

Basics of Accounting



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What is accounting ?



Accounting is a **link** between business activities and decision makers

- ✓ Accounting measures business activities by **recording data** about them for future use.
- ✓ Data are stored until needed and then processed to become **useful** information.
- ✓ Information is communicated, through **reports**, to decision makers.



What is the purpose of accounting ?

Accounting information is utilised by -

Internal users -
Management of the
company



External users with
direct financial
interest - Investors,
Creditors, etc

External users with
indirect financial
interest - Tax
authorities, Labour
Unions, Investment
advisors, Consumer
groups, etc



What is the purpose of accounting ?

Income
Statement

Statement of
Financial
Position

Statement of
Changes in
Equity

Cash Flow
Statement



Evaluate performance of business (including comparison with past yrs)



Understand cash flow position of the business



Efficient control over assets



Compliance with legal requirements (taxes, stock exchanges, etc)



Communicate financial performance to stakeholders



Facilitate decision making (business growth, cost control, etc)

What are the basic accounting principles ?

1. Accrual Accounting

- a. Records business transactions **when they occur**
- b. Complies with GAAP
- c. Presents **accurate** financial picture



Accrual accounting records **both** cash & non-cash transactions

income is reported in the financial year it is **earned**, regardless of when it is received.

Expenses are deducted in the financial year they are **incurred**, regardless of when they are paid.

What are the basic accounting principles ?

2. Conservatism

- ✓ The basic accounting principle of conservatism leads accountants to anticipate or **disclose losses**

But it does **not allow** a similar action for gains !!!!



For example



Potential losses from lawsuits will be reported on the financial statements or in the notes



Potential gains will not be reported

What are the basic accounting principles ?

3. Economic Entity



Business owner is considered a **separate entity** from the business



Personal transactions are kept separate and **not recorded** in the books of the business



For example

Money invested by the owner into the business is a **Loan (Capital)** for the business

Money withdrawn by the owner from the business is recorded as **Drawings**



What are the basic accounting principles ?

4. Monetary Unit Assumption



Economic activity is measured in U.S. dollars/ GBP/ Euros, etc , and only transactions that can be expressed in **monetary currency** are recorded.



If any transaction is settled in kind, it must be given a **monetary value** and then recorded in the books of accounts



What are the basic accounting principles ?

5. Time Period Assumption



Accounting transactions are reported with respect to a financial year; reporting is also done for a half year, quarter, etc.



Also known as the periodicity assumption

The period of time must be shown in the heading of each financial statement

- ❖ Income statement
- ❖ Statement of stockholders' equity
- ❖ Statement of cash flows.

BUSINESS CONSULTING COMPANY.	
Income Statement	
For the Year Ended December 31, 2015	
Revenue:	
Consulting revenue earned	\$ 82,500
Expenses:	
Salaries expense	\$ 42,500
Supplies expense	1,950
Rent expense	6,000
Insurance expense	950
Advertising expense	250
Depreciation expense - equipment	900
Interest expense	450
	<u>53,000</u>
Income before income tax	\$ 29,500
Income tax expense	11,500
Net income	<u>\$ 18,000</u>

What are the basic accounting principles ?

6. Matching Principle

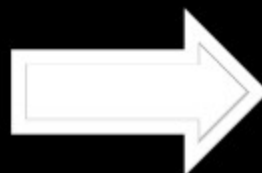
- ✓ In line with Accrual basis of accounting, the matching principle requires that expenses be matched with revenues.
- ✓ If expenses are not properly recorded in the correct period, the net income for a particular period may be either understated or overstated and so will be the related asset/liability balances.

For example

Assume that a retail company makes most of its **sales on account** (i.e., on credit);

Hence, it carries a large balance in its books in the form of **Accounts Receivable**.

It estimates that 4% of its A/R balance at the end of 2017 will be **uncollectible** in 2018.



The company records **estimated bad debt expense** on the last day of 2017 – in the same year that the **associated sales** revenues were recorded.

In this way, revenues and expenses are **matched** in the same period.

What are the basic accounting principles ?

7. Cost Principle

- ✓ "Cost" refers to the **amount spent** (cash or the cash equivalent) when an item was originally obtained
- ✓ All costs shown in financial statements are referred to as **historical costs**.
- ✓ The concept of **historical cost** is **important** because market values change so often that allowing reporting of assets and liabilities at current values would **distort** the whole fabric of accounting, impair **comparability** and makes accounting information **unreliable**.



Let's assume that a company **purchased land in 2005 for \$100,000.**

Today the land should be reported on the **at its historical cost of \$100,000**

even though its **current cost**, appraised value, etc and assessed value amounts to approx. **\$600,000**

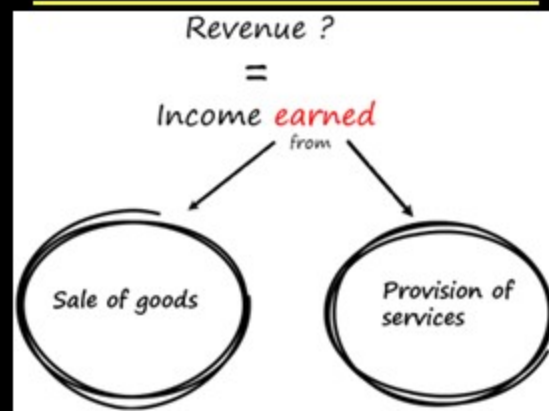
What are the basic accounting principles ?

8. Revenue Recognition Principle

\$ Under the **accrual basis** of accounting - revenues are recognized as soon as a product has been **sold** or a **service has been performed**, regardless of when the money is actually received.

\$ Hence, both **Cash & Credit** transactions are recorded

What is revenue ?



A **credit transaction** means that payment has not been made – **neither through cash or online remittance or credit card or any other means**

For eg. Torrent Industries sold goods worth \$56000 to AB industries on **30 day credit** terms. This will be recorded as a Revenue/ Sales even though the money hasn't been collected from the customer

What are the basic accounting principles ?

9. Going Concern



This accounting principle assumes that a company will continue to exist long enough to carry out its objectives and commitments and will **not liquidate** in the foreseeable future..



If the business shows signs that it is not in the position to be assumed to continue to exist into the near future, this is known as **going concern risk**



- A company manufactures a chemical known as Chemical-X. Suddenly, the government imposes a **restriction on the manufacture**, import, export, marketing and sale of this chemical in the country.
- If Chemical-X is the **only product** that company manufactures, the company will no longer be a going concern.



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