Financial Accounting

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Some basic concepts:

CAPITAL: Generally refers to the amount invested in an enterprise by its owner(s) e.g. paid – up share capital in a corporate organization. It is also used to refer to the interest of owner(s) in the assets of an enterprise i.e. owners' equity, which is residual interest in the assets of the enterprise after deducting its liability. So, Capital = Assets – Outside Liabilities.

ASSET: An Asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.

Assets can be classified in following 3 categories:

Current Assets are those assets that can be expected to turn into cash within a year or less. Current assets include cash, marketable securities, accounts receivable, and inventory.

Fixed Assets cannot be quickly turned into cash without interfering with business operations. Fixed assets include land, buildings, machinery, equipment, furniture, and long-term investments.

Intangible Assets are items such as goodwill, patents, copyrights, trademarks, licenses, franchises, and other kinds of rights or things of value to a company, which are not physical objects. These assets may be the most important ones a company owns.

LIABILITY: A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise. It can be classified as follows:

Current liabilities are those amounts due within one year or less and usually include accounts payable, accruals, loans due to be paid within a year, taxes due within a year, and so on.

Long-term liabilities normally include the amounts of mortgages, bonds, and long-term loans that are due more than a year in the future.

EQUITY: In simple term it is the owners' share of a business. Equity is the residual interest in the assets of an enterprise after deducting all its liabilities.

REVENUE: It is the gross inflow of economic benefits (cash, receivables, other assets) arising from the ordinary operating activities of an entity (such as sales of goods, sales of services, interest, royalties, and dividends). It causes an increase in capital.

EXPENSES: Expenses may be defined as the cost of goods and services used up in the process of obtaining revenue. Examples include the cost of goods sold, wages and salaries, depreciation etc. Expenses cause the owner's capital to decrease.

ACCRUAL - BASIS ACCOUNTING

Under the accrual basis accounting, revenues and expenses are recognized as follows:

Revenue recognition: Revenue is recognized when both of the following conditions are met:

a. Revenue is earned.
b. Revenue is realized or realizable.

Revenue is earned when products are delivered or services are provided.
Realized means cash is received.
Realizable means it is reasonable to expect that cash will be received in the future.

Expense recognition: Expense is recognized in the period in which related revenue is recognized (**Matching Principle)**.

CASH -BASIS ACCOUNTING

Under the cash basis accounting, revenues and expenses are recognized as follows:
Revenue recognition: Revenue is recognized when cash is received.
Expense recognition: Expense is recognized when cash is paid.

ACCRUAL VERSUS CASH-BASIS ACCOUNTING

There are two ways companies can keep their accounting books - Accrual and Cash-Basis. The accrual basis is used by most companies; only very small businesses use cash-basis.

Under the **accrual method**, expenses and revenue are recognized in the period they occur regardless of whether a cash transaction has occurred. For example, if a sale is made in January but payment is not expected until February, the revenue from the sale would be recognized in January (when it was earned) and the amount due to the company is recorded (accrued) in accounts receivable. Below are the Journal entries for the "sale on account" and the "payment on account".

General Journal					
Date		**Account Titles/Explanation**		**Debit**	**Credit**
2010 Jan	5	Accounts Receivable Sales Revenue ***Sale on Account***		250.00	 250.00
Feb	5	Cash Accounts Receivable ***Payment on Account***		250.00	 250.00

Notice that the first entry above recognizes the sale in January, when it actually occurred. This method matches the revenue from the sale to the expenses incurred during the same period.

On the other hand, under the **cash-basis method**, the revenue would not be recorded until February when the cash is actually received, as in the example journal entry below.

General Journal					
Date		**Account Titles/Explanation**		**Debit**	**Credit**
2010 Feb	5	Cash Sales Revenue ***Received Cash from Sale***		250.00	 250.00

While this method is easier and requires fewer journal entries, the sale revenue would not be matched-up to the expenses the company incurred to make the sale possible.

ACCOUNTING CYCLE

Accounting cycle refers to a complete sequence of accounting procedures which are required to be repeated in same order during each accounting period. Accounting cycle includes:

Recording:

First, all transactions should be recorded in the journal or books of original entry known as subsidiary books as and when they take place.

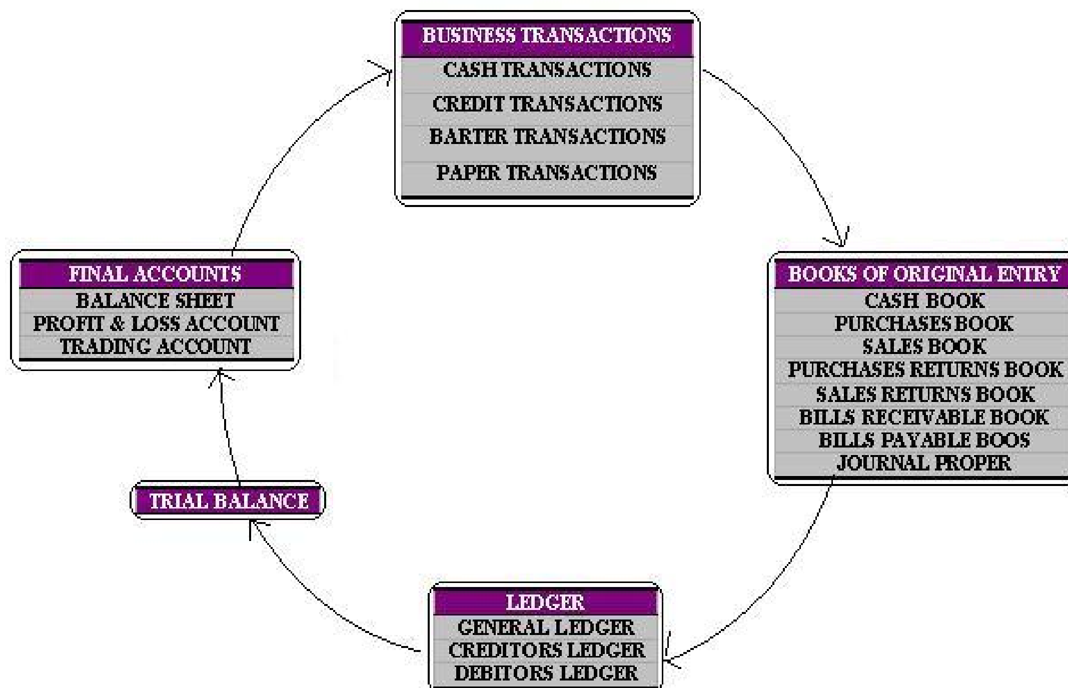
Classifying:

All entries in the journal of books of original entry should be posted to the appropriate ledger accounts to find out at a glance the total effect of all such transactions in a particular account.

Summarising:

Last stage is to prepare the trial balance and final accounts with a view to ascertaining the profit or loss made during a trading period and the financial position of the business of a particular date.

Accounting Cycle



DOUBLE ENTRY SYSTEM OF BOOKKEEPING: The **double entry system of bookkeeping** owes its origin to an Italian merchant named Lucas Pacioli who wrote the first book on ***double entry bookkeeping.*** All modern methods of accounting are simply adaptation of the system invented by that ancient pioneer.

Definition and Explanation:

The double entry theory of bookkeeping can be defined as the system of recording transactions having two fundamental aspects - one involving the receiving of a benefit and the other to giving the benefit - in the same set of books.

In this theory, as the two fold aspects of each transaction are recorded, the name "double entry" has been given to this system.

Every transaction involves two fold aspects e.g., an aspect of receiving and an aspect of giving. One who receives is a debtor (Dr) and one who gives is a creditor (Cr). Under the double entry system, both the aspects of giving and receiving are recorded in terms of accounts. The account which receives the benefit is debited and the account which gives the benefit is credited. It is the ultimate result of this system that every debit must have corresponding credit and vice versa and on any particular day the total of the debit entries and the credit entries on the various accounts must be equal.