CHAPTER 2

USEFUL FACTS TO IMPROVE UNDERSTANDING OF ACCOUNTING

1 BASIS OF ACCOUNTING

2 THE DOUBLE ENTRY SYSTEM OF ACCOUNTING

3 JOURNAL ENTRIES

4 METHODS OF ACCOUNTING

5 ACCOUNTING ASSUMPTIONS

6 ACCOUNTING REGULATORY BODIES

5 BASIS OF ACCOUNTING

Purpose of Accounting is to record financial transactions conducted by a Business over a period of time. These financial transactions are then put together to prepare Accounts.

In order for Accounts to contain meaningful information, it is equally important that the person responsible for Accounting has complete understanding of financial transactions.

When performing the Accounting function, three broad principles are observed:

- Recording
- Classifying
- Summarizing

These three principles are briefly explained below:

5.1 RECORDING

Recording is documentation of financial transactions in the Books of Accounts which are explained in Chapter 3. Recording follows the principles of Double Entry System of Accounting.

5.2 CLASSIFYING

At the time that a financial transaction is recorded, it is also important to understand how that transaction will be classified. This classification will then facilitate proper recording of that transaction in the Books of Accounts.

Each financial transaction undertaken by a Business can be classified as either one of the following:

- Assets
- Liabilities
- Income
- Expense

These categories are explained below:

5.2.1 ASSETS

In general, Assets are a resource for a Business and have a certain value attached to them. Assets have some or all of the following characteristics:

- It may have a form and shape.
- It has a value.
- It is in a Business's ownership.
- The Business has a use of it.

All types of Assets in a Business are further categorized between two sub-categories:

a) Fixed Assets

Assets that are expected to be used by a Business over an extended period of time are called Fixed Assets. These Assets are not normally held or owned for sale purposes rather they are retained for longer term use to facilitate running of a Business.

Some examples of Fixed Assets are:

- Land
- Buildings
- Motor vehicles
- Plant & machinery

b) Current Assets

Current Assets are those Assets that are consumed during the normal course of a Business sales cycle. These Assets are purchased or manufactured and are normally sold by a Business during its normal operations.

Some examples of Current Assets are:

- Stock of raw materials.
- Stock of finished goods.
- Spare parts inventory.
- Cash & Bank balances.

Having said this, classification of an Asset between Fixed Assets or Current Assets, will vary from one Business to another. The main criteria used to determine the classification of an Asset is to assess the purpose for which that Asset will be used by the Business.

As an example, a car dealer who buys and sells motor vehicles will purchase vehicles for the purposes of selling them to its customers. These motor vehicles will be classified as "Stock of Finished Goods" within "Current Assets" for such a Business. On the other hand, if we consider the example of a Workshop which has purchased a motor vehicle for its owner – this vehicle will be categorized as "Motor Vehicle" within "Fixed Assets" because selling cars is not the normal activity for a Workshop.

5.2.2 Liabilities

Liabilities are obligations and represent amounts owed to others in connection with running of the Business. These Liabilities will have arisen because a Business has taken goods, supplies, services, materials etc. from vendors and money is owed against them.

All types of Liabilities in a Business can be sub-categorized as follows:

Long Term Liabilities:

- Obligations of a Business which will be paid after more than twelve months.

Some examples of Long Term Liabilities are:

- Long term loans from banks.
- Lease liabilities.

Current Liabilities:

Current Liabilities represent obligations of a Business that will be paid within the next twelve months. Some examples of Current Liabilities are:

- Staff salaries.
- Payables for supply of materials & services.
- Utility bills.

5.2.3 Income

Income, also known as "Revenue", represents amounts that a Business has earned or received from sale of goods and / or services.

Further distinction is made between different types of Income:

- Business Income

Business Income is realized from selling goods and / or services that are considered to be a part of a Business's normal activities.

- Other Income

Other Income is realized from selling other goods and / or services which are not considered to be part of a Business's normal activities. For example, interest credited by a Bank on savings account will be called Other Income.

5.2.4 Expenses

Expenses are amounts spent to meet normal operating expenditure. For example, money spent on utilities, electricity, conveyance, entertainment, and salaries.

5.3 Summarizing

Summarizing is the activity whereby financial transactions of similar category are added together into one consolidated amount.

A Balance Sheet is an example of "summarizing" where all transactions relating to Assets and Liabilities, in a given period, are summarized. For example, a Business will typically have multiple customers at any given time. One Accountant could put down the names and amounts owed by each customer individually on the Balance Sheet, or alternatively the same information can be presented on the Balance Sheet as "Accounts Receivable" along with a consolidated amount. This consolidation of balances is called "summarizing".

6 THE DOUBLE ENTRY SYSTEM OF ACCOUNTING

Probably the single most important concept, Double Entry System is the back-bone of all Accounting. A thorough understanding of this system is imperative and is a prerequisite to understanding what Accounting is. However, before we go into the Double Entry System in more detail, two related aspects need to be understood as these will reappear in our subsequent discussions.

6.1 T ACCOUNT

Accounts, in broader terms, have been described as a Balance Sheet and a Profit & Loss Account. However, these statements contain information on financial transactions in a summarized form so that individual financial transactions are consolidated into respective single balances which are then shown on these statements.

The individual financial transactions, of similar classification, are recorded in individual accounts – these individual accounts are commonly referred to as "T Accounts", so called because its form and shape resembles the capital letter "T".

A typically used T Account is as follows:

ACCOUNT NAME							Folio
DEBIT				CREDIT			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
			TOTAL				TOTAL

Key features of T Account are as follows:

- The account name is mentioned at the top of the T Account.
- The date column has the date on which transactions take place.
- The folio column gives reference to the other page number from where the transaction has originated. This is linked to the concept of double entry which is explained below.
- The description column carries the name of the Account from where the transaction has originated.
- The amount column gives the amount of transaction.
- Total is the sum total of all transactions recorded as Debit and Credit.

As an example, if we consider a Cash Account with some assumed transactions, the T Account would appear as follows:

CASH ACCOUNT							GL-5
DEBIT				CREDIT			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
1/8/05	GL-2	Owner's Equity Account	1,000,000	1/8/05	GL-6	Rent Paid Account	150,000
8/8/05	GL-10	Cash Sales Account	125,000	2/8/05	GL-11	Asset – Computer Account	500,000
				3/8/05	GL-20	Salaries Account	50,000

6.2 DEBIT & CREDIT

Rather than refer to the left or right side of a T Account, Accounting always uses the words "Debit" and "Credit" to refer to the location of an entry in the T Account; Debit means the left side and Credit means the right side.

There is a popular misconception that Debit means increase and Credit means decrease. This is not correct! Debit and Credit only point to the location of a transaction in an account – the general rule of thumb is that Debit will always be on the left side and Credit on the right side for all transactions irrespective of whether the transaction is for an Asset, Liability, Income or Expense.

All financial transactions are categorized as Assets or Expenses or Income or Liabilities. For each transaction there will always be corresponding dual (double) entries, one debit and the other a credit, and both of same amounts. This is what is called the Double Entry System of Accounting.

Therefore, it needs to be understood how a debit or a credit of each transaction gets affected in the case of each of the four categories. The following table has summarized the general rule which can be followed at all times.

SUMMARY FOR DEBIT & CREDIT RULE		
Assets	Increase in Assets Decrease in Assets	Debit Credit
Liabilities	Increase in Liability Decrease in Liability	Credit Debit
Income	Increase in Income Decrease in Income	Credit Debit
Expenses	Increase in Expense Decrease in Expense	Debit Credit

Just to illustrate this, let us take a simple example which will show practical application of the Debit & Credit rule: Say, Rs. 5,000 rent is paid by a shopkeeper in cash on 2/7/05. Rent paid is Expense and Cash is Asset. When we apply the Debit & Credit rule:

Account	Category	Increase / decrease	Debit /Credit
Rent	Expense	Increase	Debit
Cash	Asset	Decrease	Credit

Thus, since payment of rent results in an increase in the Expense, Rent Paid (Expense) account is debited. On the other hand, since rent payment will result in decrease in cash balance, Cash Account (Asset) is credited by the same amount.

If we show this transaction in the form of T Accounts, it would appear as:

RENT ACCOUNT							GL-11
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
2/7/05	GL-5	Cash Account	5,000				

CASH ACCOUNT GL-5							
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				2/7/05	GL-11	Rent Account	5,000

Accounting Equation: In Accounting language, Businesses are treated as being separate and different from the Owner(s) of that same Business. This means that all properties of a Business belong to that Business alone and not to the Owner(s) of that Business. In short, the Business is an independent entity that stands separate from its Owner(s).

Keeping in mind the Double Entry System, we can say that for any Business:

DEBITS	=	CREDITS

Now, if we consider the four categories of all financial transactions which include Assets, Liabilities, Income and Expense, we can expand the above equation as follows:

DEBITS	=	CREDITS
ASSETS + EXPENSES	=	LIABILITIES + OWNERS' CAPITAL + INCOME

To further simplify this equation:

ASSETS	=	LIABILITIES + OWNERS' EQUITY

This is referred to as the Accounting Equation and is an important concept in Accounting.

7 JOURNAL ENTRIES

Journal entries are the presentation of financial transactions before those entries get recorded in the Books of Accounts. Journal entries are prepared for each transaction and facilitate recording by summarizing and standardizing the manner in which information is presented. Journal entries are prepared irrespective of the source where these transactions originate from, i.e., whether from Sales Day Book, Purchase Day Book or Cash & Bank Book.

Examples of typical journal entries are as follows:

EXAMPLE # 2.1

Journal Entries

On 31/8/05, Hussain Khaddar & Looms (Pvt) Limited carried out following transactions

Paid salaries to staff amounting Rs. 5,000 in cash.

The Bank credited Rs. 25,000 as interest income directly in the bank account.

Purchased knitting machine amounting to Rs. 500,000

Paid back Rs. 100,000 to the Bank against financing

The above transactions are converted into journal entry as follows.

Date		Debit (Rs.)	Credit (Rs.)
31/8/05	Salaries Account	5,000	
	Cash Account		5,000
31/8/05	Bank Account	25,000	
	Interest Income Account		25,000
31/8/05	Knitting Machine Account	500,000	
	Cash Account		500,000
31/8/05	Loan Account	100,000	
	Bank Account		100,000

7.1 METHODS OF ACCOUNTING

While Accounting is done under the principles of Double Entry System, there are two generally used methods of Accounting:

- Cash Basis
- Accrual Basis

7.2 CASH BASIS

Under Cash basis, revenues are recorded and recognized when payments are received from customers, and expenses are recorded and recognized when cash payments are made to vendors. Under this method, what is important is the timing of receiving and making payments, and not when a Business enters into buying and selling transactions. Payments will be recorded at the actual time it is received or made irrespective of the delivery of goods and services.

EXAMPLE # 2.2
Telephone Expense
Hussain Khaddar & Looms (Pvt) Limited receives its telephone bill on 24/6/2006 for PKR 2,500. Bill is paid through cash on the last date which was 12/7/2006. When Accounts are prepared for June 2006, no telephone expense is recorded. However, when Accounts are prepared for July 2006, the Business will record the expense in that month because payment was made on 12/7/2006 i.e. in the month of July 2006.

7.3 ACCRUAL BASIS

Under Accrual basis, revenues and expenses are recorded and recognized in the Books of Accounts as and when expenditure is incurred and revenue is earned irrespective of the time when payments were made and received. There is a time lag between delivery of goods and services and receiving or making cash payment.

In above example, the Business would have recorded the telephone expense in June 2006 by showing a corresponding Liability for the same amount since this expense was not paid in June 2006. Subsequently, in July 2006, when the Business has made the payment, the Liability will be settled by making the payment i.e. there will be no expense recorded in July 2006.

7.4 COMPLIANCE WITH INCOME TAX

Income Tax Ordinance, 2001 accepts both methods as being acceptable. Federal Board of Revenue has published a Brochure # 002 dated July 2002 under the name "Business Accounts, Records and Documents" (which can be found on the website www.fbr.gov.pk) which says that both methods of accounting are acceptable. The following is an extract from this Brochure:

"You have the choice to adopt any method of accounting. However a company has no choice of selection of method of accounting. Under section 32(2) of the Income Tax Ordinance 2001, a company is obliged to adopt the accrual method of accounting. Once you have adopted your accounting method you cannot change it without the prior approval of the Commissioner of Income Tax. A change in method of accounting not only includes a change in your overall system of accounting, but also a change in the treatment of any material item."

7.5 COMPARISON OF TWO METHODS

Suitability of either method depends on circumstances and the option is available to every Business depending upon its size and complexity of transactions, quality and knowledge level of accounting staff. For smaller Businesses, where most transactions involve simple cash payments or receipts, cash basis of accounting may be preferred.

Accrual method, although more difficult to understand and apply, presents an accurate picture of Business's performance. It is generally a more preferred method and is more commonly used, especially by larger Businesses.

8 ACCOUNTING ASSUMPTIONS

Accounting assumptions are a set of general rules and guidelines which dictate how Accounting will be carried out in various circumstances. Businesses and business practices change over time; the manner in which a transaction is recorded today may change tomorrow, and the way in which a transaction is applied to one Business may not be appropriate for another.

Accounting assumptions are the set of rules which enable Accounting staff to interpret different situations to work out a suitable Accounting solution for those situations. As explained in earlier section of this Chapter, Accounting follows three basic principles i.e. recording, classifying and summarizing - Accounting assumptions are the tools to determine:

- How a transaction is recorded.
- How a transaction is classified.

These Accounting assumptions are briefly discussed below.

8.1 GOING CONCERN

This assumes that a Business will continue its activities in the foreseeable future and shall not stop its operations in the near future.

8.2 MATCHING CONCEPT

This assumption states that revenues earned in a period shall be matched with expenditure that has been incurred to generate the revenues. This assumption has a very close linkage with the Accrual basis of Accounting.

8.3 CONSISTENCY

This assumption requires that the manner in which a financial transaction is recorded and classified in a period should be consistently applied to future periods. Exceptions are possible but only if there are strong reasons for doing so.

8.4 HISTORICAL COST

This concept requires that financial transactions are recorded at an amount on which they were originally transacted even though there may be subsequent increases in costs.

EXAMPLE # 2.3

Historical Cost

Hussain Khaddar & Looms (Pvt) Limited buys 10 bales of cotton for Rs. 8,500 each, costing PKR 85,000 on 13/6/2006. Accounts are being prepared for June 2006. On 30/6/2006, cotton bales have not been sold and its price has now risen to Rs. 10,000 per bale.

On 13/6/06, when cotton bales were purchased, the following journal entry will be prepared to record this transaction:

Date		Debit (Rs.)	Credit (Rs.)
13/6/06	Purchases Account	85,000	
	Cash Account		85,000

When Accounts are prepared for June 2006, there will be no change in this Accounting entry as a result of increase in price for cotton bales.

8.5 PRUDENCE

Prudence requires Accounting to take a "conservative", "cautious" and "careful" approach. Probably one of the most important assumptions, its practical application is that it helps to quantify and to put a value on the outcome of uncertain events. In simple accounting language, this concept requires recognition of expenses as soon as they are likely to be incurred and recommends that income should be recognized only if it is highly probable that income will be received by the Business.

9 ACCOUNTING REGULATORY BODIES

Accounting is a combination of rules and regulations derived from various underlying assumptions which enable financial transactions to be recorded and accounts prepared there from. Because each Business is unique and circumstances change over time, Accounting becomes open to interpretation with the result that similar financial transactions may get recorded differently by Businesses.

In order to standardize Accounting, there are Bodies which govern what, how & why of Accounting. We will now briefly explain the role of such Bodies:

9.1 COMPANIES ORDINANCE 1984

Companies Ordinance 1984 is the supreme legislation for businesses listed as "Limited" or "Private Limited" companies. While this Ordinance provides a comprehensive legal framework, it also sets minimum standards and requirements as far as Accounting is concerned.

9.2 INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN (ICAP)

In Pakistan, Accounting as a profession is regulated by ICAP by taking decisions on various accounting and related issues, formulating code of conduct for accounting professionals, providing guidance on accounting related matters, maintaining standards through peer reviews and issuing technical releases. ICAP is also a member of internationally recognized bodies and, therefore, ensures that Accountants in Pakistan stay in line with global practices.

9.3 INTERNATIONAL ACCOUNTING STANDARDS (IAS)

IASs are set of instructions prepared by International Accounting Standards Committee Foundation which formulates rules and regulations of Accounting. Currently, 41 IASs have already been published and new IASs are announced as and when a need arises. These IASs act as a “Dictionary” for the Accounting profession worldwide and their compliance is mandatory for all. In Pakistan, Accounting professionals also follow these IASs.

CHAPTER HIGHLIGHTS

What have we covered?

1. Accounting requires an understanding of how to record, classify & summarize each transaction.

2. All transactions are categorized as either assets, liabilities, income or expenses.

3. Within assets and liabilities, there are sub-categories i.e. in case of liabilities, there are long term liabilities and current liabilities and in case of assets, there are fixed assets and current assets.

4. Double Entry System is the only accepted system of Accounting which requires each transaction to have a debit and a credit of the same amount.

5. T Accounts represent accounts which are opened to record transactions for each category.

6. Debit and Credit are terms used to refer to the location of an entry in a T account and do not necessarily mean that it is increasing or decreasing, respectively.

7. Every account has a normal account balance which will be denoted by either a debit or a credit.

8. Accounting equation reinforces the double entry system and requires assets to equal liabilities.

9. Journal entries are prepared to document an accounting transaction in an easily understood manner.

10. Two methods of accounting can be used, cash and accruals. Both are acceptable.

11. Accounting assumptions are set of rules and guidelines available to accounting profession to facilitate interpretation of transactions.

12. In order to standardize and regulate the accounting profession, various regulatory bodies are present, both in Pakistan and internationally.