

4

Introduction to Accounting



The following facts are discussed in this chapter.

- 4.1 Accounting
- 4.2 Objectives and need of accounting
- 4.3 Business transactions
- 4.4 Assets, liabilities, equity, income and expenses that arose through various business transactions

In this book 'Accounting' is referred only to include financial accounting.

4.1 Accounting

Accounting can be explained as a process of providing information required by the interested parties of a business for their decision making. Financial information is very important in decision making in a business. Accounting that mainly provides financial information is called as Financial Accounting.

4.2 Objectives and need of Accounting

As mentioned above, Accounting is needed to provide useful information to interested parties of a business for their decision making. Further, the business activities also impact various other parties. All these parties including owners and debt holders are named as interested parties (stakeholders) of a business. Owners, debt holders, investors, customers, employees and the government are usually considered as key interested parties among other parties. Each party takes decisions in various nature and for that they require information. Accordingly, providing information is the main objective of accounting. Based on this main objective, there are various other expected objectives and few of such objectives are given below.

- j To know whether the business has earned an adequate profit
- j To know whether the financial position of the business is sound
- j To fulfill legal requirements (presentation of financial reports is a mandatory requirement by law for some organisations)
- j To minimize disadvantages arising through omission and commission of transactions, and to organize financial activities

In order to fulfill above objectives, accounting provides various types of reports to the interested parties. These reports are generally termed as Financial Statements. These financial statements are based on business transactions.

4.3 Business transactions

When a business carries out its activities, it requires to exchange resources with various parties. For example, when a business purchases goods on cash basis, cash and goods are exchanged between the business and the supplier. Accordingly, a transaction can be identified as an exchange of resources between a business and other parties.

In a business, there can be various types of transactions. Among those transactions, the transactions of which their amounts can be measured in terms of money, are considered in accounting.

Examples :-

- Sales of goods for Rs 100 000
- Monthly salary payment of Rs 50 000
- Obtain a bank loan amounting to Rs 300 000
- Payment of Rs 5 000 for electricity

In addition, to the exchange of resources mentioned above, some events that had occurred in businesses are also considered in accounting.

Examples :-

- Damage of trade stocks - Rs. 10 000
- A trade receivable that becomes a bad debt - Rs. 3 000

These events are also considered as transactions in a broader sense in accounting. Most of the transactions that occur in a business are associated with purchases and sales of goods and providing services. Such transactions could be made either on cash or credit basis. If the value of the transaction is settled at the point of the transaction, it will be considered as a transaction on cash basis. On the other hand, if the settlement is made later, it will be considered as a transaction on credit basis.

4.4 Assets, liabilities, equity, income and expenses, that arise from various transactions

As a result of transactions following accounting elements occur.

- j Assets
- j Liabilities
- j Equity
- j Income and Expenses.

Assets

The resources that are generated as a result of a past transaction are simply called assets.

Examples :-

- Purchase of a machine by a business
- Purchase of a motor vehicle by a business

In order to recognize an asset in accounting reports, its cost/value should be able to be measured reliably. Assets generate future economic benefits to the business.

Examples :-

If a machine that had been purchased by a business is used to manufacture and sale goods, the cash that flows to the business in future from that machine.

The profits that are generated by the future sale of purchased stocks.

If any item does not generate future economic benefits, that item cannot be considered as an asset. Further, the item should be controlled by the business. This means, the business should be able to use that asset according to the discretion of the business and to take decisions on the asset. For example, the above mentioned machine and the stock should be able to be used by the business according to the discretion of the business. A building on a rental basis cannot be considered as an asset as it is not controllable by the business.

The following characteristics are observed of an asset.

- j Arose as a result of a past transaction
- j Controlled by the business
- j Inflow of future economic benefit to the business

Accordingly,
an asset could be defined as follows.

An asset is a resource controlled by the business as a result of a past transaction and from which future economic benefits are expected to flow to the business.

Examples :-

Land and buildings, machinery, furniture, equipment, stocks, debtors including receivables, cash at bank, cash in hand.

The assets of a business can be categorised into two types as follows.

- j Current Assets
- j Non-current Assets

Current Assets

The assets that are expected to be used, sold or converted into cash in a short time period as 12 months in the ordinary activities of a business are classified as current assets.

Examples :-

Stocks to be resold, loans and advances receivable that needs to be recovered within 12 months.

Non-current Assets

All the assets that cannot be considered as current assets are considered as non-current assets.

Examples :-

Land and buildings, machinery, furniture, equipment, motor vehicles.

Liabilities

Payables of a business that had arose as a result of past transactions could be simply considered as liabilities.

Examples :-

A loan obtained from a bank

The business is bound to repay these liabilities in future. Therefore, these are considered as current obligations. When these liabilities are settled, the resources which generate future economic benefits (assets) will flow out from the business. Further, in order to depict a liability in the accounts, its amount should be able to be measured reliably.

Example :-

In settling a bank loan, it requires to pay cash and cash outflows from the business.

Accordingly,
following characteristics are observed of a liability

- j Arose as a result of a past transaction
- j Outflow part of economic resources when settlement is made
- j Having a current obligation

Examples :-

Bank loans, creditors

Liabilities also can be categorised into two types as follows.

- j Current Liabilities
- j Non-current Liabilities

Current Liabilities

The liabilities that should be settled in a short period of time as within 12 months are classified as current liabilities. These are also termed as short-term liabilities.

Examples :-

Trade creditors that arise when goods are purchased on credit for resale, accrued electricity expense.

Non-current Liabilities

All of the liabilities that cannot be considered as current liabilities are classified as non-current liabilities.

Example :-

The portion of a bank loan that needs to be settled after one year.

Equity

If the business has liabilities, a part of its assets has to be used to settle those liabilities. After the settlement of such liabilities the assets that remains belongs to the owners of the business.

The value of assets that belongs to owners of the business is termed as equity.

Example :-

Let us assume that a business has Rs. 500 000 worth of assets and a bank loan amounting to Rs. 200 000. Rs. 200 000 out of Rs. 500 000 of assets has to be used to settle the bank loan and therefore, the remaining of assets worth of Rs. 300 000 belongs to the owners.

Equity	=	Assets	-	Liabilities
	=	Rs 500 000	-	Rs 200 000
	=	Rs 300 000		

In a sole proprietorship, the capital invested represents the equity.

Income and Expenses

Profit of a business is the difference between income and expenses. Accordingly,

Profit = Income - Expenses

Profit belongs to the owners of the business. Therefore, profit must be added to the equity. Profit can be calculated separately and thereby it can be added to the equity. Alternatively, income could be added to the equity and expenses could be deducted from the equity. In other words, equity is increased by income and decreased by expenses.

As mentioned above, income belong to the owners. Therefore, it should be added to the equity. As a result, equity gets increased. However, an increase of equity does not occur only from receipt of income. When owners bring additional capital to the business it causes to increase the equity. This increase in equity is not considered as income.

Therefore, income can be defined as an increase in equity except due to the increases from capital introductions by owners.

Examples :-

- ☆ Sales
- ☆ Interest received
- ☆ Rent received
- ☆ Commission received

As income belong to the owners, expenses should also be born by the owners. Therefore, expenses should be deducted from the equity and it causes to reduce the equity. However, a decrease of equity does not occur only from expenses. When owners take goods or cash out of the business for their private use (which is termed as drawings), equity gets decreased.

Therefore, expenses can be defined as a reduction in equity except due to drawings.

Examples :-

- ☆ Salaries and wages
- ☆ Insurance expenses
- ☆ Cost of goods sold
- ☆ Interest expenses

The difference between income and expenses is identified as the profit or loss. If it is a profit, it belongs to owners and if it is a loss, owners have to bear that as well. Therefore, profit or loss should be ultimately adjusted to the equity. Then, what remain are assets, liabilities and equity. The relationship among these assets, liabilities and equity could be shown in an equation. This equation is named as the Accounting Equation. You can learn about the accounting equation in the next chapter.



Activity 01

Following are some items of Yeshika's business who carries out a canteen.

- Electricity expense
- Investments
- Commission received
- Sales
- Advertising expense
- Bank loans
- Capital
- Creditors
- Commission paid
- Vehicles
- Vehicle repair expense
- Investment interest income
- Debtors
- Interest paid on bank loan

Using a tabular format categorise each of above items under the columns of assets, liabilities, equity, income and expenses.



Activity 02

Sajini Perera is carrying out a business of selling garments. Classify following items under the given categories.

Item	Assets		Liabilities	
	Current assets	Non current assets	Current liabilities	Non Current liabilities
Stock of garments				
Cash counting machines used by the cashier				
Amount payable for the credit purchases of fabrics				
Bank loan that was obtained to expand the business				
The building owned by the business				
Point of sales machines				