the ***<u>foundation pillars</u>*** *on which the structure of accounting is based:*

1. Accounting Entity Assumption "الوحدة المحاسبية المستقلة"

According to this assumption, business is treated as a unit or entity apart from its owners, creditors and others. In other words, the proprietor of a business concern is always considered to be separate and distinct from the business which he controls. All the business transactions are recorded in the books of accounts from the view point of the business. Even the proprietor is treated as a creditor to the extent of his capital.

2. Money Measurement Assumption "وحدة القياس النقدي"

In accounting, only those business transactions and events which are of financial nature are recorded. For example, when Sales Manager is not on good terms with Production Manager, the business is bound to suffer. This fact will not be recorded, because it cannot be measured in terms of money.

3. Accounting Period Assumption "الفترة المحاسبية"

The users of financial statements need periodical reports to know the operational result and the financial position of the business concern. Hence, it becomes necessary to close the accounts at regular intervals. Usually a period of 365 days or 52 weeks or 1 year is considered as the accounting period.

*4. **Going Concern Assumption "الاستمرارية"***

As per this assumption, the business will exist for a long period and transactions are recorded from this point of view. There is neither the intention nor the necessity to wind up the business in the foreseeable future.

Concepts

1. Revenue Realization Concept "تحقق الإيراد"

According to this concept, revenue is considered as the income earned on the date when it is realized. Unearned or unrealized revenue should not be taken into account. The realization concept is vital for determining income pertaining to an accounting period. It avoids the possibility of inflating incomes and profits.

2. Historical Cost Concept "مبدأ التكلفة التاريخية"

Under this concept, assets are recorded at the price paid to acquire them and this cost is the basis for all subsequent accounting for the asset. For example, if a piece of land is purchased for Sr. 500,000 and its market value is Sr. 800,000 at the time of preparing final accounts the land value is recorded only for Sr. 500,000. Thus, the balance sheet does not indicate the price at which the asset could be sold for.

3. Matching Concept "المقابلة "

Matching the revenues earned during an accounting period with the cost associated with the period to ascertain the result of the business concern is called the matching concept. It is the basis for finding accurate profit for a period which can be safely distributed to the owners.

4. Full Disclosure Concept "الإفصاح التام"

Accounting statements should disclose fully and completely all the significant information. Based on this, decisions can be taken by various interested parties. It involves proper classification and explanations of accounting information which are published in the financial statements.

5. Verifiable and Objective Evidence Concept

This principle requires that each recorded business transactions in the books of accounts should have an adequate evidence to support it.

For example, cash receipt for payments made. The documentary evidence of transactions should be free from any bias. As accounting records are based on documentary evidence which are capable of verification, it is universally acceptable.

Principles

1. Cost Benefit Principle "مبدأ التكلفة"

This modifying principle states that the cost of applying a principle should not be more than the benefit derived from it. If the cost is more than the benefit then that principle should be modified.

2. Materiality Principle "الأهمية النسبية"

The materiality principle requires all relatively relevant information should be disclosed in the financial statements. Unimportant and immaterial information are either left out or merged with other items.

3. Consistency Principle "مبدأ الثبات"

The aim of consistency principle is to preserve the comparability of financial statements. The rules, practices, concepts and principles used in accounting should be continuously observed and applied year after year. Comparisons of financial results of the business among different accounting period can be significant and meaningful only when consistent practices were followed in ascertaining them. For example, whichever method is followed, it should be followed regularly.

4. Conservatism Principle "الحيطة والحذر (التحفظ)"

Conservatism principle takes into consideration all prospective losses but leaves all prospective profits. The essence of this principle is "anticipate no profit and provide for all possible losses". For example, while valuing stock in trade, market price or cost price whichever is less is considered.

Frame Work of Accounting

Assumptions	***Concepts***	***Principles***
1. Accounting Entity *2. Money Measurement* *3. Accounting Period* *4. Going Concern*	*1. Revenue Realization* *2. Historical Cost* *3. Matching* *4. Full Disclosure* *5. Verifiable and objective evidence*	*1. Cost Benefit* *2. Materiality* *3. Consistency* *4. Conservatism*

QUESTIONS

a) Fill in the Blanks:

1. Stock in trade are to be recorded at cost or market price whichever is less is based on ______________ principle.

2. The assets are recorded in books of accounts in the cost of acquisition is based on ______________ concept.

3. The benefits to be derived from the accounting information should exceed its cost is based on ______________ principle.

4. Transactions between owner and business are recorded separately due to ______________ assumption.

5. Business concern must prepare financial statements at least once in a year is based on ____________ assumption.

6. ______________ principle requires that the same accounting methods should be followed from one accounting period to the next.

b) Choose the correct answer:

1. As per the business entity assumption, the business is different from the a) owners b) banker c) government

2. Going concern assumption tell us the life of the business is a) very short b) very long c) none

3. Cost incurred should be matched with the revenues of the particular period is based on a) matching concept b) historical cost concept c) full disclosure concept