

Basic Concepts: Accounting, Scope, Cycle, Equation, Principles, Assumptions

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Basic Concepts of Accounting

Accounting:

Accounting is the process of systematically recording, summarizing, analyzing and reporting financial transaction & information of an organization.

Scope of Accounting:

Accounting is a fundamental component of business and finance, and its scope extends to various fields, including financial accounting (external reporting), managerial accounting (internal decision-making), tax accounting (compliance with tax laws), and auditing (independent verification). It plays a vital role in the functioning of organizations and helps stakeholders assess their financial performance and make informed decisions.

Contnd...

Recording Transactions:

Documenting all financial transactions, such as sales, purchases, expenses, and investments, in a systematic and organized manner.

Summarizing Data:

Aggregating and categorizing financial data into financial statements, like the income statement, balance sheet, and cash flow statement, to provide a clear overview of the organization's financial position and performance.

Analysis:

Examining financial data to assess the financial health and efficiency of an entity. This involves ratio analysis, trend analysis, and other techniques to make informed decisions.

Reporting:

Generating financial reports and statements that are used by various stakeholders, including investors, creditors, management, and government authorities, to make informed decisions.

Contnd...

Compliance:

Ensuring adherence to relevant accounting standards, regulations, and taxation requirements to maintain transparency and legality in financial reporting.

Decision Making:

Providing crucial financial information to help stakeholders make informed decisions about resource allocation, investment, and strategic planning.

Auditing:

Conducting audits to verify the accuracy and reliability of financial information and ensure compliance with accounting principles and standards.

Accounting Information

Accounting information is the information that arises from business transactions. Once identified, the information is then classified and recorded, and it eventually finds its way into various reports in useful forms and presented to decision-makers, i.e. the management. Accounting information refers to the financial statements generated through the process of book-keeping and accounting i.e., trading and profit and loss account and balance sheet.

Types of Accounting Information

There are 3 main types of accounting information:

1. **Statutory Accounting Information** – the information provided in accordance with existing regulations.
2. **Budgetary Accounting Information** – for internal planning, assessment, and decision-making purposes, the information is provided in the form of a budget.
3. **Additional Accounting Information** – other relevant information used to raise the effectiveness of decision-making.

Forms of Delivering Accounting Information

Some **forms** of delivering accounting information:

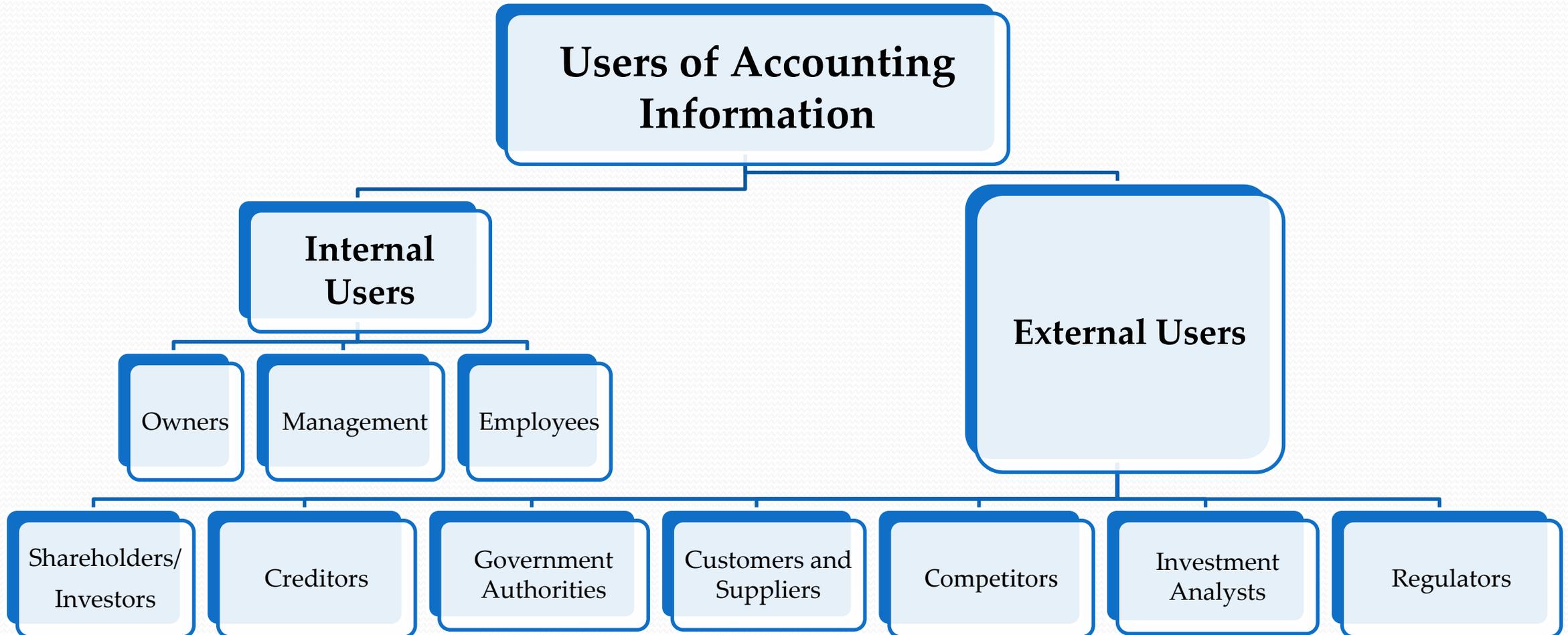
- Annual Financial Statements
- Financial ratios (relative figures)
- Raw data presented from Accounting System (absolute figures)

Limitations of Accounting Information

Accounting information is data that has its limitations. A few of them are:

- **Based on Judgments and Interpretations:** The basis of accounting information is the judgment, estimates, and interpretations of the managers many times. Hence, it can be vulnerable, full of bias, and not always accurate. For example, if a product comes with a replacement guarantee of five years, how and when should the manager recognize a profit? Recording of sales and profit may have been done in the current accounting period. But it may come back as a return after some time. Therefore, it may be a loss for the company eventually after booking the profit for the same.
- **Improper Valuation:** Such information is usually based on the historical cost principle and does not value assets at their fair market value. Thus, it becomes impossible to value a business correctly at any point in time.

Users of Accounting Information



Role/Importance of Accounting

Accounting is essential to managing a business because it makes it easier to keep track of income and expenses, ensures legal compliance, and gives investors, management, and the government access to quantitative financial data that you can use to make decisions. Here are a few of the factors supporting its significance for your company, no matter how big or small:

1.

- **Evaluates business performance**

2.

- **Creates a budget and plans**

3.

- **Accounting role in a company's growth**

4.

- **Monitors cash flow**

5.

- **Ensures statutory compliance**

6.

- **Fraud prevention and detection**

7.

- **Improved payment cycles**

Accounting Principles

- Accounting principles, also known as Generally Accepted Accounting Principles (GAAP), are a set of standardized guidelines and rules that govern the preparation, presentation, and reporting of financial statements for businesses and other organizations. GAAP ensures consistency, transparency, and comparability in financial reporting. Here are some key accounting principles:
- **Prudence (Conservatism):** This principle suggests that when there are multiple acceptable accounting methods, the one that results in lower profits and lower asset values should be chosen. It encourages a more cautious approach to financial reporting.
- **Historical Cost:** Assets and liabilities should initially be recorded at their historical cost, which is the original cost incurred to acquire them. While certain assets can be revalued over time, historical cost remains the foundation for many accounting valuations.

Contnd...

- **Fair Value Principle:** It states that assets and liabilities should be presented at fair value
- **Accrual Basis:** Under this principle, revenues and expenses are recognized when they are earned or incurred, regardless of when the cash is received or paid.
- **Consistency:** Consistency requires that an organization uses the same accounting methods and procedures from one period to another.
- **Materiality:** Materiality states that financial information should be presented in a way that highlights important or material items, ensuring that users can make informed decisions based on relevant information.

Basic Accounting Assumptions

Basic Accounting Assumptions

1.	2.	3.	4.
Business/Economic Entity Assumption: This assumption states that the business entity is separate from its owners and other businesses	Going Concern Assumption: The going concern assumption assumes that a business will continue to operate indefinitely unless there is evidence to the contrary	Time Period Assumption: The time period assumption divides the life of a business into specific time periods, usually fiscal years or quarters, for financial reporting purposes	Monetary Unit Assumption: This principle assumes that all transactions are recorded and reported in a common monetary unit, such as the local currency

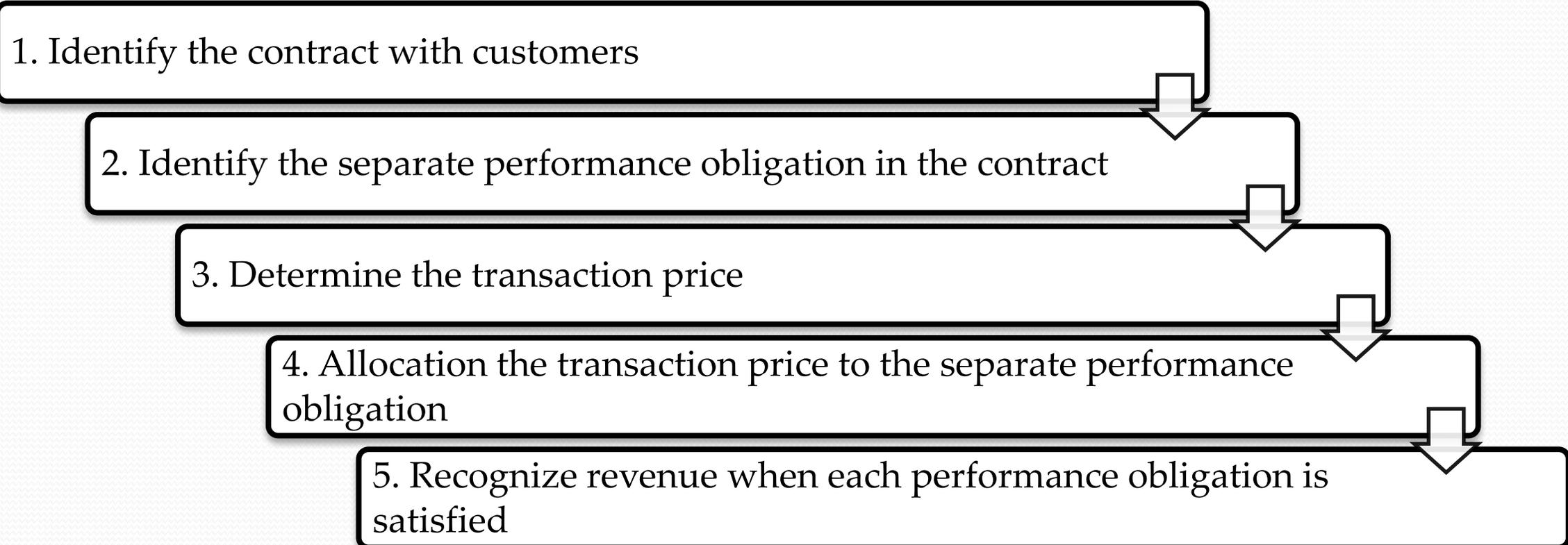
Principle of Revenue Recognition

- When a company agrees to perform a service or sell a product to a customer, it has a performance obligation. When the company meets this performance , it recognizes revenue.
- The revenue recognition principle requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied.

Five steps of Revenue Recognition

Revenue Recognition results from a five step process.

1. Identify the contract with customers



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graph TD; A[1. Identify the contract with customers] --> B[2. Identify the separate performance obligation in the contract]; B --> C[3. Determine the transaction price]; C --> D[4. Allocation the transaction price to the separate performance obligation]; D --> E[5. Recognize revenue when each performance obligation is satisfied];
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2. Identify the separate performance obligation in the contract

3. Determine the transaction price

4. Allocation the transaction price to the separate performance obligation

5. Recognize revenue when each performance obligation is satisfied

The Accounting Equation

The Accounting Equation, also called *balance sheet equation* or *fundamental accounting equation* is a mathematical formula in financial accounting based on the double-entry bookkeeping and accounting system that proves Total Assets equals Total Liabilities plus Total Equity from a company's balance sheet. For each transaction, the total debits equal the total credits. It can be expressed as furthermore:

$$\text{Assets} = \text{Liabilities} + \text{Equity/Owner's Equity}$$

Contd...

Where,

Owner's Equity = Contributed Capital + Retained Earnings

Retained Earnings = Net Income – Dividends

Net Income = Revenue – Expenses

Thus, the equation can be re-written as follows:

Assets = Liabilities + Contributed Capital + Revenue – Expenses – Dividends

Simply,

$$\mathbf{A = L + C + R - E - D}$$

Or,

$$\mathbf{\underline{A + E + D} = \underline{L + C + R}}$$

$$\mathbf{Dr. = Cr.}$$

Thus, when Assets, Expenses & Dividends (Increase) = Dr. and (Decrease) = Cr.

and when Liabilities, Capital & Revenue (Increase) = Cr. and (Decrease) = Dr.

Accounts and its types:

Accounts is formal record of a particular type of transaction expressed in money or other unit of measurement and kept in a Ledger.

- Traditionally, accounts were divided into two classes
 1. **Personal Accounts:** It can be divided into three Sub-Accounts.
 - a. **Natural persons**
 - b. **Artificial Persons**
 - c. **Representative Persons**
 2. **Impersonal Accounts:** It can be divided into two Sub-Accounts
 - a. **Real Accounts**
 - b. **Nominal Accounts**

Rules for Identifying Debit & Credit:

A. Golden Rules of Accounting:

SL. No.	Name of the Account	Debit	Credit
01	Personal Account	Receiver the value	Giver the value
02	Real Account	What comes in?	What goes out?
03	Nominal Account	Expenses /Loss	Income/Gain

Rules for Identifying Debit & Credit:

B. Modern/Alternative Approach:

Sl. No.	Name of the Account	Debit	Credit	Normal Balance
01	Assets Account	Increase (+)	Decrease (-)	Debit
02	Liability Account / Owners' Equity A/C	Decrease (-)	Increase (+)	Credit
03	Revenue Account	Decrease (-)	Increase (+)	Credit
04	Expense Account	Increase (+)	Decrease (-)	Debit



Tabular Analysis

May – 2023 (Question no. 5c)

Show the effect of the following transaction in an accounting equation creating a tabular summary:

- i) Investment of the owner TK.100,000 in the business.
- ii) Purchase a furniture from Hasan Traders for TK.70,000 on credit.
- iii) Providing consultancy services to the customer for TK.50,000 in cash.
- iv) Payment made to Hasan Traders TK.70,000.
- v) Provided consultancy services to Mr. Kibria TK.40,000.
- vi) Paid TK.20,000 as rent for the period.
- vii) Cash received from Mr. Kibria TK.20,000.

Contnd....

- viii) Provided services to Mr. Zakaria of TK.80,000 and out of which TK.30,000 was in cash.
- ix) The owner paid TK.20,000 as a tuition fees for his child from the business.

Solution

Tabular Analysis

Date /Sl.	Particulars	Dr.					Cr.			
		Assets					Liabilities	Owners' Equity		
		Cash	A/c. Receivable	Furniture	Expense	Total	A/c. Payable	Capital	Revenue	Total
i	Own Investment in business	100,000				100,000		100,000		100,000
ii	Purchase of furniture on credit			70,000		70,000	70,000			70,000
iii	Provided consultancy services in cash	50,000				50,000			50,000	50,000
iv	Cash payment to accounts payable	(70,000)				(70,000)	(70,000)			(70,000)
v	Provided consultancy services on credit		40,000			40,000			40,000	40,000
vi	Cash payment of rent	(20,000)			20,000	-				-
vii	Cash received from accounts receivable	20,000	(20,000)			-				-
viii	Provided consultancy services on credit & in cash	30,000	50,000			80,000			80,000	80,000
ix	Cash payment of child tuition fees from business	(20,000)				(20,000)		(20,000)		(20,000)
	Total	90,000	70,000	70,000	20,000	<u>250,000</u>	-	80,000	170,000	<u>250,000</u>

The Accounting Cycle

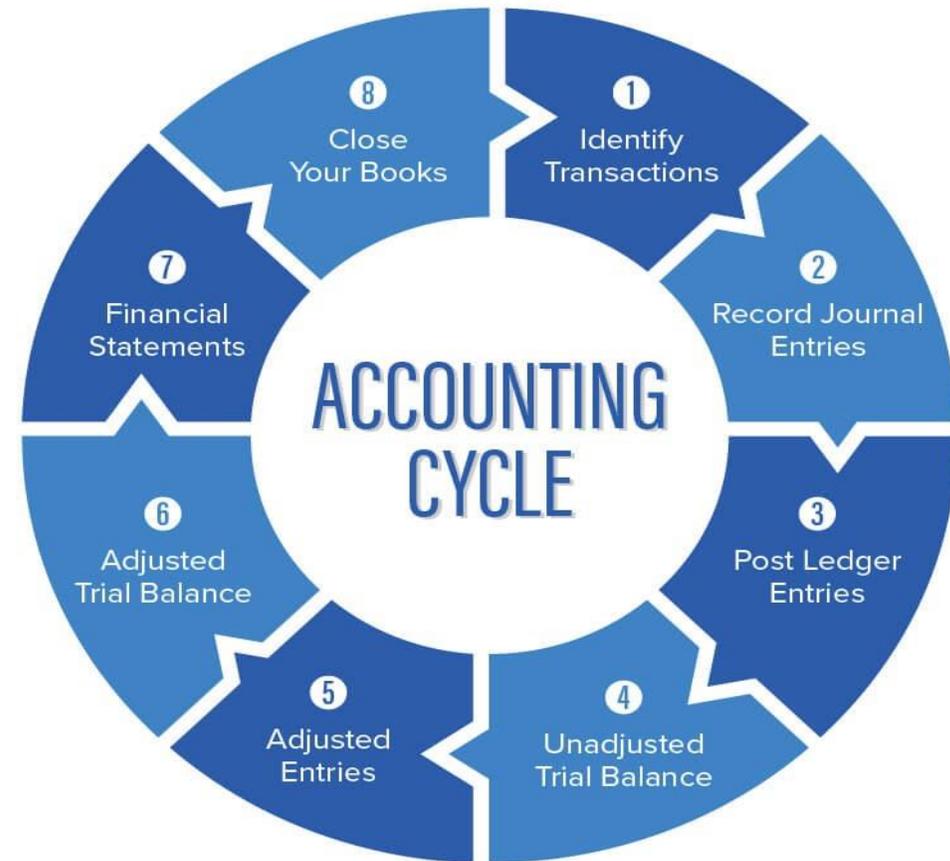
The accounting cycle is a multistep process used by businesses to create an accurate record of their financial position, as summarized on their financial statements. During the cycle's various stages, companies record their financial transactions in a journal, transfer the details into a general ledger, analyze the entries and make sure the books are balanced and error-free before generating financial statements and closing the books for the period.

The main purpose of the accounting cycle is to keep track of all financial activities that occur during a specific accounting period, be it monthly, quarterly or annually.

The Accounting Cycle - Steps

Eight steps to the Accounting Cycle:

1. Identify Transactions
2. Record Journal Entries
3. Posting Ledger Entries
4. Unadjusted Trial Balance
5. Adjusted Entries
6. Adjusted trial Balance
7. Preparing Financial Statements
8. Closing Books



Thank You All

Any Question?