



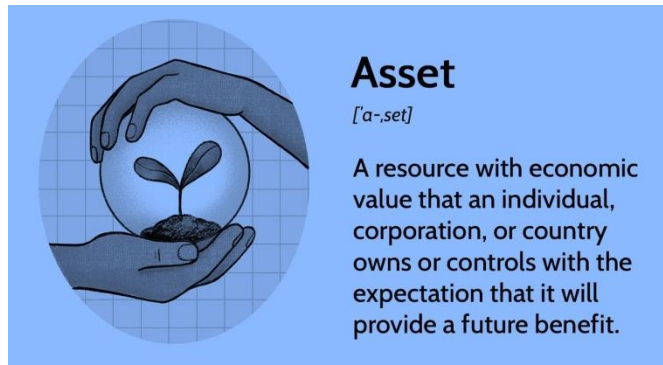
## Financial Accounting - 6



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### Understanding Assets

Dear Friends, welcome back to the study of Financial Accounting. Please recall that we used a fictitious case study for an intuitive understanding of the three fundamental accounting statements. Next we undertook a more detailed understanding of the principles behind them, so that we may be able to apply them in our different circumstances. We followed the earlier pattern, where Bala Sir interacts with the ladies of a Self Help Group (SHG) to explain the theory. We learned in some detail the 'Balance Sheet Equation'. In this lesson, we shall learn to recognise assets more precisely.



Bala Sir opened his door and welcomed Vaishali and her friends into his study room. All of them sat down on the mattress spread out on the floor. Bala Sir started his session saying, 'Welcome back to our study of basics of accounting. I hope you could do the exercises I gave you in the last class. Don't worry; I shall give you the answers soon. But let us briefly recap the main points we learned.

1. A business is a separate entity, and through financial accounting we keep track of its financial status. Our APS is a live example.
2. APS owns some assets, in order to carry out the business, and it holds the assets on behalf of the owners and external parties like the bank, suppliers, etc. These are known as liabilities.
3. At any point in time, the assets must equal the liabilities, for the simple reason that we have to account for all assets, and know, on whose behalf, APS holds those assets.
4. This is achieved by starting with a simple balance sheet at the beginning of a business, and then recording every transaction with (at least) two entries, such that the balance is retained.
5. In the balance sheet equation (**Assets = Liabilities**), assets are sub-divided into cash and non-cash items. Liabilities are divided into owners or shareholders equity and liabilities to external parties.
6. All businesses are required to maintain records of all its business-related transactions, which essentially boils down to two sets – income or revenues and expenditures or expense. It is necessary to prepare annual reports. In India, the financial year starts from April 1<sup>st</sup> and ends on March 31<sup>st</sup>.

7. Net income at the end of a period (month, quarter, half-year or year) equals the difference between total revenues and total expenses. If this is positive, we say, the business has made a profit. If this is negative, we say, the business has incurred a loss.
8. In case of a profit, the business keeps it on behalf of the owners as retained earnings.
9. In case of a loss, the business records a reduction of the owners retained earnings.
10. Thus, the balance sheet equation takes the following form:

$$\text{Cash + non-cash assets} = \text{Shareholders equity} + \text{Liabilities} + \text{Retained earnings}$$

11. We break up retained earnings into (revenues – expenses), and transpose expenses to the left hand side to get the final balance sheet equation:

$$\text{Cash + Non-cash assets} + \text{Expenses} = \text{Shareholders equity} + \text{Liabilities} + \text{Revenues}$$

We shall use this equation most often in our accounting practice.

Bala Sir told them that in this session, he would explain how to apply these concepts in more details, with the help of examples and exercises. But before that, Bala Sir told them that it is necessary to give precise definitions of each term used in the balance sheet equation.

So, the first item is **assets**. What is an asset for a business? In order to qualify any item to be considered as an asset for a business, it must fulfil two conditions:

1. There must be a past or recent transaction giving rise to the creation of this asset, and
2. Using this asset, the business must expect to get some future value. This could be either an increase in cash inflow or a decrease in cash outflow. The amount of this future value should be known.

In accounting we use the term **'recognise'** to indicate that the conditions are fulfilled. Therefore, an accountant will recognise something as an asset provided it is a result of a past transaction, and the future value we would get out of this item can be reasonably estimated. All women's face showed signs of worry. Bala Sir quickly understood their problem – everything sounded rather abstract. Bala Sir said, 'Don't worry. You have already done this. It would be clear to you as soon as you see the example'.

Do you remember that APS bought some furniture and fixtures? The women had a puzzled look – we bought them, not APS they thought. Bala Sir quickly reminded them: a business is a separate entity - APS is a live example. So it is customary to say, APS did this, APS did that etc.

Is this an asset? Well, the first condition – the result of a past transaction is fulfilled. What about its future value? We expect that we would receive in future some value equal to the amount we paid for the furniture and fixtures. How do we get that? We get that by charging as expenses, the use of the furniture and fixtures for the period under consideration. Do you recall that we noted as 'Depreciation Expense' an amount of Rs. 2000 for the month of October 2021? We have already seen such calculations. Therefore, we can recognise the furniture and fixtures as an asset, as on the date of purchasing them.

There was a smile on Vaishali's face! Bala Sir understood, that Vaishali was thinking, 'These accountants are funny people. They can never think straight. Why should we go to such lengths, to establish a simple fact? Is this not clear that the furniture and fixtures are assets of APS?' He told Vaishali, 'You would very soon appreciate the need for making this type of analyses. Let us try to examine each of our earlier transactions, from this angle. I am reproducing the relevant facts, once again.

"APS was now ready to start their store, and rented a shop on the roadside, and paid Rs. 12,000 in advance, as rental for one year on October 7<sup>th</sup>. They bought some essential items like storage shelves, weighing scales, a packing machine, a table and chair, a cash register, a tri-cycle for home delivery, etc. costing Rs. 120,000. They also purchased from the wholesale market, all groceries that they expected to sell over a month, at a total cost of Rs. 200,000. The wholesaler accepted a down payment of 50% of the amount, and agreed to extend a credit period of 30 days for the balance. For the sake of simplicity, we shall assume that by the end of the month, APS was able to sell merchandise worth 180,000 at a price of Rs. 240,000, but Rs. 40,000 was sold on credit, and they received cash of Rs. 200,000 for the sales".

"During the month, they paid an electricity bill for Rs. 1000. They had engaged a full-time assistant to help them in the stores on a monthly salary of Rs. 7500. Each member took turns in assisting the running of the store, like supervision and training, pre-packing, home delivery, sorting and cleaning etc. They decided to charge the store a monthly remuneration of Rs. 2,500 each for this service. All the salaries, including those charged to themselves for their services were paid at the end of the month".

1. **APS paid Rs. 12,000 in advance, as rental for one year on October 7<sup>th</sup>.** The first condition, a business transaction, is satisfied. The second condition – expected future value – is also known to be same as the advance amount paid. As both conditions are satisfied, we did purchase an asset as on October 7<sup>th</sup>. Now the next question is, how do we name this asset? Can anyone say? Everyone was looking at one another. Bala Sir gave them a hint – look at the financial statements we prepared earlier. Which one, Uma asked. Suneetha said, it must be the balance sheet, because that is where we talk of assets and liabilities. Vaishali quickly opened the balance sheet, and shouted, 'Prepaid rent 11,000'. Bala Sir congratulated Vaishali, but made a small correction. He said, you are correct, it's called 'Prepaid rent' but you also added the amount, and that amount is not correct. That is the amount APS had on October 31<sup>st</sup>. On October 7<sup>th</sup>, when they just paid the advance, the amount of 'Prepaid rent' they created was Rs. 12,000. Vaishali, said, 'Sorry Sir, I now understand why it is necessary to make all the analyses like splitting hairs'.
2. O.K. not to worry, said Bala Sir and continued with the next transaction: APS bought some furniture and fixtures costing Rs. 120,000. Everybody shouted in unison – yes, yes, both conditions are satisfied, and Bala Sir moved on to the next transaction.
3. APS purchased groceries worth Rs. 200,000, with a down payment of 50% and a credit period of 30 days for the balance. The first condition is satisfied. APS also expects to gain some future value by selling the groceries. The question is 'how much?' Bala Sir gave them 3 options to choose from:
  - a) 100,000 – being the amount of cash outflow
  - b) 200,000 – being the value of the purchase
  - c) 250,000 – being the expected sales value

The ladies didn't expect this complication to arise, although a few of them did have a doubt, if it should be 100,000 they paid or the full 200,000. Bala Sir explained that the accounting practice is to recognise the full amount, irrespective of whether cash has been paid in full or in part. It is also a common practice to book it at the purchase price, and not add the future profit margin that may accrue. Therefore, this transaction creates an asset, we call 'Merchandise inventory' valued at Rs. 200,000 on the date of purchase.

4. Next transaction: APS sold merchandise worth 180,000 at a price of Rs. 240,000, but Rs. 40,000 was sold on credit, and they received cash of Rs. 200,000 for the sales. The first condition is satisfied we do have a transaction. The question is, did APS get any asset through this transaction, which will fetch future value for APS in terms of cashflows? Well, this case is a bit complex, and therefore, let us examine each part of the transaction carefully, to see if it fits this condition. Bala Sir wrote the activities separately and asked every member to copy it on their notebook and just select 'yes' or 'No' against each item.

APS sold merchandise worth 180,000	Yes / No
Price of Merchandise was 240,000	Yes / No
APS sold Rs. 40,000 on credit	Yes / No
APS received cash Rs. 200,000	Yes / No

Later he showed them the correct answer as under, and asked them to check on their own, how they fared.

APS sold merchandise worth 180,000	<del>Yes</del> / No
Price of Merchandise was 240,000	<del>Yes</del> / No
APS sold Rs. 40,000 on credit	Yes / <del>No</del>
APS received cash Rs. 200,000	<del>Yes</del> / No

Vaishali said, she had no doubt about the first two entries, but why selling on credit created an asset? What about the cash received, was this not an asset? Bala Sir was happy to answer her questions. He explained that when APS sold merchandise on credit, they expect to receive the amount within the next 30 days, the promised credit period. Therefore, this would result in a future cash inflow of Rs. 40,000. Thus, it meets the second condition. So far as receiving cash is concerned, it increases our cash in bank no doubt, but there it ends.

How do we name such assets? Suneetha quickly consulted the balance sheet, and responded, 'Accounts Receivable'. Everyone applauded.

5. Bala Sir now gave a final example, new to them. He knew that Vaishali's mother was running a mess for some college students. He asked Vaishali, suppose your mother entered into a contract with APS for supply of groceries worth Rs. 100,000 per month on a regular basis, at a discount of 2% over the sale price. The contract was for 6 months. Would this be an asset?

Let us analyse this situation. A contract was signed, but no real transaction has happened as yet. APS can expect some profits in the next 6 months as a result of this contract, but there is no real exchange of goods or services to back up these expectations. Therefore, this cannot be considered as a case for creation of an asset. All of them understood the need for being careful in recognising an asset.

