BASICS OF ACCOUNTING

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What is accounting and who use it?

The ultimate goal of financial accounting is to compile business transactions and other input documents like invoices and receipts in the form of general-purpose financial statements that can be understood by external users. The key is that external users must be able to understand and use this financial information when they are making decisions about the company.

Who are external users?

Shareholders or Investors: These can be individuals or entities which own the enterprise by virtue of holding the shares in the company. The ownership would have been acquired by subscribing to the share capital through an offer by the company / promoters or by buying the shares in the open market, if the shares are traded. They will participate in the profits and losses of the company. Participation in the losses might be limited or unlimited depending upon the type of organization.

Lenders or Creditors: Are the people who fund the company to get over the short or long terms financial needs of the company. They do not possess any ownership rights. However, they would lend money at some interest rate.

Customers: People or entities which buy goods and services from the enterprise.

Suppliers: Those who supply goods or services to the enterprise.

Regulators: Government agencies who regulate the type of businesses.

Media: Report about the way the company and the promoters operate.

Basic Accounting Terms:

In order to understand the subject matter clearly, one must understand the following common expressions always used in business accounting. The aim here is to enable the student to understand with these often-used concepts before getting into actual accounting concepts.

Transaction: It means an event or a business activity which involves exchange of money or money's worth between parties. The event can be measured in terms of money and changes the financial position of a person e.g. purchase of goods would involve receiving material and making pay mentor creating an obligation to pay to the supplier at a future date. Transaction could be a cash transaction or credit transaction. When the parties settle the transaction immediately by making payment in cash or by cheque, it is called a cash transaction. In credit transaction, the payment is settled at a future date as per agreement between the parties.

Profit: The excess of Revenue Income over expense is called profit. It could be calculated for each transaction or for business as a whole.

Loss: The excess of expense over income is called loss. It could be calculated for each transaction or for business as a whole.

Asset: Asset is a resource owned by the business with the purpose of using it for generating future profits. Assets can be Tangible and Intangible. Tangible Assets are the Capital assets which have some physical existence. e.g. Plant and Machinery, Furniture and Fittings, Land and Buildings, Books, Computers, Vehicles, etc. The capital assets which have no physical existence and whose value is limited by the rights and anticipated benefits that possession confers upon the owner are known as intangible Assets. e.g. Goodwill, Patents, Trade-marks, Copyrights, Designs, etc.

Liability: It is an obligation of financial nature to be settled at a future date. It represents amount of money that the business owes to the other parties. E.g. when goods are bought on credit, the firm will create an obligation to pay to the supplier the price of goods on an agreed future date or when a loan is taken from bank, an obligation to pay interest and principal amount is created.

Capital: It is amount invested in the business by its owners. It may be in the form of cash, goods or any other asset which the proprietor or partners of business invest in the business activity. From business point of view, capital of owners is a liability which is to be settled only in the event of closure or transfer of the business. Hence, it is not classified as a normal liability. For corporate bodies, capital is normally represented as share capital.

Debtor: The sum total or aggregate of the amounts which the customer owe to the business for purchasing goods on credit or services rendered or in respect of other contractual obligations, is known as Sundry Debtors or Trade Debtors, or Trade Payable, or Book-Debts or Debtors. In other words, Debtors are those persons from whom a business has to recover money on account of goods sold or service rendered on credit.

Creditor: A creditor is a person to whom the business owes money or money’s worth. e.g. money payable to supplier of goods or provider of service. Creditors are generally classified as Current Liabilities.

Business usually prepares several reports

1. **A statement of financial position referred to as balance sheet**
2. **Profit and loss account (Income statement)**
3. **Statement of cash flows.**

In this book chapter, we will concentrate on the income statement and Balance sheet as it is most commonly used.

Balance Sheet: It is the statement of financial position of the business entity on a particular date. It lists all assets, liabilities and capital. It is important to note that this statement exhibits the state of affairs of the business as on a particular date only. It describes what the business owns and what the business owes to outsiders (this denotes liabilities) and to the owners (this denotes capital). It is prepared after incorporating the resulting profit/losses of Income statement.

Profit and Loss Account or Income Statement: This account shows the revenue earned by the business and the expenses incurred by the business to earn that revenue. This is prepared usually for a particular accounting period, which could be a month, quarter, a half year or a year. The net result of the Profit and Loss Account will show profit earned or loss suffered by the business entity.

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Double Entry System:

Double entry is a simple yet powerful concept each and every one of a company's transactions will result in an amount recorded into at least two of the accounts in the accounting system. Every transaction has two-fold aspects, i.e., one party giving the benefit and the other receiving the benefit.

Because of the double entry system all of a company’s transactions will involve a combination of two or more accounts from the balance sheet and/or the income statement.

The whole Financial Accounting depends on Accounting Equation which is also known as Balance Sheet Equation. The basic Accounting Equation is:

Assets = Liabilities + Owner’s equity Or A = L + P

Where A = Assets, L = Liabilities, P = Capital

Please note that incomes or gains will increase owner’s equity and expenses or losses will reduce it. Basics of accounting can be understood through the story of a courier service business started by Jan who named it as ‘Rychle dorucenie’.

- Jan will no doubt start his business by putting some of his own personal money into it. In means, he owns shares of ‘Rychle dorucenie’ equity.
- Rychle dorucenie will need to buy a sturdy, dependable delivery vehicle.
- The business will begin earning fees and billing clients for delivering their parcels.
- The business will be collecting the fees that were earned.
- The business will incur expenses in operating the business, such as a salary for Jan (as he works for the company,) expenses associated with the delivery vehicle, advertising, etc.

With thousands of such transactions in a given year, Jan should get into the habit of entering all of the day's business transactions. Then at the end of the year, try to track what the business has earned or what the business has lost to be given to its owner Jan or the investor.

Balance Sheet accounts:

Asset accounts (Examples: Cash, Accounts Receivable, Supplies, Equipment) Liability accounts (Examples: Notes Payable, Accounts Payable, Wages Payable) Stockholders' Equity accounts (Examples: Common Stock, Retained Earnings)

Income Statement accounts:

Revenue accounts (Examples: Service Revenues, Investment Revenues)

Expense accounts (Examples: Wages Expense, Rent Expense, Depreciation Expense) Let's illustrate the business with few sample transactions:

1. On December 1st, 2018 Jan starts his business Rychle dorucenie, Inc. The first transaction that Jan will record for his company is his personal investment of 20,000 in exchange for 5,000 shares of Rychle dorucenie equity.

Transaction Date	**Assets**		**=**	**Liabilities**	**+**	**Equity**
	Cash					
1	20,000			-		20,000

2. On December 2nd, Rychle dorucenie purchases a used delivery van for 14,000 by writing a check for 14,000. The two accounts involved are Cash and Vehicles (or Delivery Equipment).

Transaction Date	**Assets**		**=**	**Liabilities**	**+**	**Equity**
	Cash	Van				
1	20,000			0		20,000
2	-14,000	14,000				

3. On December 2nd when Jan contacts an insurance agent regarding insurance coverage for the vehicle Rychle dorucenie just purchased. The agent informs him that 1,200 will provide insurance protection for the next six months. Jan immediately writes a cheque for 1,200 and mails it in. Prepaid Insurance (an asset account reported on the balance sheet) and Insurance Expense (an expense account reported on the income statement).

Transaction Date	**Assets**			**=**	**Liabilities**	**+**	**Equity**
	Cash	Van	Instalment				
1	20,000				0		20,000
2	-14,000	14,000					
Balance	**6,000**	**14,000**			**0**		**20,000**
3	-1,200		1,200				
Balance	**48,00**	**14,000**	**1,200**				**20,000**

4. On December 3rd, a customer gives Rychle dorucenie a cheque for 10 to deliver two parcels on that day.

Transaction Date	**Assets**			**=**	**Liabilities**	**+**	**Equity**
	Cash	Van	Instalment				
1	20,000				0		20,000
2	-14,000	14,000					
Balance	**6,000**	**14,000**			**0**		**20,000**
3	-1,200		1,200				
Balance	**4,800**	**14,000**	**1,200**				**20,000**
3	10						10
Balance	**4,810**	**14,000**	**1,200**				**20,010**

5. On December 3rd the company gets its second customer-a local company that needs to have 50 parcels delivered immediately. Jan's price of 250 is very appealing.

Transaction Date	**Assets**			**=**	**Liabilities**	**+**	**Equity**
	Cash	Van	Instalment				
1	20,000				0		20,000
2	-14,000	14,000					
Balance	**6,000**	**14,000**			**0**		**20,000**
3	-1,200		1,200				
Balance	**4,800**	**14,000**	**1,200**				**20,000**
3	10						10
Balance	**4,810**	**14,000**	**1,200**				**20,010**
3	250						250
Balance	**5,060**	**14,000**	**1,200**				**20,260**

6. The only expense incurred by Direct Delivery so far was a fee to a temporary help agency for a person to help Joe deliver parcels on December 3. The temp agency fee is 80 and is due by December 12th.

Transaction Date	Assets				=	Liabilities	+	Equity
	Cash	Van	Instalment	Receivables				
1	20,000					0		20,000
2	-14,000	14,000						
Balance	**6,000**	**14,000**				**0**		**20,000**
3	-1,200		1,200					
Balance	**4,800**	**14,000**	**1,200**					**20,000**
3	10							10
Balance	**4,810**	**14,000**	**1,200**					**20,010**
3				250				250
Balance	**4,810**	**14,000**	**1,200**	**250**				**20,260**
3						80		-80
Balance	**4,810**	**14,000**	**1,200**	**250**		**80**		**20,180**

Assets include costs that are not yet expired (not yet used up), while expenses are costs that have expired (have been used up). Since the 1,200 payment is for an expense that will not expire in its entirety within the current month, it would be logical to debit the account Prepaid Insurance. (At the end of each month, when 200 has expired, 200 will be moved from Prepaid Insurance to Insurance Expense.)

Let's now get to the basics of getting started with recording his transactions

Basic accounting equation, which is really the same concept as the balance sheet, it's just presented in an equation format:

Just as assets are on the left side of the accounting equation, to increase an asset account's balance, you put more on the left side of the asset account. In accounting jargon, you debit the asset account. To decrease an asset account balance you credit the account, that is, you enter the amount on the right side.

Just as liabilities and stockholders' equity are on the right side (or credit side) of the accounting equation, to increase the balance in a liability or stockholders' equity account, you put more on the right side of the account. In accounting jargon, you credit the liability or the equity account. To decrease a liability or equity, you debit the account, that is, you enter the amount on the left side of the account.

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Income Statement

Income statement will show how profitable a business has been during the time interval. The reporting of profitability involves two things: the amount that was earned (revenues) and the expenses necessary to earn the revenues.

Income Statement accounts:

Revenue accounts (Examples: Service Revenues, Investment Revenues)

Expense accounts (Examples: Wages Expense, Rent Expense, Depreciation)

Revenues:

The main revenues for a business are the fees it earns for delivering parcels. The revenues are recorded when they are earned, not when the company receives the money (accrual basis of accounting). Recording revenues when they are earned is the result of one of the basic accounting principles known as the revenue recognition principle.

For example, if Jan delivers 1,000 parcels in December for 4 per delivery, he has technically earned fees totaling 4,000 for that month. He sends invoices to his clients for these fees and his terms require that his clients must pay by January 10. Even though his clients won't be paying Direct Delivery until January 10, the accrual basis of accounting requires that the 4,000 be recorded as December revenues, since that is when the delivery work actually took place. After expenses are matched with these revenues, the income statement for December will show just how profitable the company was in delivering parcels in December.

When Jan receives the 4,000 worth of payment cheque from his customers on January 10, he will make an accounting entry to show the money was received. This 4,000 of receipts will not be considered to be January revenues, since the revenues were already reported as revenues in December when they were earned. This 4,000 of receipts will be recorded in January as a reduction in Accounts Receivable. (In December Jan had made an entry to Accounts Receivable and to Sales.)

Expenses

Now let’s turn to the second part of the income statement expenses. The December income statement should show expenses incurred during December regardless of when the company actually paid for the expenses. For example, if Jan hires someone to help him with December deliveries and Jan agrees to pay him 500 on January 3, that 500 expense needs to be shown on the December income statement. The actual date that the 500 is paid out doesn't matter. What matters is when the work was done when the expense was incurred and, in this case, the work was done in December. The 500 expense is counted as a December expense even though the money will not be paid out until January 3.

The 500 of wages expense on the December income statement will result in a matching of the cost of the labour used to deliver the December parcels with the revenues from delivering the December

parcels. This matching principle is very important in measuring just how profitable a company was during a given time period.

Other expenses to be matched with December's revenues would be such things as gas for the delivery van and advertising spots.

One simple yet important point: an income statement, does not report the cash coming in rather, its purpose is to

1. Report the revenues earned by the company's efforts during the period, and

2. Report the expenses incurred by the company during the same period.

The purpose of the income statement is to show a company's profitability during a specific period of time. The difference (or "net") between the revenues and expenses for Quick Parcel is often referred to as the bottom line and it is labelled as either Net Income or Net Loss.

Rychle dorucenie s.r.o.	
Income statement	
For the 3 days ended Dec 3, 2018.	Euro
Revenue from services	260
Help Expenses	80
Net Income	**180**

A balance sheet is a document that tracks a company's assets, liabilities and owner's equity at a specific point in time. As you know, if the company's own something, it belongs to someone. After the entries through December 3 have been recorded, the balance sheet will look like this:

Assets	Euro	Liabilities	Euro
Cash	**4,810**	**Accounts payable**	**80**
Accounts receivable	**250**	**Shareholders’ Equity**	**20,000**
Prepaid insurance	**1,200**	**Retained earnings**	**180**
Vehicles	**14,000**		
	20,260		**20,260**

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