Principles of Accounting

Chapter 1

Accounting concepts & principles

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1.1 Definition

- Accounting is the art of Recording, Summarizing, Evaluating, Reporting and Interpreting business transactions of an enterprise for the various decision makers.
- Since accounting is a system of gathering and communicating business information it is often referred to as —***the language of businesses.”***

1.1 Users of Accounting Information

The people who use accounting information basically fall in to two categories:

- External Users, and
- Internal Users

External Users: External Users of accounting information are parties, which are not directly involved in running the business enterprise.

These include lenders, shareholders (stock holders), suppliers, employees and their Unions, government (regulatory bodies) and others.

1.1 Users…

- **Internal Users:** These are persons that are directly involved in managing and operating an organization.
- They include managers and other important decision makers.

1.2 Accounting concepts, Assumptions and Principles

Accounting procedures rely on a number of concepts so as to get comparable results.

These concepts can be classified as:

- Assumptions
- Principles and
- Constraints

The principles and concepts used in accounting are called Generally Accepted Accounting Principles (**GAAP**).

Assumptions

- Separate entity assumption
- Going concern
- Stable monetary unit assumption
- Periodicity assumption

Principles

- Historical cost principle
- Matching principle
- Revenue recognition principle
- Full disclosure principle

Constraints

- Materiality
- Objectivity
- Conservatism

1.3 Business Transactions and the Accounting Equation

- Business transactions are economic events that should be recorded because they affect the financial position of the business enterprise.
- Are the raw materials(input) of accounting reports
- A transaction can be an exchange (such as the purchase or sale of property, payment or collection of a loan etc.) between two or more parties.

Assets, Liabilities and Owner's Equity

Assets are resources and properties obtained and controlled by a business enterprise and are expected to provide future economic benefits.

An asset is any thing of value that is owned.

Liabilities are obligations or debts incurred by a business that probably make the business to sacrifice its future economic benefits (assets) to settle them.

Assets, Liabilities and Owner's Equity

Capital is the net worth (net assets) that remain after deducting all liabilities from the total assets of a business enterprise.

Capital is the residual equity that remains after all the liabilities are deducted. It is also referred to as Owner's Equity.

$A = L + C$

Transactions and the Accounting Equation

- ***Transection (1)- Owner's investment***
- Ato Dawit starts business by depositing Br. 100,000 in a bank account opened in the name of Effective Garage.
- ***Transaction (2)- Purchase of land for cash***
- Effective Garage bought land for Birr 20,000 in cash, to be used as a future site for the business.
- **Transaction (3) -Purchase of Supplies On credit**
- Ato Dawit bought office supplies for birr 2,500 on credit, to be used by the business. Assets can be purchased on credit (on account) basis, where the buyer promises to pay in the future.
- ***Transaction (4) – Payment of liability***
- Effective Garage paid Birr. 1,500 to creditors on account.

Transactions and the Accounting Equation

- ***Transaction 5 – Selling of service***
- The amount charged to customers for goods or services sold to them is called ***revenue***.
- During the first month of operation, Effective Garage earned service Fees of Birr 30,000 receiving the amount in cash for the garage services it rendered.
- ***Transaction (6)- Recording Expenses***
- During the month of September, Effective Garage paid Birr 15,000 for different types of expenses (birr 10,000 to salary of employees, birr 3000 Telephone, birr 1,500 for rent, and birr 500 for advertisement).
- ***Transaction – 7 Owner's Withdrawal***
- Ato Dawit Gemechu, the owner, withdrew Birr 3000 for his personal from the business.

Transactions and the Accounting Equation

Assets				= Liability	+ Owners Equity	
Tra. No	Cash +	Supplies +	Land	Accounts Payable	Dawit Gem. Capital	Type of owner's Transaction
1	+100,000	-	-	-	+100,000	Owners Investment
Bal	Birr 100,000	-	-	-	Birr 100,000	
2	-20,000	-	+20,000	-	-	
Bal	Birr 80,000	-	Birr 20,000	-	Birr 100,000	
3	-	+2500		+2500		
Bal	Birr 80,000	Birr 2,500	Birr 20,000	Birr2500	Birr 100,000	
4	-1,500	-		-1500		

Transactions and the Accounting Equation

Bal	Birr 78,500	Birr 2,500	Birr 20,000	Birr1,000	Birr 100,000	
5	+30,000	-	-	-	+30,000	Service fee
Bal	Birr 108,500	Birr 2,500	Birr 20,000	Birr1,000	Birr 100,000	
6	-15,000	-	-	-	-10,000 -3000	Salary Exp. Teleph. Exp
	-	-	-	-	-1500 -500	Rent Exp. Adv. Exp.
Bal	Birr 93,500	Birr 2500	Birr 20,000	Birr 1000	Birr 115,000	
7	-3,000	-	-	-	-3000	Owner's withdrowal
Bal	Birr 90,500	Birr 2500	Birr 20,000	Birr 1,000	Birr 112,000	
	Total Assets =Birr 113,000			Total Liabilities and Owner's Equity = Birr 113,000		

1.4 Financial Statements of Sole Proprietorships

The major financial statements used to communicate accounting information about a business are:

- Income statement
- Balance sheet
- Statement of owner's Equity
- Statement of cash flows

Income statement

Effective Garage

Income statement

For the Month Ended September 30,200x

Revenues:		
Service Fee		Birr 30,000.00
Expenses:		
Salary Expense	Birr 10,000.00	
Telephone Expense	3,000.00	
Rent Expense	1,500.00	
Advertising Expense	500.00	
Total Expenses		15,000.00
Net Income		Birr 15,000.00

Statement of owner's equity

Effective Garage

Statement of Owner's Equity

For the Month ended September 30,200x

Dawit G. Capital, September 1……	Birr	-0-
Add: Investments……	Birr 100,000.00	
Net income……	15,000.00	115,000.00
		115,000.00
Less: Drawings……		3,000.00
Dawit G. Capital, September 30……	Birr	112,000.00

Balance Sheet

Effective Garage

Balance Sheet

September 30,200x

Assets	Liability
Cash……Birr 90,500.00	Accounts payable…… Birr 1,000.00
Supplies……2,500.00	
Land……20,000.00	Owner's Equity
	Ato Dawit Gem., Capital Br12,000.00.
	Total Liabilities and
Total Assets……..113,000.00	Owner's equity……...Birr 113,000.00

End of Chapter 1