BASIC ACCOUNTING - 1

GENERAL CONCEPTS & THE BALANCE SHEET

Accounting is the language of business, and is concerned with the collecting, analyzing and communicating financial information. This information is useful for those who need to make decisions and plans about businesses, and those who need to regulate those businesses. Such include, managers, owners, investors, governmental agencies, and others inside and outside the organization to which the financial information refers.

Accounting provides answers and insights to questions like these:

- Will First Bank show good returns in the future?
- Should I invest in Cadbury or NB stock?
- What percentage of GLO's marketing budget is allocated to e-business?
  - How does that percentage compare with the competition?
  - What is the overall financial condition of GLO?
- Can Disco Group pay its debt obligations?

Smaller businesses also need answers to their financial questions:

- Should *Shayos* spend more money to design, produce, and send out new brochures in an effort to create more business?
- At *Utopia Co.*, did business increase enough over the last year to warrant hiring a new assistant?
- What role should the Internet play in the future of business spending?

Accounting is as important to individuals as it is to businesses; it answers questions like these:

- Would my money work better in a money market or in the stock market?
- Should I take out a loan to buy a new *Innoson* CRV or wait until I can afford to pay cash for it?

The accounting process analyzes, records, classifies, summarizes, reports, and interprets financial information for decision makers whether individuals, small businesses, large corporations, or governmental agencies in a timely fashion.

Classifying Business Organizations

A business can be classified by what it does to earn money, regardless of whether it is a sole proprietorship, a partnership or a corporation. Generally, companies fall into the following categories: service, merchandise, or manufacturing.

GLO is a good example of a service company because it provides services. *Mach Group* sell products hence it is called a merchandise company. Merchandise companies can either make their own products or sell products that are made by another supplier. Companies such as *Dangote* and *Intel* that make their own products are called manufacturers.

Definition of Accounting

Accounting (also called the accounting process) is a system that measures the activities of a business in financial terms. It provides various reports and financial statements that show how the various transactions the business undertook (e.g., buying and selling goods) affected the business.

The Main Objectives Of Accounting are:

- ➔ To keep systematic records: Accounting is done to keep systematic records of financial transactions. The primary objective of accounting is to help us collect financial data and to record them systematically to derive accurate and useful financial statements.

- ➔ To ascertain profitability: With the help of accounting, we can evaluate the profits and losses incurred during a specific accounting period. With the help of a Trading and Profit & Loss Account, we can readily determine the profit or loss of a firm.

- ➔ To ascertain the financial position of the business: A balance sheet or a statement of affairs indicates the financial position of a company as on a particular date. A properly drawn balance sheet gives us an indication of the class and value of assets, the nature and value of liability, and also the capital position of the firm. With the help of that, we can readily ascertain the soundness of any business entity.

- ➔ To assist in decision-making: To take decisions for the future, one requires accurate financial statements. One of the main objectives of accounting is to take right decisions at right time. Thus, accounting gives you the platform to plan for the future with the help of past records.

- ➔ To fulfill compliance with The Law: Business entities such as companies, trusts, and societies are run and governed according to different legislative acts. Flowing from this, the relevant taxation laws (direct or indirect tax) are also applicable to every business. Everyone has to keep and maintain the appropriate types of accounts and records as prescribed by the corresponding laws of the land. Accounting helps in running a business in compliance with the law.

A **Bookkeeper** may record financial transactions according to certain accounting principles and standards, and as prescribed by an accountant depending upon the size, nature, volume, and other constraints of a particular organization. An accountant takes that information and prepares the financial statements that are used to analyze the company's financial position. ***Accounting*** involves many complex activities. Often, it includes the preparation of tax and financial reports, budgeting, and analyses of financial information.

DISTINCTIONS BETWEEN BOOKKEEPING AND ACCOUNTING

Basis of difference	Bookkeeping	Accounting
Transaction	Recording of transactions in books of original entry.	To examine these recorded transactions in order to find out their accuracy.
Posting	To make posting in ledger	To examine this posting in order to ascertain its accuracy.
Total and Balance	To make total of the amount in journal and accounts of ledger. To ascertain balance in all the accounts.	To prepare trial balance with the help of balances of ledger accounts.
Income Statements And Balance Sheet	Preparation of trading, Profit & loss account and balance sheet is not book keeping.	Preparation of trading, profits and loss account and balance sheet is included in it.
Rectification of errors	These are not included in bookkeeping.	These are included in accounting.
Special skill and knowledge	It does not require any special skill and knowledge as in advanced countries; machines do this work.	It requires special skill and knowledge.
Liability	A bookkeeper is not liable for accountancy work.	An accountant is liable for the work of book- keeper.

Accounting cycle refers to the specific tasks involved in completing an accounting process. The length of an accounting cycle can be monthly, quarterly, half-yearly, or annually. And may vary from organization to organization but the process remains the same.

Accounting Concepts And Procedures

All transactions can be analyzed using the basic accounting equation:

Assets = Liabilities + Owner's Equity.

Assets Cash, land, supplies, office equipment, buildings, and other properties of value *owned* by a firm are called **assets.**

Equities The rights of financial claim to the assets are called **equities.** Equities belong to those who supply the assets. If you are the only person to supply assets to the firm, you have the sole rights or financial claims to them. For example, if you supply the law firm with =N=10,000 in cash and =N=25,000 in office equipment, your equity in the firm is =N=35,000.

Relationship Between Assets and Equities

The relationship between assets and equities is:

Assets (Total value of items *owned* by business)	=	Equities (Total claims against the assets)

The total value of the assets of your law firm will be equal to the total value of the financial claims to those assets, i.e., equal to the value of the equities.

The total value is broken down on the left-hand side of the equation to show the specific items of value owned by the business and on the right-hand side to show the types of claims against the assets owned.

Liabilities: A firm might borrow money to buy more assets; that means the firm *buys assets on account* (buy now, pay later). Suppose the firm purchases a new car for =N=2,000,000.00 on account from a car dealer, and the dealer is willing to wait 30 days for payment. The firm has created a **liability:** an obligation to pay that comes due in the future. The car dealer is called the **creditor.** This liability - the amount owed to the dealer - gives the store the right, or the financial claim, to =N=2,000,000.00 of the firm's assets. When the dealer is paid, the store's rights to the assets of the firm end, because the obligation has been paid off.

Basic Accounting Equation: To best understand the various claims to a business's assets, accountants divide equities into two parts. The claims of creditors - outside persons or businesses - are labeled *liabilities.* The claim of the business's owner is labeled **owner's equity.** Let's see how the accounting equation looks now.

Assets = Equities

1. Liabilities: rights of creditors
2. Owner's equity: rights of owner

Assets = Liabilities + Owner's Equity

The total value of all the assets of a firm equals the combined total value of the financial claims of the creditors (liabilities) and the claims of the owners (owner's equity). This calculation is known as the **basic accounting equation.** The basic accounting equation provides a basis for understanding the conventional accounting system of a business. The equation records business transactions in a logical and orderly way that shows their impact on the company's assets, liabilities, and owner's equity.

Another way of presenting the basic accounting equation is:

Assets – Liabilities = Owner's Equity

This form of the equation stresses the importance of creditors. The owner's rights to the business's assets are determined after the rights of the creditors are subtracted. In other words, creditors have first claim to assets. If a firm has no liabilities - and therefore no creditors - the owner has the total rights to assets. Another term for the owner's current investment, or equity, in the business's assets is **capital.** In accounting, capital does not mean cash. Capital is the owner's current investment, or equity, in the assets of the business.

Types of Accounts

It is necessary to know the classification of accounts and their treatment in double entry system of accounts. Broadly, the accounts are classified into three categories:

- Personal accounts: Natural, Artificial/Legal or Group/Representative. The rule for personal accounts is: **Debit the receiver**
  Credit the giver.
- Real accounts: Every Business has some assets and every asset has an account. Thus, the asset account is called a real account. There are two type of assets:

- ❖ Tangible accounts: assets are touchable assets such as plant, machinery, furniture, stock, cash, etc.
- ❖ Intangible accounts: assets are non-touchable assets such as goodwill, patents, copyrights, etc.

  The rule for Real accounts is: **Debit what comes in**
  Credit what goes out.

Accounting treatment for both types of assets is the same.

- ➔ Nominal accounts: Since this account does not represent any tangible asset, it is called a nominal or fictitious account. All kinds of expense accounts, loss accounts, gain accounts or income accounts come under the category of nominal accounts. For example, rent account, salary account, electricity expenses account, interest income account, etc.

  The rule for Nominal accounts is: **Debit all expenses and losses**
  Credit all incomes and gains

Accounting Systems: There are two systems of accounting in use, these are:

- ➔ Single Entry System
- ➔ Double Entry System

The Single Entry System:

The single entry system is an incomplete system of accounting, normally used by small businesses, where the number of transactions is very small. In this system of accounting, only personal accounts are opened and maintained by the business owner. Sometimes subsidiary books are maintained and sometimes not. Since the business owner does not open real and nominal accounts, preparation of profit & loss account and balance sheet is not possible, to enable an accurate assessment of the profit/loss or financial position of business entity.

Double Entry System:

Double entry system of accounts is a scientific system of accounts adopted all over the world without any dispute. It is an old system of accounting developed by Luco Pacioli of Italy in 1494. Under the double entry system of account, every entry has its dual aspects of debit and credit. It means that assets of the business always equal to liabilities of the business.

Assets = Liabilities

The following rules (earlier stated) of debit and credit are called the golden rules of accounts:

Classification of accounts	Rules	Effect
Personal Accounts	Receiver is Debit Giver is Credit	Debit = credit
Real Accounts	What Comes In Debit What Goes Out Credit	Debit = credit
Nominal Accounts	Expenses are Debit Incomes are Credit	Debit = credit

The Balance Sheet

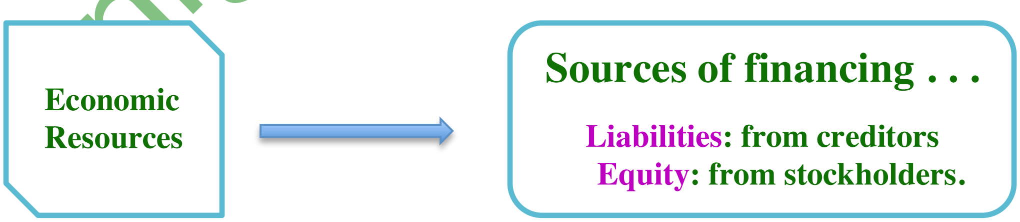
The balance sheet sets out the financial position of a business at a particular moment in time. The balance sheet is sometimes referred to as a *position statement*, because it seeks to provide the user with a picture of financial position. It reveals the forms in which the wealth of the business and how much wealth is held in each form. It sets out the assets of the business on one hand, and the claims against the business on the other hand.

The assets owned by a company appear on the left-hand side and the liabilities and equity appear on the right-hand side (the *horizontal balance sheet format*). Both sides must be equal; if they are not, an error has been made. This *balance* between left and right gives the balance sheet its name.

Assets: - Economic benefits owned by the business as a result of past transactions.
Liabilities: - Debts or obligations of the business that result from past transactions.
Stockholders' Equity: - Amount of financing provided by owners of the business operations.

Basic Accounting Equation is: -

Assets = Liabilities + Stockholders' Equity



Ledger Accounts

A **ledger account** is an item in either the Profit & Loss account or the balance sheet. A Ledger account is a/an:

- Asset
- Liability
- Equity
- Income
- Expense

Hypothetically a balance sheet (*vertical format*) may take the following form:

Assets		=N=
Current Assets		
Stock		
	X	
Debtors	X	
Bank	X	
Cash	X	
Fixed Assets		
Buildings	X	
Vehicles	X	
Total Assets		**XX**
Liabilities		
Current Liabilities		
Overdraft	X	
Creditors	X	
Long-term Liabilities		
Bank Loan	X	
Total Liabilities	**XX**	
Total Assets less Total Liabilities		**ZZ**
Owner's Capital	Y	
Retained Earnings	Y	
Owner's Equity	**ZZ**	

The accounting equation establishes the basis of Double Entry Bookkeeping.

Let us consider the Balance Sheet for *SHAYO CORP.*

The heading of the balance sheet provides the following information:

The company name: ***SHAYO CORP.***

The name of the statement: Balance Sheet.

The date for which the report is prepared: Month/Day/Year

Use of the Currency (Naira) Sign: The currency sign is not repeated each time a figure appears. It is usually placed to the left of each column's top figure and to the left of the column's total.

Distinguishing the Total: When adding numbers down a column, use a single line before the total and a double line beneath it. A single line means that the numbers above it have been added or subtracted. A double line indicates a total. It is important to align the numbers in the column; many errors occur because these figures are not lined up. These rules are the same for all accounting reports.

SHAYO CORP.
Balance Sheet
At December 31, 20XX
(In thousands of Naira)

Assets		
Cash		=N= 4,895
Accounts receivable		5,714
Inventories		8,517
Plant and equipment		7,154
Land		981
Total assets		=N= 27,261
Liabilities and Stockholders' Equity		
Liabilities		
Account payable	=N= 7,156	
Notes payable	9,000	
Total liabilities		=N= 16,156
Stockholders' Equity		
Contributed capital	=N= 2,000	
Retained earnings	9,105	
Total stockholders' equity		11,105
Total liabilities and stockholders' equity		=N= 27,261
Assets		
Cash		=N= 4,895
Accounts receivable		5,714
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Total assets		=N= 27,261
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Stockholders' Equity		
Contributed capital	=N= 2,000	
Retained earnings	9,105	
Total stockholders' equity		11,105
Total liabilities and stockholders' equity		=N= 27,261

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1. Name of entity: (the separate-entity assumption)
2. Title of statement
3. Specific date: (financial snapshot at a specific point in time)
4. Unit measure: (thousands of naira)

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Cash: Amount of cash in the company's bank account.
Accounts receivable: Amounts owed by customers from prior sales.
Inventories: Partial and completed but unsold
Plant and equipment: Factories and production machinery.
Land: Property on which factories are located.

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Accounts payable: Amounts owed to suppliers for prior purchases.
Note payable: Amount owed on written debt contracts.

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Contributed Capital: Amounts invested in the business by stockholders
Retained earnings: Past earnings not distributed to stockholders

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Income statements are divided into three major parts:

- **Revenue**
- **Expense**
- **Net Income**

SHAYO CORP. Balance Sheet At December 31, 20XX (In thousands of Naira)		
Revenues		
Sales revenue		=N= 37,436
Expenses		
Cost of goods sold	=N= 26,980	
Selling, general and administrative	3,624	
Research and development	1,982	
Interest expense	450	
Total expenses		33,036
Pretax income		=N= 4,400
Income tax expense		1,100
Net income		=N= 3,300

Revenues are earnings from the sale of goods or services

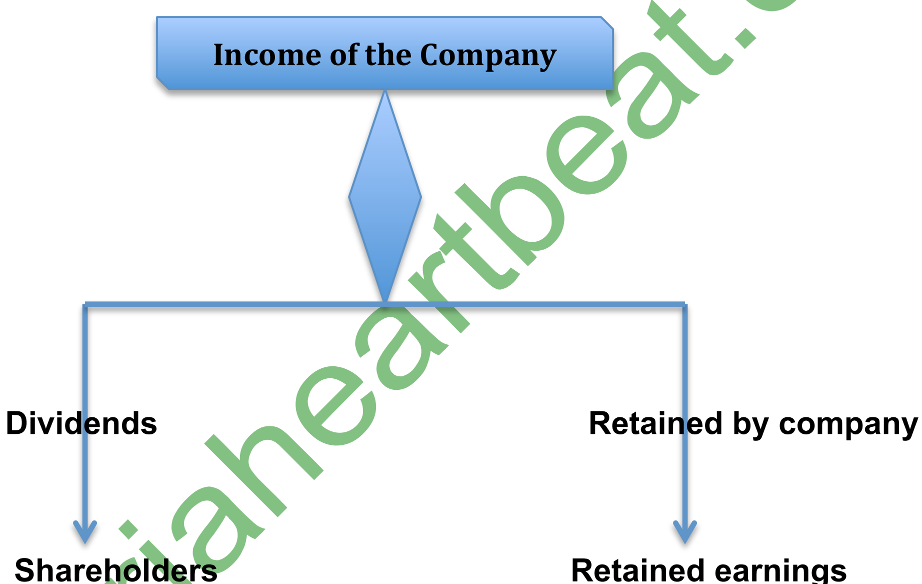
- Revenue is recognized in the period in which goods and services are sold, not necessarily the periods in which cash is received.

Expenses are the naira amount of resources used up by the entity to earn revenues during a period.

- An expense is recognized in the period in which goods and services are used, not necessarily in the period in which cash is paid.

We have a net income when revenue exceeds expenses and when expense exceeds revenue we have a net loss.

Statement of Retained Earnings



SHAYO CORP. Statement of Retained Earnings For the Year Ended December 31, 20XX (in thousands of Naira)		
Retained earnings, January 1, 20XX	=N=	6,805
Net income for 20XX		3,300
Dividends for 20XX		(1,000)
Retained earnings, December 31, 20XX	=N=	9,105