BASICS OF FINANCIAL ACCOUNTING

Definition

The American Institute of Certified Public Accountants (AICPA) had defined accounting as “the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of financial character, and interpreting the results thereof”

Sub- Fields of Accounting

- **Financial Accounting**
  It covers the preparation and interpretation of financial statements and communication to the users of accounts. It is historical in nature as it records transactions which had already been occurred. The final step of financial accounting is the preparation of Profit and Loss Account and the Balance Sheet
- **Management Accounting**
  It is concerned with internal reporting to the managers of a business unit. To discharge the functions of stewardship, planning, control and decision- making, the management needs variety of information. The different ways of grouping information and preparing reports as desired by managers for discharging their functions are referred to as management accounting
- **Cost Accounting**
  The terminology of Cost Accounting published by the Institute of Cost and Management Accountants of England defines cost accounting as: “the process of accounting for cost which begins with the recording of income and expenditure or the bases on which they are calculated and ends with the preparation of periodical statements and reports for ascertaining and controlling costs.”
- **Social Responsibility Accounting**
  social responsibility accounting is concerned with accounting for social costs incurred by the enterprise and social benefits created
- **Human Resource Accounting**
  Human resource accounting is an attempt to identify, quantify and report investments made in human resources of an organisation that are not presently accounted for under conventional accounting practice.

Users of Accounting Information

- **Internal Users**:
  1. Owners
  2. Management
  3. Employees and workers
- **External Users:**
  1. Banks and Financial Institutions
  2. Investors
  3. Creditors
  4. Government and other Authorities
  5. Consumers
  6. Public

Accounting concepts

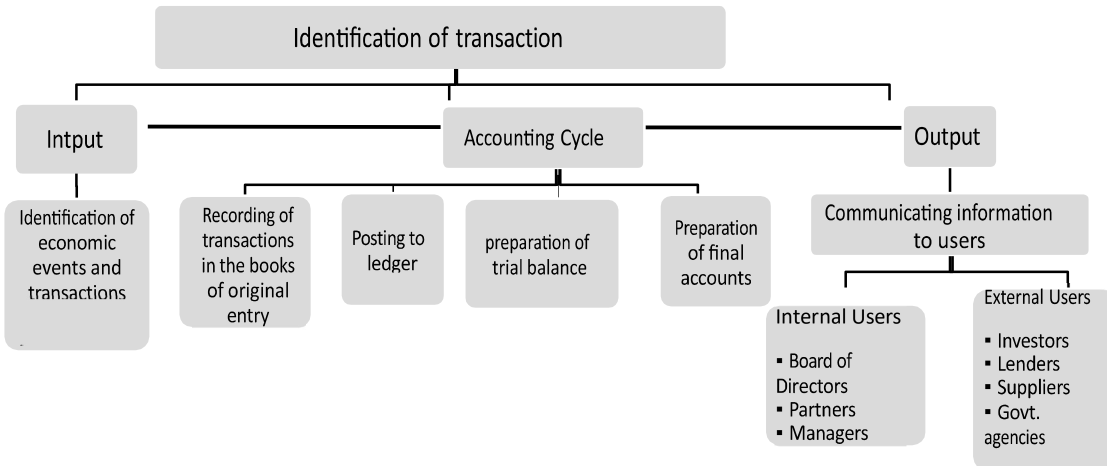
- **Entity Concept**
  Entity concept states that business enterprise is a separate identity apart from its owner. Accountants should treat a business as distinct from its owner. Business transactions are recorded in the business books of accounts and owner's transactions in his personal books of accounts
- **Money Measurement Concept**
  As per this concept, only those transactions, which can be measured in terms of money are recorded. Since money is the medium of exchange and the standard of economic value, this concept requires that those transactions alone that are capable of being measured in terms of money be only to be recorded in the books of accounts
- **Periodicity Concept**
  This is also called the concept of definite accounting period. As per going concern' concept an indefinite life of the entity is assumed. For a business entity it causes inconvenience to measure performance achieved by the entity in the ordinary course of business. So, a small but workable fraction of time is chosen out of infinite life cycle of the business entity for measuring performance and looking at the financial position. Generally, one year period is taken up for performance measurement and appraisal of financial position
- **Accrual Concept**
  Under accrual concept, the effects of transactions and other events are recognised on mercantile basis i.e., when they occur (and not as cash or a cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.
- **Matching Concept**
  In this concept, all expenses matched with the revenue of that period should only be taken into consideration. In the financial statements of the organization if any revenue is recognized then expenses related to earn that revenue should also be recognized.
- **Going Concern Concept**
  The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations
- **Cost Concept**
  By this concept, the value of an asset is to be determined on the basis of historical cost, in other words, acquisition cost. Although there are various measurement bases, accountants traditionally prefer this concept in the interests of objectivity
- **Dual Aspect Concept**
  This concept is the core of double entry book-keeping. Every transaction or event has two aspects:
  1. It increases one Asset and decreases another Asset;
  2. It increases an Asset and simultaneously increases Liability
  3. It decreases one Asset, increases another Asset
  4. It decreases one Asset, decreases a Liability

Fundamental Accounting Assumptions

- **Going Concern**
- **Accrual**
- **Consistency**

Accounting Process

- Input
- Accounting Cycle
- Output



Approaches

- **Traditional Approach**

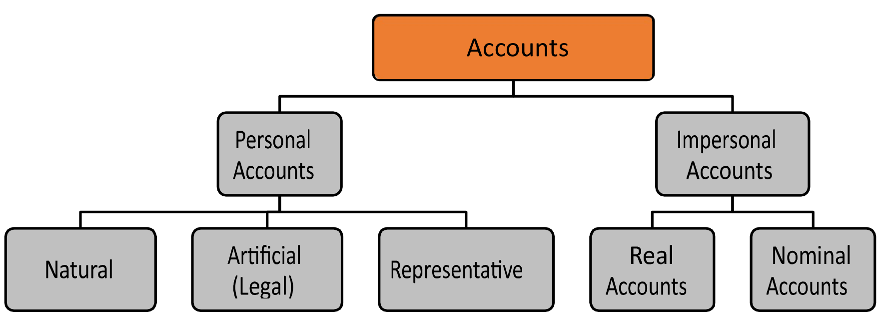
Transactions in the journal are recorded on the basis of the rules of debit and credit only. For the purpose of recording, these transactions are classified in three groups:

(i) Personal transactions.

(ii) Transactions related to assets and properties.

(iii) Transactions related to expenses, losses, income and gains.

Classification of Accounts



1. **Personal Accounts**:

Personal accounts relate to persons, trade receivables or trade payables. Example would be the account of Ram & Co., a credit customer or the account of Jhaveri & Co., a supplier of goods. The capital account is the account of the proprietor and, therefore, it is also personal but adjustment on account of profits and losses are made in it. This account is further classified into three categories:

a) Natural personal accounts: It relates to transactions of human beings like Ram, Rita, etc

b) Artificial (legal) personal accounts: For business purpose, business entities are treated to have separate entity. They are recognised as persons in the eye of law for dealing with other persons. For example: Government, Companies (private or limited), Clubs, Co-operative societies etc

c) Representative personal accounts: These are not in the name of any person or organisation but are represented as personal accounts. For example: outstanding liability account or prepaid account, capital account, drawings account

2. **Impersonal Accounts**:

Impersonal Accounts are accounts which are not personal such as machinery account, cash account, rent account etc. These can be further sub-divided as follows

a) Real Accounts: Accounts which relate to assets of the firm but not debt. For example, accounts regarding land, building, investment, fixed deposits etc., are real accounts. Cash in hand and Cash at the bank accounts are also real

b) Nominal Accounts: Accounts which relate to expenses, losses, gains, revenue, etc. like salary account, interest paid account, commission received account. The net result of all the nominal accounts is reflected as profit or loss which is transferred to the capital account. Nominal accounts are, therefore, temporary

Golden Rules of Accounting:

All the above classified accounts have two rules each, one related to Debit and one related to Credit for recording the transactions which are termed as golden rules of accounting, as transactions are recorded on the basis of double entry system

Types of Account	Account to be Debited	Account to be Credited
Personal Account	Receiver	Giver
Real Account	What comes in	What goes out
Nominal Account	Expense and losses	Income and gains

Modern Classification of Accounts:

Types of account	Normal balance of account	Account to be debited when there is:	Account to be credited when there is:
Asset account	Debit	Increase	Decrease
Liabilities account	Credit	Decrease	Increase
Capital account	Credit	Decrease	Increase
Revenue account	Credit	Decrease	Increase
Expenditure account	Debit	Increase	Decrease

JOURNALS

Transactions are first entered in this book to show which accounts should be debited and which credited. Journal is also called subsidiary book. Recording of transactions in journal is termed as journalizing the entries. It is the book of original entry in which transactions are entered on a daily basis in a chronological order. All transactions may be first recorded in the journal as and when they occur; the record is chronological; otherwise it would be difficult to maintain the records in an orderly manner. Debits and credits are listed along with the appropriate explanations

				Dr.	Cr.
Date	**Particulars**	**L.F.**		**Amount**	**Amount**
`	`			`	`

LEDGERS

After recording the transactions in the journal, recorded entries are classified and grouped into by preparation of accounts. The book which contains all set of accounts (viz. personal, real and nominal accounts), is known as Ledger. It is known as principal books of account in which account-wise balance of each account is determined

A ledger account has two sides-debit (left part of the account) and credit (right part of the account). Each of the debit and credit side has four columns. (i) Date (ii) Particulars (iii) Journal folio i.e. page from where the entries are taken for posting and (iv) Amount

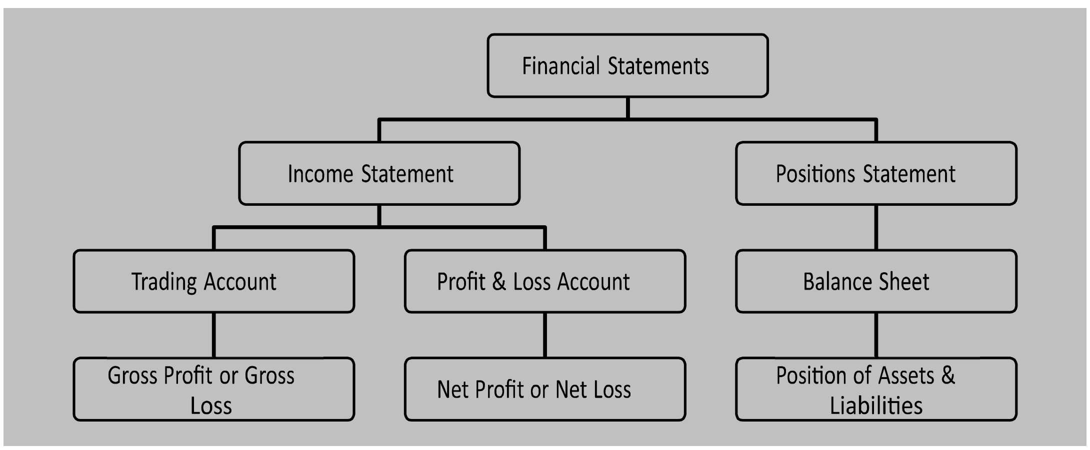
Date	**Particulars**	**J.F**	**Amount**	**Date**	**Particulars**	**J.F**	**Amount**

TRIAL BALANCE

After posting the accounts in the ledger, a statement is prepared to show separately the debit and credit balances. Such a statement is known as trial balance. It is a statement and not an account

S.No	Ledger Accounts	Dr Amount	Cr Amount

FINANCIAL STATEMENTS



Financial Statements are the systematically organized summary of all the ledger account heads presented insuch a manner that it gives detailed information about the financial position and the performance of the enterprise. As seen above, through categorization of Financial Statements into Income & Position Statement, the profit or loss is measured at two levels:

(a) Gross Profit or Gross Loss

(b) Net Profit or Net Loss

The profit or loss of the enterprise is obtained through the preparation of **Income Statement i.e Trading and Profit & Loss A/c**

The financial position of the business enterprise is judged by measuring the assets, liabilities and capital of the enterprise and the same is communicated to the users of financial statements. Financial position of the enterprise can be known through the preparation of the **Position Statement i.e. Balance Sheet**

Trading Account

It is necessary to ascertain the net profit or the net loss. For this purpose, it is first necessary to know the gross profit or gross loss. Gross Profit is the difference between the selling price and the cost of the goods sold. For a trading firm, the cost of goods sold can be ascertained by adjusting the cost of goods still on hand at the end of the year against the purchases.

Gross profit is usually ascertained by preparing a Trading account. The format of Trading Account can be shown as:

		`			`
To Opening Stock		XXX	By Sales	XXX	XXX
To Purchases	XXX		*Less*: Returns Inwards	XXX	XXX
Less: Returns outwards	XXX	XXX	By Closing Stock		
To Direct expenses:		XXX	By Gross Loss c/d*		
Freight & Carriage		XXX			
Customs & Insurance	XXX				
Wages	XXX				
Gas, Water & Fuel	XXX				
Factory Expenses	XXX				
Royalty on production	XXX	XXX			
To Gross Profit c/d*					
		XXX			XXX

*only one will appear

PROFIT AND LOSS ACCOUNT

Profit & Loss A/C is prepared to determine the profit earned or loss sustained by the business enterprise during the accounting period. It is a summary of revenue and expenses of the business and calculates the net figure termed as profit or loss. It starts with gross profit on the credit side. If there is gross loss, it will be written onthe debit side. After that all those expenses and losses, which have not been entered in the Trading Account, will be written on the debit side of Profit and Loss Account. Incomes and gains, other than sales, will be written on the credit side. The profit/loss A/c appears as follows

Particulars	`	Particulars	`
To Gross Loss b/d		**By Gross Profit b/d**	
Management expenses		**Other Income**	
To Salaries (administrative)		By Discount Received	
To Office rent, rates and taxes		By Commission Received	
To Printing and stationery		**Non-trading Income**	
To Telephone charges		By Bank Interest	
To Postage and telegrams		By Rent of property let-out	
To Insurance		By Dividend from shares	
To Audit Fees		**Abnormal Gains**	
To Legal Charges		By Profit on sale of machinery	
To Electricity Charges		By Profit on sale of investment	
Maintenance expenses			
To Repairs & renewals		**By Net Loss(transferred to capital A/c)**	
To Depreciation on:			
Office Equipment			
Office Furniture			
Office Buildings			
Selling and Distribution expenses			
To Salaries (selling staff)			
To Advertisement			
To Godown rent			
To Carriage Outward			
To Bad Debts			
To Provision for bad debts			
To Selling commission			
Financial expenses			
To Bank charges			
To Interest on loans			
To Discount on bills			
To discount allowed to customers			
Abnormal Losses			
To Loss on sale of machinery			
To Loss on sale of investment			
To loss by fire			
To Net Profit (transferred to Capital A/c)			

Note:

- Gross loss appears in the debit side of the Profit and Loss Account at the top; while Gross Profit on the credit side.
- Net loss appears in the credit side of the Profit and Loss Account; while Net profit on debit side as balancing figures

CLOSING ENTRIES:

The entries that have to be made in the journal for preparing the Trading and the Profit and Loss Account that is for transferring the various accounts to these two accounts are known as closing entries.

For items to be debited to the Profit and Loss Account this account will be debited and the various accounts concerned will be credited. For example

Profit and Loss Account Dr
To Salaries Account
To Rent Account
To Interest Account
To Other Expenses Account

Items of income or gain such as interest received or miscellaneous income will be credited to Profit and Loss Account

Discount Received Account Dr
Bad Debts Recovered Account Dr
To Profit and Loss Account

At this stage, the Profit and Loss Account will show net profit or net loss. Both have to be transferred to the Capital Account. In case of net profit, i.e., when the credit side is bigger than the debit side, the entry is

Profit and Loss Account Dr
To Capital Account

In case of Net Loss, entry will be:

Capital Account Dr
To Profit and Loss Account

BALANCE SHEET

The balance sheet may be defined as *"a statement which sets out the assets and liabilities of a firm or an institution as at a certain date.* Since even a single transaction will make a difference to some of the assets or liabilities, the balance sheet is true only at a particular point of time. That is the significance of the word "as at

The assets are shown on the right hand side and liabilities and capital on the left hand side as below

Liabilities	Amount	Assets	Amount
Bills Payable		Cash in Hand	
Trade Creditors		Cash at Bank	
Loans		Government Securities	
Outstanding Expenses		Other Investments	
Reserves & Surplus		Bills Receivable	
Capital		Sundry Debtors	
		Stock	
		Furniture & Fixtures	
		Plant & Machinery	
		Land and Building	