CHAPTER 2
BASIC ACCOUNTING CONCEPTS

LEARNING OUTCOMES

2.1 Describe the meaning and the importing of Generally Accepted Accounting Principles (GAAP)

2.2 Describe the accounting concepts : historical cost, monetary measurement assumption, economic entity, going concern, consistency, accounting period, materiality, revenue recognition, expense recognition (matching concept), full disclosure, objectivity and fair value measurement

2.3 Describe the accounting equation for service business

2.4 Define assets, liabilities and owner's equity

2.5 Double-Entry System

2.6 Describe the rules of debit and credit on assets, liabilities, capital revenue, expenses and drawings

2.1 GENERALLY ACCEPTED ACCOUNTING

Describe the meaning and the importance of Generally Accepted Accounting Principles (GAAP)

- The accounting profession has developed standards that are generally accepted and universally practiced. This common set of standards is called generally accepted accounting principles (GAAP). These standards indicate how to report economic events.
- The different opinions among accountants can be solved by referring to GAAP.
- It covers conventions, concepts, regulations, procedures and the guidelines standards.
- It is important because the Financial Statements must be completed and easy to understand by others in order to make a comparison or to make any economic decision.

2.2 Accounting Concepts

CONCEPT	EXAMPLE	SOLUTION
1. Historical Cost ✓ The acquired assets and services by a company should be recorded at their actual cost. ✓ The cost is a reliable measure and can be approved and company should continue reporting the historical cost of an asset over its useful life.	The company purchases a car from supplier at a cost price of RM20,000 on 21 August 2016. The market value increases up to RM25,000 on the next day. Which amount should be recorded by the company? Why?	
2. Monetary Measurement ✓ Money is the common denominator in business. The concept states that a business should only record an accounting transaction if it can be expressed in terms of money	A transaction occurred in the organization but the value cannot be determined because of inflation.	
3. Economic Entity ✓ The business and its' owner are two different entities. ✓ The activities of the business must be kept separated and distinctively from the activities of the owner and of all other economic entities such as the creditors, suppliers, customers etc. ✓ The entity can hold properties and debts under its' own	Sally Salleh, owner of Sally's Boutique, must keep her personal living costs separate from the expenses of the business. Whatever she took from the boutique must be declared as withdrawal or also known as drawings.	

name.		
4. Going Concern ✓ The business will continue to operate long enough to carry out its' existing objectives. It means that the entity will remain in operation for the foreseeable future. ✓	The company purchases a car with a cost of RM20,000 with the estimated useful life for 10 years . It is suggested that the car should be depreciated for 5 years because the business is expected to make a clearance in a short period.	
5. Consistency ✓ Consistency means that a company uses the same accounting principles and methods from year to year. ✓ It implies that a business must refrain from changing its accounting policy unless on reasonable grounds. ✓ Consistency concept is important because of the need for comparability, that is, it enables investors and other users of financial statements to easily and correctly compare the financial statements of a company..	The company uses a straight line method in depreciating the fixed asset of the company. The company decides to change to declining balance method.	
6. Accounting Period ✓ Time period covered by financial statements is known as accounting period. ✓ Time period assumption means business activities can be divided into specific period such as a month, a quarter and a year in order to enable comparison of business performance over time.	The company established on 1 January 2013. The trade closes the business account every 12 months at 31 December every year. Explain the concept involved.	
7. Materiality ✓ Materiality relates to an item's impact on a firm's overall financial condition and operations. An item is material when it is likely to influence the decision of a	A company purchases a calculator at cost RM20 and it will depreciate for 5 years over its useful life. Give your opinion.	

reasonably prudent investor or creditor. The concept of materiality in accounting is very subjective, relative to size and importance. Financial information might be of material importance to one company but stand immaterial to another company.		
8. Revenue Recognition ✓ Revenue is recognized in the period they are earned. ✓ When the merchandise has arrived to the buyer or when services are rendered although cash has not been received. ✓ Criteria to recognize a revenue: - o there is a change of ownership/title. o buyers are willing to pay. o the stability of the currency. o buyers are able to pay.	Azmal is a pottery entrepreneur. He has received reservations of porcelain vases on 1st of Jan, 2017 and has received a payment of RM1,000. The booking was sent on 1st of Feb. When is the sales for the 100 units of porcelain vase should be recognized? Give your opinion.	
9. Expense Recognition ✓ Expenses are recorded in the accounting period in which it has been involved for a business revenue. ✓ Expenses are recognized when they are incurred even if payment has not yet been made. ✓ The goal - to find out the actual amount of revenue and expenditure for a financial period.	Tina has recorded expenses of RM2,000 for utilities used in December 2016, although payment will only be made in January 2017. Is she doing the right thing?	
10. Full Disclosure ✓ The company should report the sufficient information (ie: relevant, reliable, comparable) so that the external parties can make a reasonable decision.	Farida Ent. has made changes in stock valuation method used. The company did not disclose the information in the financial statements for the accounting period.	

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<tr><td>11. Objectivity
✓ All accounting data should be valid and has reliable evidence to support transactions occurred.
✓ The goal - to prevent accountants in giving subjective and inaccurate opinion.</td><td>KZB Co. issues only receipt for cash transactions, but for the return of goods from sales transactions, no source document is issued. Give your opinion.</td><td></td></tr>
<tr><td colspan="3">12. Fair Value Measurement
▪ FAIR VALUE MEASUREMENT states that assets and liabilities should be reported at fair value when it come to the point of selling assets or settling liabilities.
▪ FAS No. 157 defines <u>fair value</u> as the price that would be received to sell an asset or paid to transfer a liability (i.e., the “exit price”) in an orderly transaction between market participants at the measurement date.</td></tr>
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2.3 ACCOUNTING EQUATION

2.3.1 Accounting Equation for service businesses

ASSETS = LIABILITIES + OWNER’S EQUITY

⇩

ASSETS = LIABILITIES + (CAPITAL + REVENUES – EXPENSES – OWNER’S WITHDRAWAL)

2.3.2 Define Assets, liabilities and owner’s equity

ASSETS

- *Wealth /resources owned by the business.*

1. Non-Current Assets

- *Assets that have a life of more than one year.*

i.Tangible/fixed assets

– can be seen physically.

Example: -

ii. Intangible assets

– cannot be seen physically.

Example:-

iii. Long-term investments

Example:-

2. Current Assets

❖ Exist in one accounting period and can be converted into cash within a year.
❖ Constantly of changing form and value.

Example: -

LIABILITY

- *Debt / business obligation to be paid by business entity to another party.*

1. **Non-Current Liabilities (> 1 year)**

❖ Debt to be settled within a period exceeding one year.

Example:-

1. **Current Liabilities (<1 year)**

❖ Debt due in less than a year.

Example:-

OWNER'S EQUITY

- **Owner's claims on the business. They include:**
  - Capital invested by the owner into the business.
  - The net profit from the business activities.

Owner's claims on the business. They include:

❖ Capital
- **Capital invested by the owner into the business.**
- **The net profit from the business activities.**

❖ Drawing / Withdrawals
- **Owner takes asset (cash or merchandise) for his own use.**
- **This will reduce the value of owners' equity.**

❖ Profit
- Expenses
  - This will reduce the owner's equity.
- Revenues
  - This will add value to the owner's equity.

Revenues

- ***Income from the sale of goods or services to customers.***
- ***It is based on the concept of revenue recognition.***

- 2 types of revenue:-

✓ **Operating Revenue – from business main activities**
Example:-

✓ **Non-Operating Revenue – from a side activity**
Example:

Expenses

- ***An expense is the money spent or cost incurred in an entity's effort to generate revenue.***
- ***Expenses use up assets or create liabilities in the course of operating a business. Expenses decrease equity.***

2 types of Expenses:

✓ **Operating Expenses**
Example:-

✓ **Non-Operating Expenses**
Example:-

2.3.3 Analyse the effects of business transactions on accounting equation

Transaction Analysis

ASSETS = LIABILITIES + OWNER'S EQUITY

1. J. Scott, the owner, contributed $20,000 cash to start the business.	**(1) Cash (asset) increases** **(2) J. Scott, Capital (equity) increases**
2. Purchased supplies paying $1,000 cash.	
3. Purchased equipment for $15,000 cash.	
4. Purchased Supplies of $200 and Equipment of $1,000 on account.	
5. Borrowed $4,000 from 1st American Bank.	
6. Rendered consulting services receiving $3,000 cash.	
7. Paid salaries of $800 to employees.	
8. J. Scott withdrew $500 from the business for personal use.	

J. Scott **Transaction Analysis**

	ASSETS			=	LIABILITIES		OWNER'S EQUITY	Notes
	Cash	Supplies	Equipment		Accounts Payable	Notes Payable		
1								
2								
3								
4								
5								

List four Financial Statements reflecting the transactions we have recorded.

1. Statement of Comprehensive Income/ Profit or Loss
   The Statement of Profit or Loss (SOPL) describes a company's revenues and expenses along with the resulting profit or loss over a period of time due to earnings activities.

2. Statement of Owner's Equity
   The Statement of Owner's Equity explains changes in equity from profit (or loss) and from owner investments and withdrawals for a period of time

3. Statement of Financial Position
   The Statement of Financial Position (SOFP) describes a company's financial position at a point in time.

4. Statement of Cash Flows

2.4 DOUBLE-ENTRY SYSTEM

- Accounting uses the double-entry system, which means that we record the dual effects of each transaction. As a result, every transaction affects at least two accounts. It would be incomplete to record only the giving side, or only the receiving side, of a transaction

DEBIT =

CREDIT =

Rules of Debit and Credit

Account	Record	Debit/Credit	Normal Balance
ASSET EXPENSE DRAWINGS	↑ ↓		
LIABILITY EQUITY REVENUE	↑ ↓		