Basic Accounting Principles

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What is Accounting

- Accounting is defined as the art of
  - Recording,
  - Classifying
  - Summarizing transactions in monetary terms
  - For preparation of Financial Statements

Entity Concept

- The entity concept considers the company separate from its owners
- Business is the complete entity
- Account are the parts of the entity

Transactions

- Every Transaction in any business, there must be ledger accounts to record transaction details
- For every transaction, there are minimum two entries for ledger accounts, one for debit and another for credit
- They will be equal and offsetting

Transactions - Types

- A ***debit*** is an accounting entry
  - that either increases an asset or expense account,
  - or decreases a liability or equity account
  - It is positioned to the **left** in an accounting entry
- A ***credit*** is an accounting entry
  - that either increases a liability or equity account
  - or decreases an asset or expense account
  - It is positioned to the **right** in an accounting entry

Type of Accounts

- **Personal** eg supplier, customer etc.
- **Real** eg machinery, assets
- **Nominal** eg profit ac, depreciation ac

Personal Accounts

- The elements or accounts which represent persons and organisations.
- Mrs. Vimla a/c - representing Mrs. Vimla a person.
- M/s Bharat & Co a/c - representing M/s Bharat & Co, an organisation.
- Capital a/c - representing the owner of the business, a person or organisation.
- Bank a/c - representing Bank, an organisation.

Real Accounts

- **The elements or accounts which represent tangible aspects.**
  - **Cash a/c - representing cash which is tangible.**
  - **Goods/Stock a/c - representing Stock which is tangible.**
  - **Furniture a/c - representing Furniture which is tangible.**

Nominal Accounts

- The elements or accounts which represent expenses, losses, incomes, gains.
  - Salaries a/c - representing expenditure on account of salaries, an expense.
  - Interest received a/c - representing income on account of interest, an income.
  - Loss on sale of Asset a/c - representing the loss incurred on sale of assets, a loss.
  - We do not come across such accounts till a later stage of our learning. For now, please, assume that such accounts exist.
  - Profit on sale of Asset a/c - representing the profit made on sale of assets, a gain.

Golden Rule of Accounting

- Personal Account: Debit The Receiver, Credit The Giver
- Real Account: Debit What Comes In, Credit What Goes Out
- Nominal Account: Debit All Expenses And Losses, Credit All Incomes And Gains

Chart of Accounts

Chart of Accounts

- A chart of accounts is a listing of the names of the accounts that a company has identified and made available for recording transactions in its general ledger.

Chart of Accounts

- Capital
  - Assets
  - Liability
  - Equity
- Revenue
  - Income
  - Expense

Balance Sheet

Profit-Loss Account

Mapping of Account Types vs Chart of Accounts

Account Types	Chart of Account
Personal Account	Capital Liability
Real Accounts	Assets
Nominal Accounts	Revenue Expenses

Capital (Balance Sheet Items)

Basic Accounting Equation

- **Assets will always equal to liabilities plus equity**

Assets = Liabilities + Shareholder Equity

Asset Accounts

- Things that are resources owned by a company and which have future economic value that can be measured and can be expressed in dollars.
  - cash, investments, accounts receivable, inventory, supplies, land, buildings, equipment, and vehicles.
- Assets are reported on the balance sheet usually at cost or lower.
- Some valuable items that cannot be measured and expressed in dollars include the company's outstanding reputation, its customer base, the value of successful consumer brands, and its management team. As a result these items are not reported among the assets appearing on the balance sheet.

Asset Accounts

- Characterized as
  - **current**
  - **non-current(Fixed)**

Asset Accounts

- Current Assets
  - Cash and other assets that will be converted into cash during one operating cycle
- Non-Current Assets
  - Those not expected to be converted into cash in one operating cycle

Liability Accounts

- Claims that others have against the assets
- Obligations of a company or organization. Amounts owed to lenders and suppliers.
- Liabilities often have the word "payable" in the account title.
- Liabilities also include amounts received in advance for a future sale or for a future service to be performed.

Liability Accounts

- Have a known:
  - Amount
  - Date to be paid
  - Person to whom payment owed
- Also current and non current

Liability Accounts

- **Current Liabilities**
  - Debts that will come due within one year from the balance sheet date
- **Non-Current Liabilities**
  - Those debts due more that one year from the balance sheet date

Equity Accounts

- Initially this is Capital Amount invested by owners
- Difference between value of assets and liabilities
- Sometimes called net worth
- Claims that the owner has against the assets

Revenue (Profit and Loss Items)

Income Accounts

- Amounts to be received or to be received from customers for sale of products/service
  - sales
  - performance of services
  - rent
  - interest

Income Accounts - Types

- Direct Income: Earning directly from business activities
  - Eg sale of product/service
- Indirect Income: Earnings from non-business activites
  - Eg interest, rent,sale of garbage

Expense Accounts

- Amounts that have been paid or will be paid for buying products/services
- Salaries & wages
- Supplies used
- Utilities
- Advertising

Expense Accounts - Types

- Direct Expenses: Expenses connected with purchase of goods/services
  - Eg price, duty, freight, insurance
- Indirect Expense: expenses have no relationship with purchase of goods
  - Eg rent, salary, depreciation

Financial Statements

Financial Reports

- Balance Sheet
- Income & Expense Statement or Profit & Loss Account
- Statement of Cash Flows
- Statement of Owner Equity

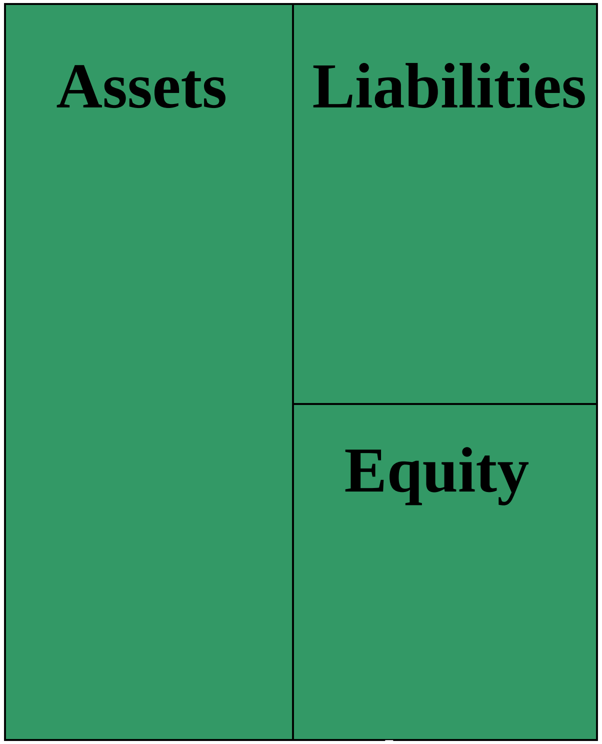
Balance Sheet

- Represents a financial situation at a single point in time
- Has a date on it
- Broken down by:
  - Type of Asset or liability
  - Time or life of the account type

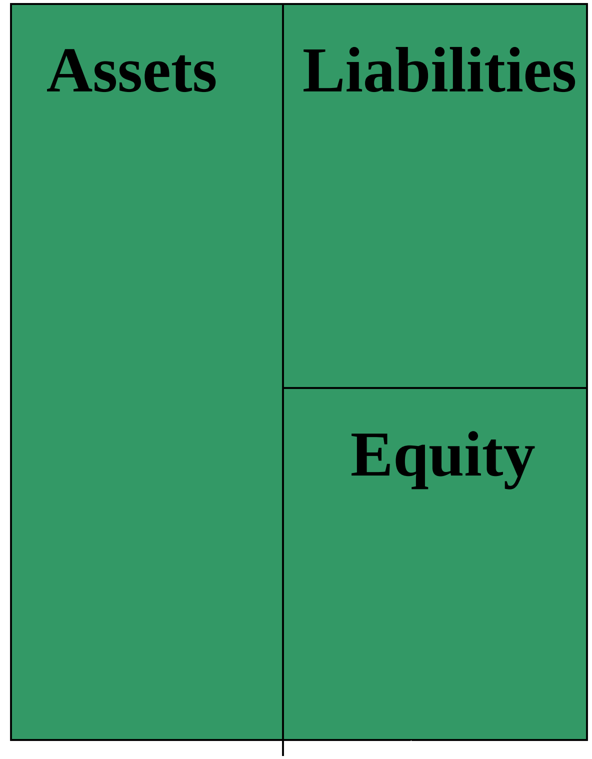
Balance Sheet

- Intermediate Assets and Liabilities
- Long term Assets and Liabilities
- Can use cost or market valuations or both
- Supporting Schedules are very helpful
- Will need a balance sheet for beginning and ending of accounting period

Beginning Balance Sheet



Ending Balance Sheet



+/- Net Income

+/- Valuation Changes

- Family living withdrawals

+ Capital contributions

Income Statement

- Summary of income and expenses
- Represents a period of time between two balance sheets
- Explains the change in equity between two balance sheets
- Can be divided into enterprise reports
- Can be cash or accrual

Income Statement

- Will have more than one profit line
- Definition of Profit
  - Financial profit is the net return to business equity

Accrual Adjusted Income Statement

- **Cash incomes and expenses must be adjusted by:**
  - Changes in non-cash assets
    - Inventories
    - Pre paid expenses
    - Receivables
  - Changes in non-cash liabilities
    - Payables
    - Accrued interest

Statement of Cash Flows

- Not the same as a cash flow plan (Budget)
- Is a historical record of sources and uses of funds
- Divisions of Statement:
  - Cash from operating activities
  - Cash from investing activities
  - Cash from financing activities

Statement of Owner Equity

- Explains the change in owners equity between two balances sheets
- Changes due to :
  - Net income
  - Change in inventory valuation
  - Family living withdrawals
  - Capital contributions
  - Capital distributions

Account Valuation

Account Valuation

- Income Accounts
  - Value received is recorded
- Expense Accounts
  - Value paid is recorded
- Liability Accounts
  - Value is dollar amount owed

Account Valuation

- **Asset Accounts**
  - More difficult because they may not be traded routinely

Asset Valuation

- Cost Basis
- Market Value Basis

Cost Basis Asset Valuation

- Original cost minus depreciation
- Must establish a depreciation method

Market Basis Asset Valuation

- Recorded as the price they could bring if sold, less selling expenses
- Based on recent auctions, appraisals, etc.

Depreciation

- Allocation of the expense that reflects the "using up" of capital assets employed by the business
- Conceptually, this is done over the useful life of the asset in a "systematic and rational" manner
- Depreciation will come under the <u>indirect expenses</u> head

Depreciation

- Allocation applied to original cost minus salvage value
- Accelerated versus straight line methods
  - Example of difference between management records and tax records
- Can overstate or understate true income

Financial Analysis

Financial Analysis

- All business owners should have a basic set of financial statements at their disposal and they should know how to analyze and interpret them.

Financial Analysis

- **Two Objectives**
  - Measure financial condition of the business
  - Measure financial performance of the business

Financial Analysis

- Horizontal Analysis
- Vertical Analysis
- Ratio Analysis

Horizontal Analysis

- Looks at trends in performance and strength over time
  - For example, percent change in net income from year to year

Vertical Analysis

- Looks at within year events rather than over time
  - For example, interest expense as a percent of total expenses

Ratio Analysis

- Allows for consistent comparison of a single business over time as well as comparison between businesses
- Converts nominal dollar amounts to a common basis

Source of data for Ratio Analysis

- Balance Sheet
- Income Statement

Farm Financial Standards Council (Five Criteria)

- Liquidity
- Solvency
- Profitability
- Financial Efficiency
- Repayment Capacity

Ratio Analysis

- 16 different ratios commonly used
- Each has limitations
- Proper interpretation is critical

Liquidity

- Ability of a business to pay current liabilities as they come due

Liquidity

- Current Ratio
  - Current Assets/Current Liabilities
  - Less than one is bad
- Working capital
  - Current assets minus current liabilities
  - Negative number is bad

Solvency

- Ability of the firm to repay all of its financial obligations

Solvency

- Debt to Asset Ratio
  - Total liabilities/total assets
  - Greater than one bad
- Equity to Asset Ratio
  - Total equity/total assets
- Debt to Equity Ratio
  - Leverage ratio
  - Less than one better

Profitability

- Rate of return on assets
- Rate of return on equity
- Operating profit margin ratio

Financial Efficiency

- **Measures the intensity with which a business uses its assets to generate gross revenues and the effectiveness of production**

Financial Efficiency

- Asset turnover ratio
- Operating expense ratio
- Depreciation ratio
- Interest expense ratio
- Net income from operations ratio

Repayment Capacity

- Measures the borrower's ability to repay term debts and capital leases rather than financial position or performance

Repayment Capacity

- Term debt and capital lease coverage ratio
- Capital replacement and term repayment margin

Cautions

- Measures are only as good as the data used
- Methods must be consistent between years and between operations
  - Example – Asset valuation methods
- Measures ask the right questions but do not provide the answers

Cash and Accrual Accounting

- Refers to the timing of entries into the accounting system

Cash Based Records

- Transactions are recorded when cash is received or paid out

Accrual Based Records

- Transactions are recorded when they take place
- Regardless of whether cash is involved

Accrual Adjusted Statements

- Cash based records are kept throughout the year
- Non-Cash adjustments are made to the cash based income statement at the end of the year