FINANCIAL ACCOUNTING & REPORTING

(Basic Concepts)

Financial Accounting

- **Text Books:**

1. *Financial Accounting – A Managerial Perspective* by R. Naryanswamy, PHI
2. *Financial Accounting for Management* by Ramchandran & Kakani, TMH

- **Reference Books:**

1. *Accounting Text & Cases* by Anthony, Hawkins & Merchant, TMH
2. *Accounting principles* by Weygandt, Kimmel & Kieso, Wiley
3. Case Studies - to be provided by the instructor

Accounting

- Process of identifying, measuring & communicating economic information of a business unit for decision making

  I. *Financial Accounting (Financial statements from users' perspective)*
  II. *Management Accounting (Formulating & implementing plans for managers)*

Types of Business

1. Manufacturing - transforms raw materials into a finished product by combining *raw materials, labour, and overhead costs* in its production process

2. Merchandising - buys a product and sells it without changing its form – supply chain activities

3. Service rendering - intangible products

Forms of business organizations

1. Sole Proprietorship – No legal formalities, unlimited liabilities.
2. Partnership – Partnership Act, 1935 (minimum 2 – maximum 100 partners), unlimited liabilities.
3. Limited Company – Companies Act, 2013 (Private Limited: Min 2 & Max 200; shareholders & 2 directors/ Public Limited: Min 7 shareholders & 3 directors), limited liabilities.
4. A one-person company has a single shareholder with limited liability.
5. Limited Liability Partnership (LLP) - Hybrid of a company & partnership; governed by LLP Act 2008; limited liabilities & can have corporate bodies as partners (min 2 – max unlimited partners). Suitable for professional services firms.

Accounting Measurement Assumptions

- Five major assumptions that underlie all accounting measurements are:

1. Reporting Entity
2. Going Concern
3. Periodicity
4. Money Measurement
5. Historical Cost

GAAP &
Institutions influencing Indian GAAP

- GAAP consist of conventions, rules & procedures that define accepted accounting practices.
- The accounting profession, government, and tax authorities have a major influence on GAAP.
- Accounting standards specify the acceptable methods from the wide variety of accounting choices.
- Accounting policies define the application of GAAP by an enterprise in preparing financial statements.

Indian Accounting Standards(Ind-AS)

- Ind-AS were issued under the supervision and control of Accounting Standards Board (ASB), constituted in 1977

- ASB is a committee under ICAI consisting of representatives from government department, academicians, other professional bodies viz. ICAI, ASSOCHAM, CII, FICCI, etc.

- The Ind-AS are named & numbered in the same way corresponding to IFRS

- As on date MCA has notified 41 Ind AS. These have been applied to the companies from financial year 2015-16 voluntarily and from 2016-17 on a mandatory basis

Financial Reporting

Financial Information of Business during a given period

Utilization of Funds

(i) Fixed Assets

Land& Building, Plant & Machinery, Equipment

(+)

(ii) Current Assets

Inventories + Receivables + Debtors (Credit Sales) + Cash

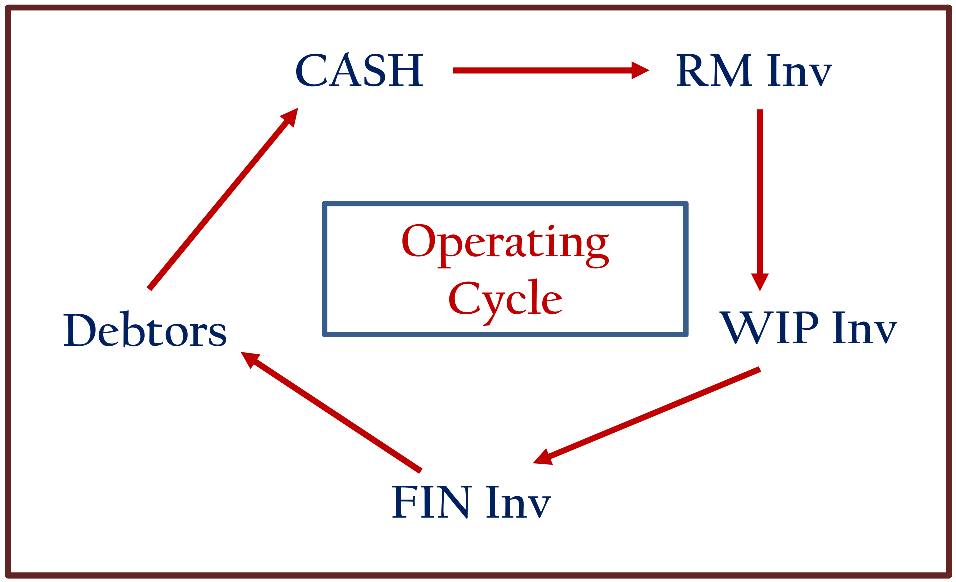
Arrangement of Funds

Owners' Equity (+) Outsiders' Equity (Liabilities)

FAs convert CAs to generate Sales Revenue during a period

At the end of the period:

1) Compute the Income – Income Statement
2) Financial status of the firm – Statement of changes in Owners' Equity & Balance sheet
3) Cash flows during the period – Cash Flows Statement



The Accounting Equation

- Shows the relationship i.e. Economic Resources of business = Claims of the business
- Economic resources are assets & the claims consist of creditor's claims or *liabilities* and owners' claims (as business is a separate legal entity) or *equity*:
- Assets = Liabilities + Owners' Equity

Case for Discussion – Music Mart, Inc.

(Effects of business transactions on the accounting equation)

- **Jan 1** - John Smith starts an incorporated CD & tape store called Music Mart, Inc.
- He does this by depositing $25,000 of his own funds in a bank account that he has opened in the name of the business entity & taking $25,000 of stock certificates in return.
- He is the sole owner of the corporation.

Music Mart, Inc. Balance Sheet as on January 1			
Assets		Liabilities & Owner's Equity	
Cash	$25,000	Paid-in-Capital	$25,000

Music Mart, Inc. …………

- **Jan 2** – Music Mart borrows $12,500 from bank; the loan is evidenced by a legal document called a *note.*

Music Mart, Inc. Balance Sheet as on January 2			
Assets		**Liabilities & Owner's Equity**	
Cash (25,000 + 12,500)	$37,500	Notes Payable Paid-in-Capital	$12,500 25,000
	37,500		37,500

Music Mart, Inc. …………

- **Jan 3** - The business buys inventory (merchandise it indents to sell) in the amount of $5,000, paying cash

Music Mart, Inc. Balance Sheet as on January 3			
Assets		**Liabilities & Owner's Equity**	
Cash (37,500 – 5,000)	$32,500	Notes Payable	$12,500
Inventory	5,000	Paid-in-Capital	25,000
	37,500		37,500

- Change in CAs only …… No changes in Liab & OE

Music Mart, Inc. …………

- Jan 4 – For $750 cash, the store sells merchandise that costs $500.
- $500 of Merchandise Inventory consumed (became an expense – COGS)
- Sold for $ 750 – (Sales Revenue generated for $750)
- Net Income of $250, which would enhance Owner's Equity (i.e. paid-in-capital) in the form of Retained Earnings
- In the business, the Owner's Equity should always be shown as per actuals

Music Mart, Inc. Balance Sheet as on January 4			
Assets		Liabilities & Owner's Equity	
Cash (32,500 + 750)	$33,250	Notes Payable	$12,500
Inventory (5,000 – 500)	4,500	Paid-in-Capital	25,000
		Retained Earnings	250
	37,750		37,750

- ***Prepare the date wise Balance Sheets for remaining dates on the basis of Explanation of each transaction given in subsequent slides***

Music Mart, Inc. …………

- **Jan 5 -** The store purchased and received merchandise for inventory for $5,000, agreeing to pay within 30 days
- Inventory balance (current asset) increased by $5,000
- A new Liability in the form of ‘Creditor’ is created for the firm for the credit supplier

- **Jan 6** – Merchandise costing $1,500 was sold for $2,300, which was received in cash.
- Merchandise Inventory reduced by $1,500
- Cash increased by $ 2,300
- Profit of $ 800 enhances the Retained Earnings

- **Jan 7** – Merchandise costing $1,700 was sold for $2,620, the customers agreeing to pay $2,620 within 30 days.
- It is a credit transaction
- Merchandise Inventory reduced further by $1,700
- Debtors (Credit customers) increased by $ 2,620
- Profit of $ 920 enhances the Retained Earnings

Music Mart, Inc. …………

- **Jan 8** – The store purchased a three-year free insurance policy for $1,224, paying cash.
- Cash is reduced further by $1,224
- *Advance payment made for Insurance Policy* – Pre-paid Expense & hence the benefit shall be used by the firm in future period – Current Asset
- *After the completion of a particular time period, part of this current asset shall become expense*

- **Jan 9** – The store purchased two lots of land of equal size for a total of $24,000. It paid $6,000 in cash and gave a 10-year mortgage for $18,000.
- Cash is reduced further by $6,000
- *New Mortgage Loan (Long-term Loan)* is created for $ 18,000
- *A new Fixed Asset i.e. Land* is created for the firm for $24,000

- **Jan 10** – The store sold one of the two lots of land for $12,000. It received $3,000 cash, and in addition, the buyer assumed $9,000 of the mortgage; that is, Music Mart, Inc., became no longer responsible for this half.
- Cash is increased by $3,000; Mortgage Loan (Long-term Loan) is reduced by $ 9,000; & Land is reduced by $12,000.

Music Mart, Inc. …………

- **Jan 11 –** Smith received a bonafide offer of $33,000 for the business; although his equity was then only $26,970, he rejected the offer. It was evident that the store had already acquired goodwill of $6,030.
- Here Equity is referred to as (Paid-in-Capital + Retained Earnings) = $26,970.
- Firm is offered to be sold out for $ 33,000. The excess offer of $(33,000 – 26,970) = $ 6,030 is the goodwill of the firm, which can only be ascertained at the time of selling the business to another party.
- It is an offer – No economic event is taking place – So, **No change in Balance sheet.**

- **Jan 12** – Smith withdrew $1,000 cash from the store's bank account for his personal use.
- Cash reduced by $1,000 & the Paid-in-capital should be reduced by $1,000 for Drawings. **As the book value of the equity can not be changed (even there is clear evidence that the book value is lesser than the real value), the deduction shall be from Retained earnings.**
- *Drawings from business can only be possible in Sole-Proprietorship firm*.

- **Jan 13** – Smith took merchandise costing $750 from the store's inventory for his personal use.
- Merchandise Inventory reduced by $ 750 and the Retained earnings is further reduced by $750 in the form of Drawings.

Music Mart, Inc. …………

- **Jan 14** – Smith learned that the individual who purchased the land (No.6 above) subsequently sold it for $14,000. The lot still owned by Music Mart, Inc., was identical in value with this other plot.
- No effect on Balance Sheet

- **Jan 15** – The store paid off $6,000 of its note payable(disregard interest)
- Cash & Notes payable decreased by $6,000

- **Jan 31** – Smith sold one-third of the stock he owned in Music Mart, Inc., for $11,000 cash
- Music Mart, Inc. is a separate legal entity in the eyes of law. So, it continues to exist irrespective of the change in ownership.
- No effect on Balance Sheet.

Music Mart, Inc. …………

- **Jan 31** – Merchandise costing $850 was sold for $1,310, which was received in cash.
- Inventory reduced by $850 (became an expense – cost of goods sold);
- Cash increased by $ 1310.
- Increase in Retained Earnings by $(1,310 – 850) = $460.

usic Mart, Inc. Balance Sheet as on January 15			
Assets		**Liabilities & Owner's Equity**	
Cash (24,326 + 1,310)	**$25,636**	**Creditors**	**$5,000**
Inventory (5,550 – 850)	**4,700**	**Notes Payable**	**6,500**
Debtors	**2,620**	**10 Yr. Mortgage Loan**	**9,000**
Insurance Policy	**1,224**	**Paid-in-Capital**	**25,000**
Land	**12,000**	**Retained Earnings (220 + 460)**	**680**
	46,180		**46,180**

Music Mart, Inc. …………Recognition of Expense (Not relating to the case)

- **Jan 31** – Firm needs to take the cognizance of Insurance expense as the purchased insurance policy will now cover the hazards for next 35 months
- Insurance expense for the month of January = $(1224 /36) = $34
- Insurance Policy as an asset is now reduced by $34 & the Retained Earnings shall now be reduced by insurance expense of $34 for January

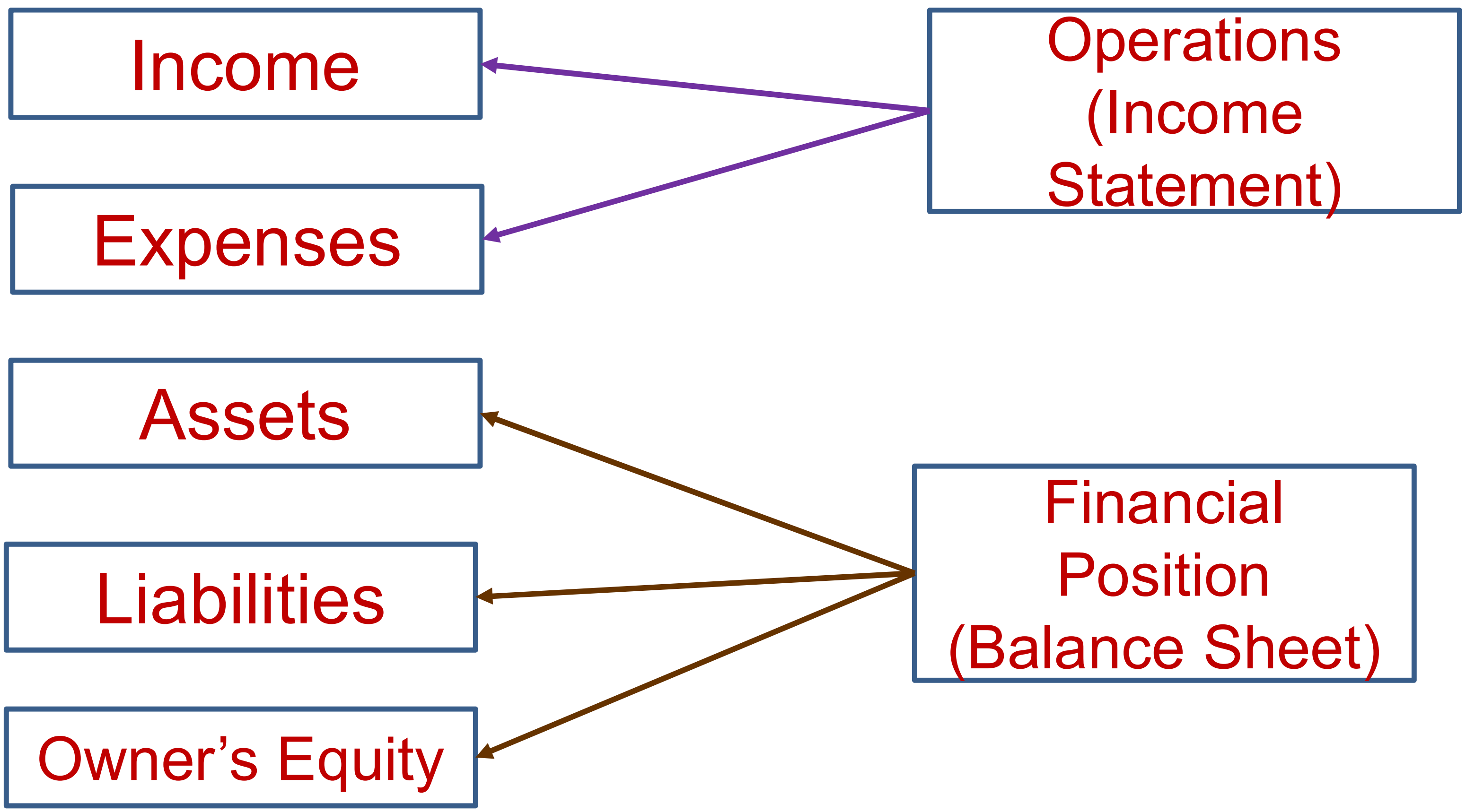
Music Mart, Inc. Balance Sheet as on January 15			
Assets		**Liabilities & Owner's Equity**	
Cash	$25,636	Creditors	$5,000
Inventory	4,700	Notes Payable	6,500
Debtors	2,620	10 Yr. Mortgage Loan	9,000
Insurance Policy (1,224 – 34)	1,190	Paid-in-Capital	25,000
Land	12,000	Retained Earnings (680 -34)	646
	46,146		46,146

Expanded form of Accounting Equation

- Assets = Liabilities + Owners' Equity
- Assets = Liabilities + [Owners' Equity+ Retained earnings]
- Assets = Liabilities + [Owners' Equity+ Retained earnings (Revenues – Expenses)]
- Assets = Liabilities + Owners' Equity+ Retained Earnings (Revenues – Expenses – Dividends – Drawings)

Major Account categories

Accounts are the categories into which the effects of transactions are recorded & from which different financial reports are created.



Financial Statements

1. The Balance Sheet shows the financial position of the enterprise at a particular point of time
2. The Profit & Loss Account or Income Statement reports the financial performance of an enterprise during a period
3. The Statement of Changes in Equity explains the changes in equity including share capital due to retained earnings & in some cases (for Sole Proprietorship firm) due to Drawings also
4. The Cash Flow Statement summarizes the cash inflows and outflows of the enterprise resulting from its operating, investing and financing activities during a period

Balance Sheet

- The Balance Sheet details the financial position of a company on a particular date; the company's assets (that which the company owns), &liabilities (that which the company owes), grouped logically under specific heads

BALANCE SHEET

#REF!

#REF!

ASSETS		LIABILITIES & EQUITY	
Current Assets:		*Current Liabilities:*	
Cash at Hand	0.00	Accounts Payable	0.00
Cash at Bank	0.00	Sales Taxes Payable	0.00
Accounts Receivable	0.00	Payroll Taxes Payable	0.00
Less: Reserve for Bad Debts	0.00	Income Taxes Payable	0.00
Stock	0.00	Accrued Wages Payable	0.00
Prepaid Expenses	0.00	Unearned Revenues	0.00
Notes Receivable	0.00	Bank Overdraft	0.00
		Short-Term Loan Payab	0.00
Total Current Assets	**0.00**	***Total Current Liabilities***	**0.00**
Fixed Assets:		*Long-Term Liabilities:*	
Vehicles	0.00	Long-term Bank Loans Payable	0.00
Less: Accumulate	0.00	Mortgage Payable	0.00
Furniture and Fixtures	0.00	***Total Long-Term Liabili***	**0.00**
Less: Accumulated Deprecia	0.00		
Equipment	0.00	**Total Liabilities**	**0.00**
Less: Accumulate	0.00		
Buildings	0.00		
Less: Accumulate	0.00	*Capital & Reserves*	
Land	0.00	Capital	0.00
Total Fixed Assets	**0.00**	Add: Net Profit	0.00
		Less: Drawings	0.00
Other Assets:		***Net Capital***	**0.00**
Goodwill	0.00		
Total Other	**0.00**		
Total Assets	**0.00**	**Total Liabilities and Equity**	**0.00**

Income Statement
Or Profit & Loss Statement

- Reports the revenues and expenses for a specific period of time
- The income statement lists revenues first, followed by expenses. Finally the statement shows net income (or net loss) - Net income results when revenues exceed expenses (& vice-versa)
- Recording practices vary & so alternative formats for the statement are in use
- It does not include investment and withdrawal transactions between the owner and the business in measuring net income

ABC Electronics Company Income Statement For the quarter ending September 30, 2020		
Sales		$ 200,000.00
Cost of goods sold		(110,000.00)
Gross profit		90,000.00
Operating expenses		
Selling expenses		
Advertising costs	5,000.00	
Payroll and commission	35,000.00	40,000.00
Administrative expenses		
Rent	6,000.00	
Office equipment	1,500.00	
Utilities	700.00	8,200.00
Total operating expenses		(48,200.00)
Operating income		41,800.00
Non-operating and other		
Interest revenues	2,000.00	
Gains from investment sales	1,500.00	
Interest expenses	(600.00)	
Taxes	(200.00)	
Total non-operating items		2,700.00
Net income		44,500.00

Income Statement

Company Name

For the Time Period & Ending Date

- Net sales = Gross sales - (Returns and Allowances)
- Less, Cost of goods sold (COGS) = certain direct costs incurred for a product, when is manufactured or sold (for Service firms, it is Cost of Sales)
- Gross profit
- Less, Operating expenses = normal expenses other than COGS(management salaries, advertising expenditures, repairs & maintenance costs, research & development expenditures, lease payments, and general & administrative expenses)
- Add, Non-Operating Incomes = (Income from investment made outside the business)
- Operating profit
- Less, Depreciation & Interest expense
- Profit before taxes
- Less, Taxes
- Net income

Statement of Changes in Equity

- Reconciliation between the opening balance and closing balance of Owner's equity
- Summarises the transactions related to the Owner's equity over an accounting period (i.e. movement in retained earnings & changes in share capital such as the issue of new shares and payment of dividends are recorded in this report)
- The statement of changes in equity is also known as the statement of retained earnings in U.S. GAAP
- Changes in Retained earnings:

Opening Retained Earnings
Add, Net Income
Less, Dividends distributed
Less, Drawings (in case of sole-proprietorship firm)
Closing Retained Earnings

Retained Earnings Connects the Income Statement and the Balance Sheet

Income Statement

Revenues
Less, Expenses
Net Income

Statement of Changes in Equity

Opening Balance of RE
+ Net Income
(-) Dividends
(-) Drawings
Cl Balance of RE

Balance Sheet

Assets
Current Assets
Long-Term Investments
Property, Plant & Equipment
Intangible Assets
Other Assets
Liabilities & OE
Current Liabilities
Long-term Liabilities
Owners' Equity
+ Cl Balance of RE

Cash Flow Statement

- Comprising of cash flows from three specific activities & the statement is prepared from the inputs received from Accrual basis accounting statements (i.e. IS & BS)

  1. Operating Activities
  2. Investing Activities
  3. Financing Activities

  – In the Statement of Cash flow, the opening cash balance is adjusted with the net flows from these three activities to identify the closing cash balance (as reflected in the Balance Sheet)

Cash flow Statement

- Opening balance of Cash & Cash equivalents
- Add, Net cash flows from Operating activities
- (net of operating cash inflows & outflows - on the basis of inputs from– Income Statement & B/S (only CAs & CLs)Items)
- Add, Net cash flows from Investing activities
- (net of investing cash inflows & outflows - on the basis of inputs from B/S Items referring to the acquisition and disposal of long-term assets & other investments not included in cash equivalents)
- Add, Net cash flows from Financing activities
- (net of financing cash inflows & outflows - on the basis of B/S Items referring to changes in Long-term Liabilities & OE)
- Closing balance of Cash & Cash equivalents

ABC Co Ltd.
Statement of Cash Flows
For the Year Ended December 31, 2018

	$
Cash flows from Operating Activities	
Cash received from customers	126,860
Cash paid to suppliers	(69,600)
Cash paid to employees	(25,300)
Cash paid to landlord	(8,520)
Cash paid for interest	(2,400)
Cash paid for tax	(3,840)
Others	(1,624)
Total Cash flows from Operating Activities	**15,576**
Cash from Investing Activities	
Purchased Equipment	(9,142)
Total Cash from Investing Activities	**(9,142)**
Cash from Financing Activities	
Paid back principal of loan	(10,000)
Total Cash from Financing Activities	**(10,000)**
Net Cash Flows	**(3,566)**
Beginning cash balance	14,862
Ending Cash balance	**11,296**