UNIT-IV
FINANCIAL ACCOUNTING

Business organizations:

Business organizations provide goods and services in order to earn a profit. Goods have form and substance and the seller of goods physically transfers them to the buyer. Soaps, pens, computers, cars and medicines etc. examples for products. Services are work done by one person that benefits another. Examples are hairstyling, writing computer programs etc.

Business organizations are of three types

Merchandizing or trading organizations: Buy and sell goods without any processing.

Manufacturing organizations: Buy materials, process them into finished products and sell them.

Service organizations; Provide services.

Meaning of accounting:

Accountancy means the complication of accounts in such a way that one is in position to know the state of affairs of the business.

Definition of Accounting

'The systematic and comprehensive recording of financial transactions pertaining to a business. Accounting also refers to the process of summarizing, analyzing and reporting these transactions.

_____R. N. Anthony______

Accounting is often called the language of business

Single entry system & Double entry system

Meaning Of Single Entry System

Single entry system is an incomplete form of recording financial transactions. It is the system, which does not record two aspects or accounts of all the financial transactions. It is the system, which has no fixed set of rules to record the financial transactions of the business. Single entry system records only one aspect of transaction. Thus, single entry system is not a proper system of recording financial transactions, which fails to present complete information required by the management. Single entry system mainly maintains cash book and personal accounts of debtors and creditors. Single entry system ignores nominal account and real account except cash account. Hence, it is incomplete form of double entry system, which fails to disclose true profit or loss and financial position of a business organization.

Features Of Single Entry System

The following are the main features of single entry system:

1. No Fixed Rules

Single entry system is not guided by fixed set of accounting rules for determining the amount of profit and preparing the financial statements.

2. Incomplete System

Single entry system is an incomplete system of accounting, which does not record all the aspects of financial transactions of the business.

3. Cash Book

Single entry system maintains cash book for recording cash receipts and payments of the business organization during a given period of time.

4. Personal Account
Single entry system maintains personal accounts of all the debtors and creditors for determining the amount of credit sales and credit purchases during a given period of time.

5. Variations In Application
Single entry system has no fixed set of principles for recording financial transactions and preparing different financial statements. Hence, it has variations in its application from one business to another.

The following are the notable disadvantages of single entry system:

1. Unscientific And Unsystematic
The single entry system is unsystematic and unscientific system of recording financial transactions. It does not have any set of fixed rules and principles for recording and reporting the financial transactions.

2. Incomplete System
Single entry system is incomplete system because it does not record the two aspects or accounts of all the financial transactions of the business. It does not maintain any record of the transactions relating to the nominal account and real account except cash account.

3. Lack Of Arithmetical Accuracy
Single entry system is not based on the principles of debit and credit. It fails to provide the arithmetical accuracy of the books of accounts. Trial balance cannot be prepared under this system to check the arithmetical accuracy of books of accounts.

4. Does Not Reflect True Profit Or Loss
Under single entry system, the true amount of profit or loss cannot be ascertained because it does not maintain the nominal accounts.

5. Does Not Reflect True Financial Position
The single entry system does not maintain real accounts except cash book. Therefore, it cannot reveal the true financial position of the business.

6. Frauds And Errors
The single entry system of book-keeping is incomplete, inaccurate and unscientific. It does not help to check the arithmetical accuracy of the books of accounts. Therefore, there is always a possibility of committing frauds and errors in the books of accounts.

7. Unacceptable For Tax Purpose
The single entry of book keeping has incomplete records of the financial transactions of the business. Hence, the tax office cannot accept the account maintained under this system for the purpose of assessment of tax.

Double entry system:

Double entry system is a scientific way of presenting accounts. As such all the business concerns feel it convenient to prepare the accounts under double entry system.
Under dual aspect concept the accountant deals with the two aspects of business transaction I. e., (I) receiving aspect and (II) giving aspect, receiving aspect is known as 'Debit aspect' and giving aspect is known as 'credit aspect'. In double entry book keeping system these two aspects are recorded facilitating the preparation of trial balance and the final accounts.
The principle under which both debit and credit aspects are recorded is known as the principle of double entry. According to this principle every debit must necessarily have a corresponding credit and vice versa.

Features of Double Entry System of Book-keeping

The following are some features or characteristics of double-entry book-keeping.

1. Double effecting: It follows the principle of double aspect by debiting and crediting the transaction.
2. Equal effect**:** It assumes that debit must be equal to credit mount i.e. It considers the effect of equal amount.
3. Debit and credit**:** It has two sides i.e. debit and credit. For example, the benefit receive is given the name debit and the benefit giver is given credit.
4. Account: It maintains the records of personal, real as well as nominal accounts.
5. Arithmetical accuracy: another feature of double entry system of book keeping to check arithmetical accuracy by preparing trial balance.

Importance or Advantage of Double Entry Book-Keeping System

The following are the advantages of double-entry book-keeping.

1. Complete records of each transaction**:** Double entry system presents a complete record of transaction. Because it records both the aspect of every transaction, which relates to personal or impersonal.
2. Checking of arithmetical accuracy**:** Arithmetical accuracy can be checked by preparing trial balance from all ledgers concerned.
3. Profit or loss: Profit and loss account can easily be prepared. The exact reason for profit and loss can be ascertain.
4. Financial position: It provides full particulars of various assets and liabilities of the business, so financial position can be known by preparing balance sheet. A comparative study of the balance sheet for various years shows a firm's progress.
5. Frauds and errors**:** It prevents frauds and errors and makes their detection easier.
6. Accepted by court and tax authorities: This system keeps a complete record of financial transaction therefore, it is accepted by court, tax authorities and banking institutions.
7. Scientific and systematic**:** Double entry system of book-keeping is scientific and systematic records of financial transaction.

Disadvantage of Double Entry Book Keeping System

1. Expensive: It is an expansive system of book-keeping which is not favorable for small business.
2. Complicated: It is complicated system where certain rules and regulations are to be followed.
3. Fails: It fails to disclose the error of omission, error of principles, errors of commission, and compensating error

Differences between single entry system & Double entry system

	Single-entry	Double-entry
Definition	Single-entry system of bookkeeping requires inputting the entry only once in either the credit column or the debit column.	Double-entry system requires putting one entry twice, once in the credit column and once in the debit column of another account.
Duality	Is not based on the concept of duality.	Is based on the concept of duality.
Accounts	Maintains simple and personal accounts of debtors, creditors and cashbook.	Maintains all personal, real and nominal accounts.
Profit Or Loss	Cannot help in making the company's profit or loss statement.	Can help in making the company's profit or loss statement.
Suitability	Small businesses where transactions are small and simple.	Big businesses and corporations that deal with complex transactions and huge inventories.
Trial Balance	Cannot prepare trial balance	Can prepare trial balance
Tax Purpose	Is not acceptable for tax purposes.	Is acceptable for tax purposes.
Financial Position	Cannot ascertain the true financial position of the business.	Can ascertain financial position of the business.
Advantages	Simple, less-expensive, easier to manage, provides general view of earnings and expenditure.	Complete data is available, provides an arithmetic check on bookkeeping, helps track debits and credits, can help ascertain the financial position of the business, makes it easier to produce year-end accounts.
Disadvantages	Incomplete data, are not able to provide a check against clerical error, does not record all transactions, does not provide a detailed record of assets, theft and loss cannot be detected.	Expensive, harder to understand, requires hiring external staff and time-consuming.

Accounting concepts

The Business Entity Concept

The business entity concept provides that the accounting for a business or organization be kept separate from the personal affairs of its owner, or from any other business or organization. This means that the owner of a business should not place any personal assets on the business balance sheet. The balance sheet of the business must reflect the financial position of the business alone.

Dual Aspect Concept:

Under dual aspect concept the accountant deals with the two aspects of business transaction I. e., (I) receiving aspect and (II) giving aspect, receiving aspect is known as 'Debit aspect' and giving aspect is known as 'credit aspect'.

The Continuing Concern Concept

It is assumed that the business will continue for a long time. With this assumption fixed assets are recorded in the books at their original cost. Keeping this assumption in view, prepaid expenses are not treated as the expenses of the year in which they are incurred. It is assumed that the business derives benefit out of it in the years to come.

The Principle of Conservatism

The principle of conservatism provides that accounting for a business should be fair and reasonable. Accountants are required in their work to make evaluations and estimates, to deliver opinions, and to select procedures. They should do so in a way that neither overstates nor understates the affairs of the business or the results of operation.

The Objectivity Principle

The objectivity principle states that accounting will be recorded on the basis of objective evidence. Objective evidence means that different people looking at the evidence will arrive at the same values for the transaction. Simply put, this means that accounting entries will be based on fact and not on personal opinion or feelings.

The Revenue Recognition Convention or Accrual Concept

The revenue recognition convention provides that revenue be taken into the accounts (recognized) at the time the transaction is completed. Usually, this just means recording revenue when the bill for it is sent to the customer. If it is a cash transaction, the revenue is recorded when the sale is completed and the cash received. If this is not done, the earnings statements of the company will be incorrect and the readers of the financial statement misinformed.

The Matching Principle

The matching principle is an extension of the revenue recognition convention. The matching principle states that each expense item related to revenue earned must be recorded in the same accounting period as the revenue it helped to earn. If this is not done, the financial statements will not measure the results of operations fairly.

The Cost Principle

Usually all the transactions will be recorded at cost in the books. However, at the end of every year the accountant shows the reduced value of the assets, after providing for depreciation. This approach preferred because it is difficult and time consuming to ascertain the market values.

The Consistency Principle

The consistency principle requires accountants to apply the same methods and procedures from period to period. When they change a method from one period to another they must explain the change clearly on the financial statements.

The consistency principle prevents people from changing methods for the sole purpose of manipulating figures on the financial statements.

The Materiality Principle

The materiality principle requires accountants to use generally accepted accounting principles except when to do so would be expensive or difficult, and where it makes no real difference if the rules are ignored. If a rule is temporarily ignored, the net income of the company must not be significantly affected, nor should the reader's ability to judge the financial statements be impaired.

The Full Disclosure Principle

The full disclosure principle states that any and all information that affects the full understanding of a company's financial statements must be include with the financial statements.

Accounting period concept:

Accounting period is the period followed by a business concern for maintaining accounts to know profit or loss. Usually, one year will be the accounting period starting from 1st April to 31st march.

Branches of accounting

Accounting has three branches and each branch of accounting is inter - related with other branch. No one branch is perfect without other branch of accounting. Every branch of accounting works only if other branch of account will perform best.

Financial Accounting

Financial accounting is the old branch of accounting which is related to make profit and loss account and balance sheet after maintaining daily record of business transactions. Profit and loss shows net profit or net loss for a specific period and balance sheet shows the financial position on the specific date.

Cost Accounting

Cost accounting is that branch of accounting which is related to calculate of total cost or per unit cost of goods or services. Its aim is to reduce cost of production and increase businessman's profitability. In other words , it is used in an organization for controlling the cost .

Management Accounting

Management accounting is that branch of accounting which is related to use accounting information for determination of policies and other business decisions . It uses the accounting information for analysis the efficiency of different department of an organization.

ers

Users of accounting information

Accounting information is useful in making a number of decisions that affect the income or wealth of individuals and organizations. Examples of decisions that are based on accounting information include the following.

1. Decide when to buy, hold or sell an equity investment
2. Assess the stewardship or accountability of management
3. Assess the ability of the enterprise to pay and provide other benefits tom its employees.
4. Assess the security for amounts lent to the enterprise
5. Determine taxation policies
6. Determine distributable profits and dividends
7. Prepare and use national income statistics
8. Regulate the activities of enterprises.

Users of accounting information

Users of financial information may be both internal and external to the organization.

Internal users (Primary Users) of accounting information include the following:

1. Owners

Stockholders of corporations need financial information to help them make decisions on what to do with their investments (shares of stock), i.e. hold, sell, or buy more.

2. Management

In small businesses, management may include the owners. In huge organizations, however, management is usually made up of hired professionals who are entrusted with overall responsibility of operating the business or a part of the business. They act as agents of the owners.

The managers, whether owner or hired, regularly face economic decisions – How much supplies will we purchase? Do we have enough cash? How much did we make last year? Did we meet our targets? All those, and many other decisions, require analysis of accounting information.

3. Employees

Employees are interested in the company's profitability and stability. They are after the ability of the company to pay salaries and provide employee benefits. They may also be interested in the company's financial position and performance to assess the possibility of company expansion and career opportunities.

External users (Secondary Users) of accounting information include the following:

1. Lenders
Lenders of funds such as banks and other financial institutions are interested in the company's ability to pay liabilities upon maturity (solvency).
2. Trade creditors or suppliers
Like lenders, trade creditors or suppliers are interested in the company's ability to pay obligations when they become due. They are nonetheless especially interested in the company's liquidity -- its ability to pay short-term obligations.
3. Government
Governing bodies of the state, especially the tax authorities, are interested in an entity's financial information for taxation and regulatory purposes. Taxes are computed based on the results of operations and other tax bases. In general, the state would like to know how much the taxpayer is making to determine the tax due thereon.
4. Customers
When there is a long-term involvement or contract between the company and its customers, the customers may be interested in the company's ability to continue existence and its stability of operations. This need is also heightened in cases where the customers depend upon the entity.
For example, a distributor (reseller), the customer in this case, is dependent upon the manufacturing company from which it purchases the items it resells.
5. General Public
Anyone outside the company such as researchers, students, analysts and others are interested in the financial statements of a company for some valid reason.

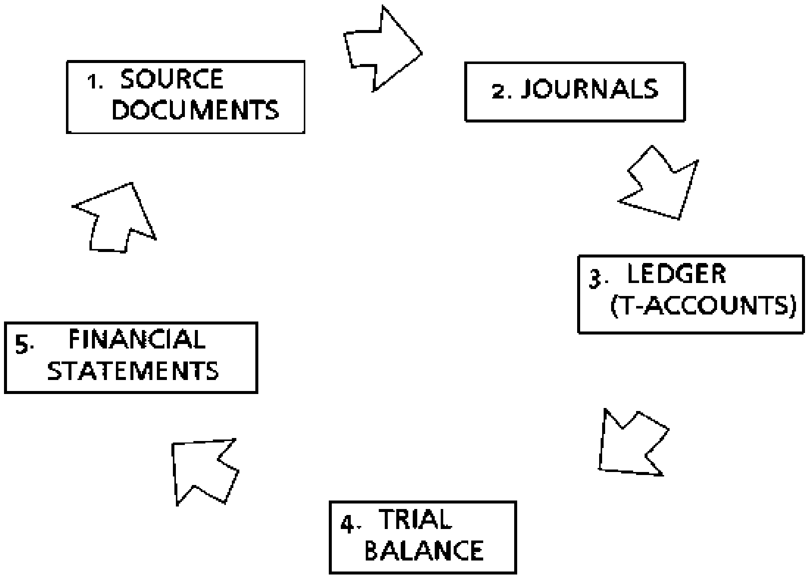
Internal users refer to managers who use accounting information in making decisions related to the company's operations.

External users, on the other hand, are not involved in the operations of the company but hold some financial interest. The external users may be classified further into users with direct financial interest – the owners, investors, lenders and creditors, and users with indirect financial interest – government, employees, customers and the others.

Accounting cycle

Accounting cycle is a step-by-step process of recording, classification and summarization of economic transactions of a business. It generates useful financial information in the form of financial statements including income statement, balance sheet, cash flow statement and statement of changes in equity.
The time period principle requires that a business should prepare its financial statements on periodic basis. Therefore accounting cycle is followed once during each accounting period. Accounting Cycle starts from the recording of individual transactions and ends on the preparation of financial statements and closing entries.

Major Steps in Accounting Cycle



Journal entries

The recording of financial data (taken usually from a journal voucher) pertaining to business transactions in a journal such that the debits equal credits. Journal entries provide an audit trail and a means of analyzing the effects of the transactions on an organization's financial position. See also journalizing.

Ledger

Collection of an entire group of similar accounts in double-entry bookkeeping. Also called book of final entry, a ledger records classified and summarized financial information from journals (the 'books of first entry') as debits and credits, and shows their current balances. In manual accounting systems, a ledger is usually a loose leaf binder with a separate page for each ledger account. In computerized systems, it consists of interlinked digital files, but follows the same accounting principles as the manual system.

Structure of ledger

Date	Particulars	J.R	Amount	Date	Particulars	J.R	Amount
2005 Dec. 17	Cash A/C		1,200	2005 Dec. 17	Purchases A/C		2,000

Trial balance

Trial Balance is a list of closing balances of ledger accounts on a certain date and is the first step towards the preparation of financial statements. It is usually prepared at the end of an accounting period to assist in the drafting of financial statements. Ledger balances are segregated into debit balances and credit balances. Asset and expense accounts appear on the debit side of the trial balance whereas liabilities, capital and income accounts appear on the credit side. If all accounting entries are recorded correctly and all the ledger balances are accurately extracted, the total of all debit balances appearing in the trial balance must equal to the sum of all credit balances.

Purpose of a Trial Balance

- Trial Balance acts as the first step in the preparation of financial statements. It is a working paper that accountants use as a basis while preparing financial statements.
- Trial balance ensures that for every debit entry recorded, a corresponding credit entry has been recorded in the books in accordance with the double entry concept of accounting. If the totals of the trial balance do not agree, the differences may be investigated and resolved before financial statements are prepared. Rectifying basic accounting errors can be a much lengthy task after the financial statements have been prepared because of the changes that would be required to correct the financial statements.
- Trial balance ensures that the account balances are accurately extracted from accounting ledgers.
- Trail balance assists in the identification and rectification of errors.

TRADING AND PROFIT AND LOSS ACCOUNT

- **Final Accounts of sole Traders:** show the calculation of profit earned or the loss incurred during the period and the financial position of the business at the end of the period. Final accounts usually prepared from a trial balance.

1. Trading Account: deals with trading (buying and selling). The account shows the calculation of profit earned on goods sold.

Gross Profit = Sales – Cost of Goods Sold Cost of goods sold = opening stock + purchases + carriage inwards - closing stock

Drawings of goods for personal use is deducted from purchases Carriage inwards is added to the purchases

- **2. Profit and Loss Account**: shows the calculation of final or true profit. This is the profit after all running expenses and any other items of income.

Net Profit = Gross profit + other incomes - Expenses

3. Balance Sheet: is a statement of the financial position of the business on a certain date. It shows what the business owns, and amounts owing to the business- the assets and what the business owes, the liabilities and the capital

Proforma of balance sheet

Balance Sheet Template

Company Name Here
Balance Sheet
For the Period Ended ___________

Assets			
Current Assets			
Cash		000000	
Short-term investments		00000	
Accounts Receivables		00000	
Inventories		0000000	
Prepaid Insurance		000000	
Others		00000	000000
Long Term Investments			
Stock Investments		000000	
Cash Value of Insurance		0000000	000000
Fixed Assets			
Land		000000	
Building and Equipment	0000000		
Less Accumulated Depreciation	(00000)	000000	0000000
Intangible Assets			
Good Will			0000000
Other Assets			
Receivables from Employees			00000000
Total Assets			000000000

Liabilities			
Current Liabilities			
Accounts Payable		000000	
Salaries Payable		00000	
Accrued Interest		00000	
Taxes Payable		0000	
Current Portion of Notes		000000	00000000
Long Term Liabilities			
Note Payable		000000	
Mortgage Liability		000000	00000000
Total Liabilities			00000000
Stock Holder's Equity			
Capital Stock		00000000	
Retained Earnings		0000000	
Total Stock Holder's Equity			000000
Total Liabilities			000000000

<u>**List of some common Expenses, Income, Assets and Liabilitiess**</u>

EXPENSES.	**FIXED ASSETS**	**CURRENT LIABILITY**
Carriage inwards, carriage outwards Purchases, wages and salaries, Rent and insurance, electricity charges, advertising charges, bank charges, Discount allowed, bad debts, Depreciation of fixed assets, Provision for bad debts, office expenses, Provision for discount on debtors General expenses, motor expenses, Motor vehicle expenses Repairs to building or machinery	Plant and Machinery Land and Buildings Premises Equipment Furniture and Fittings Fixtures and Fittings Lawn Mover Computers Motor van/Motor vehicle Motor car	Creditors for goods Creditors for expenses: Eg. Rent owing, Salary accrued Wages unpaid General expenses unpaid Commission outstanding Bank overdraft [allunpaid amounts]

Interest on loan		
INCOMES: Sales, discount received, Commission received Interest received, rent received, profit on sale of old fixed assets	**CURRENT ASSETS** Cash in hand Cash at bank Debtors Closing stock Prepaid rent, insurance, rates	**LONG TERM LIABILITIES** Loan from bank Mortgage loans Debenture