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Accounting Summary

PART - 1

Entity

Entity means a reality that has a definite individual existence. Business entity means a specifically identifiable business enterprise like Super Bazaar, Hire Jewellers, ITC Limited, etc. An accounting system is always devised for a specific business entity (also called accounting entity).

Transaction

An event involving some value between two or more entities. It can be a purchase of goods, receipt of money, payment to a creditor, incurring expenses, etc. It can be a cash transaction or a credit transaction.

Assets

Assets are economic resources of an enterprise that can be usefully expressed in monetary terms. Assets are items of value used by the business in its operations. For example, Super Bazar owns a fleet of trucks, which is used by it for delivering foodstuffs; the trucks, thus, provide economic benefit to the enterprise. This item will be shown on the asset side of the balance sheet of Super Bazaar.

Liabilities

Liabilities are obligations or debts that an enterprise has to pay at some time in the future. They represent creditors’ claims on the firm’s assets.

Capital

Amount invested by the owner in the firm is known as capital. It may be brought in the form of cash or assets by the owner for the business entity capital is an obligation and a claim on the assets of business. It is, therefore, shown as capital on the liabilities side of the balance sheet.

Sales

Sales are total revenues from goods or services sold or provided to customers. Sales may be cash sales or credit sales.

Revenues

These are the amounts of the business earned by selling its products or providing services to customers, called sales revenue. Other items of revenue common to many businesses are: commission, interest, dividends, royalities, rent received, etc. Revenue is also called income.

Expenses

Costs incurred by a business in the process of earning revenue are known as expenses. Generally, expenses are measured by the cost of assets consumed or services used during an accounting period. The usual items of expenses are: depreciation, rent, wages, salaries, interest, cost of heater, light and water, telephone, etc.

Profit

The excess of revenues of a period over its related expenses during an accounting year is profit. Profit increases the investment of the owners.

Expenditure

Spending money or incurring a liability for some benefit, service or property received is called expenditure. Purchase of goods, purchase of machinery, purchase of furniture, etc. are examples of expenditure.

If the benefit of expenditure is exhausted within a year, it is treated as an expense (also called revenue expenditure).

On the other hand, the benefit of an expenditure lasts for more than a year, it is treated as an asset (also called capital expenditure) such as purchase of machinery, furniture, etc.

Gain

A profit that arises from events or transactions which are incidental to business such as sale of fixed assets, winning a court case, appreciation in the value of an asset.

Discount

Discount is the deduction in the price of the goods sold.

It is offered in two ways. Offering deduction of agreed percentage of list price at the time selling goods is one way of giving discount. Such discount is called ‘trade discount’. It is generally offered by manufactures to whole sellers and by whole sellers to retailers.

After selling the goods on credit basis the debtors may be given certain deduction in amount due in case if they pay the amount within the stipulated period or earlier. This deduction is given at the time of payment on the amount payable. Hence, it is called as cash discount. Cash discount acts as an incentive that encourages prompt payment by the debtors.

Voucher

The documentary evidence in support of a transaction is known as voucher. For example, if we buy goods for cash, we get cash memo, if we buy on credit, we get an invoice; when we make a payment we get a receipt and so on.

Goods

It refers to the products in which the business unit is dealing, i.e. in terms of which it is buying and selling or producing and selling.

The items that are purchased for use in the business are **not called goods**. For example, for a furniture dealer purchase of chairs and tables is termed as goods, while for other it is furniture and is treated as an asset. Similarly, for a stationery merchant, stationery is goods, whereas for others it is an item of expense (not purchases)

Drawings

Withdrawal of money and/or goods by the owner from the business for personal use is known as drawings. Drawings reduces the investment of the owners.

Purchases

Purchases are total amount of goods procured by a business on credit and on cash, for use or sale. In a trading concern, purchases are made of merchandise for resale with or without processing.

In a manufacturing concern, raw materials are purchased, processed further into finished goods and then sold. Purchases may be cash purchases or credit purchases.

Stock

Stock (inventory) is a measure of something on hand- goods, spares and other items in a business. It is called Stock in hand. In a trading concern, the stock on hand is the amount of goods which are lying unsold as at the end of an accounting period is called **closing stock (ending inventory).**

In a manufacturing company, closing stock comprises raw materials, semi-finished goods and finished goods on hand on the closing date.

Similarly, **opening stock (beginning inventory)** is the amount of stock at the beginning of the accounting period.

Debtors

Debtors are persons and/or other entities who owe to an enterprise an amount for buying goods and services on credit. The total amount standing against such persons and/or entities on the closing date, is shown in the balance sheet as **sundry debtors** on the asset side.

Creditors

Creditors are persons and/or other entities who have to be paid by an enterprise an amount for providing the enterprise goods and services on credit. The total amount standing to the favor of such persons and/or entities on the closing date, is shown in the Balance Sheet as **sundry creditors** on the liabilities side.

Generally Accepted Accounting Principles (GAAP):

Generally Accepted Accounting principles refer to the rules or guidelines adopted for recording and reporting of business transactions in order to bring uniformity in the preparation and presentation of financial statements. These principles are also referred to as concepts and conventions.

Basic Accounting Concepts:

The basic accounting concepts are referred to as the fundamental ideas or basic assumptions underlying the theory and practice of financial accounting and are broad working rules of accounting activities.

Business Entity:

This concept assumes that business has distinct and separate entity from its owners. Thus, for the purpose of accounting, business and its owners are to be treated as two separate entities.

Money Measurement:

The concept of money measurement states that only those transactions and happenings in an organization, which can be expressed in terms of money are to be recorded in the book of accounts. Also, the records of the transactions are to be kept not in the physical units but in the monetary units.

Going Concern:

The concept of going concern assumes that a business firm would continue to carry out its operations indefinitely (for a fairly long period of time) and would not be liquidated in the near future.

Accounting Period:

Accounting period refers to the span of time at the end of which the financial statements of an enterprise are prepared to know whether it has earned profits or incurred losses during that period and what exactly is the position of its assets and liabilities, at the end of that period

Cost Concept:

The cost concept requires that all assets are recorded in the book of accounts at their cost price, which includes cost of acquisition, transportation, installation and making the asset ready for the use.

Dual Aspect:

This concept states that every transaction has a dual or two-fold effect on various accounts and should therefore be recorded at two places. The duality principle is commonly expressed in terms of fundamental accounting equation, which is:

Assets = Liabilities + Capital

Revenue Recognition:

Revenue is the gross in-flow of cash arising from the sale of goods and services by an enterprise and use by others of the enterprise resources yielding interest royalties' and dividends. The concept of revenue recognition requires that the revenue for a business transaction should be considered realized when a legal right to receive it arises.

Matching:

The concept of matching emphasises that expenses incurred in an accounting period should be matched with revenues during that period. It follows from this that the revenue and expenses incurred to earn these revenue must belong to the same accounting period.

Full Disclosure:

This concept requires that all material and relevant facts concerning financial performance of an enterprise must be fully and completely disclosed in the financial statements and their accompanying footnotes.

Consistency:

This concepts states that accounting policies and practices followed by enterprises should be uniform and consistent one the period of time so that results are composable. Comparability results when the same accounting principles are consistently being applied by different enterprises for the period under comparison, or the same firm for a number of periods.

Conservatism:

This concept requires that business transactions should be recorded in such a manner that profits are not overstated. All anticipated losses should be accounted for but all unrealised gains should be ignored.

Materiality:

This concept states that accounting should focus on material facts. If the item is likely to influence the decision of a reasonably prudent investor or creditor, it should be regarded as material, and shown in the financial statements.

Objectivity:

According to this concept, accounting transactions should be recorded in the manner so that it is free from the bias of accountants and others.

Systems of Accounting:

There are two systems of recording business transactions, viz. double entry system and single entry system. Under double entry system every transaction has two-fold effects where as single entry system is known as incomplete records.

Basis of Accounting:

The two broad approach of accounting are cash basis and accrual basis. Under cash basis transactions are recorded only when cash are received or paid. Whereas under accrual basis, revenues or costs are recognises when they occur rather than when they are paid.

Accounting Standards:

Accounting standards are written statements of uniform accounting rules and guidelines in practice for preparing the uniform and consistent financial statements. These standards cannot over ride the provisions of applicable laws, customs, usages and business environment in the country.

Source documents :

Various business documents such as invoice, bills, cash memos, vouchers, which form the basis and evidence of a business transaction recorded in the books of account, are called source documents.

Accounting equation :

A statement of equality between debits and credits signifying that the assets of a business are always equal to the total liabilities and capital.

Rules of debit and credit :

An account is divided into two sides. The left side of an account is known as debit and the credit. The rules of debit and credit depend on the nature of an account. Debit and Credit both represent either increase or decrease, depending on the nature of an account.

Books of Original entry :

The transactions are first recorded in these books in a chronological order. Journal is one of the books of original entry. The process of recording entries in the journal is called journalising.

Ledger :

A book containing all accounts to which entries are transferred from the books of original entry. Posting is process of transferring entries from books of original entry to the ledger

Journal :

Basic book of original entry.

Cash book :

A book used to record all cash receipts and payments.

Petty cash book :

A book used to record small cash payments.

Purchase journal :

A special journal in which only credit purchases are recorded

Sales journal :

A special journal in which only credit sales are recorded

Purchases Return Book :

A book in which return of merchandise purchased is recorded.

Sales Return Book :

A special book in which returns of merchandise sold on credit are recorded.

Trial balance:

A statement showing the abstract of the balance (debit/credit) of various accounts in the ledger.

The main objectives of preparing the trial balance are : (i) to ascertain the arithmetical accuracy of the ledger accounts; (ii) to help in locating errors; and (iii) to help in the preparation of the final accounts.

Preparation of trial balance by the balance method:

In this method, the trial balance has three columns. The first column is for the head of the account, the second column for writing the debit balance and the third for the credit balance of each account in the ledger.

Various types of Errors:

Errors of Commission:

Errors caused due to wrong recording of a transaction, wrong totaling, wrong casting, wrong balancing, etc.

Errors of Omission:

Errors caused due to omission of recording a transaction entirely or party in the books of account.

Errors of Principle:

Errors arising due to wrong classification of receipts and payments between revenue and capital receipts and revenue and capital expenditure.

Compensating Errors:

Two or more errors committed in such a way that they nullify the effect of each other on the debits and credits.

Rectification of Errors:

Errors affecting only one account can be rectified by giving an explanatory note or by passing a journal entry.

Errors which affect two or more accounts are rectified by passing a journal entry.

Suspense Account:

An account in which the difference in the trial balance is put till such time that errors are located and rectified It facilitates the preparation of financial statements even when the trial balance does not tally.

Disposal of suspense account:

When all the errors are located and rectified the suspense account stands disposed off.

Depreciation :

Depreciation is decline in the value of a tangible fixed asset. In accounting, depreciation is the process of allocating depreciable cost over useful life of a fixed asset.

Depreciation and Similar Terms :

Depreciation term is used in the context of tangible fixed assts. **Depletion** (in the context of extractive industries), and **amortization** (in the context of intangible assets) are other related terms.

Factors Affecting Depreciation :
- Wear and Tear due to use and/or passage of time
- Expiration of Legal Rights
- Obsolescence

Provisions and Reserves :

A provision is a charge against profit. It is created for a known current liability the amount of which is uncertain.

Reserve on the other hand, is an appropriation of profit. It is created to strengthen the financial position of the business.

Types of Reserves : Reserves may be —

General reserve:

When the purpose for which reserve is created is not specified, it is called General Reserve. It is also termed as free reserve because the management can freely utilise it for any purpose.

specific reserve:

Specific reserve is the reserve, which is created for some specific purpose and can be utilized only for that purpose.

Revenue reserve:

Revenue reserves are created from revenue profits which arise out of the normal operating activities of the business and are otherwise freely available for distribution as dividend.

Capital reserve:

Capital reserves are created out of capital profits which do not arise from the normal operating activities. Such reserves are not available for distribution as dividend. These reserves can be used for writing off capital losses or issue of bonus shares in case of a company

Secret Reserve :

When total depreciation charged is higher than the total depreciable cost, Secret reserve' is created. Secret reserve is not explicitly shown in the balance sheet.

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