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NMIMS GLOBAL ACCESS SCHOOL FOR CONTINUING EDUCATION

Financial Accounting & Analysis

Chapter 2: Accounting Process

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LEARNING OBJECTIVES

- Explain the importance of accounting equation
- Discuss the accounting cycle
- Describe the traditional and modern classification of accounts
- Explain the rules of debit and credit
- Outline the double-entry system of accounting
- Understanding the journal and process of journalising

Accounting Equation

What Is The Accounting Equation?

The accounting equation is the fundamental equation that keeps together a balance sheet. Indeed, it states that assets always equal liability plus equity. The foundation of accounting is the double-entry system which assumes that a company balance sheet can be broken down in assets, and how they get sources (either though equity/capital or liability/debt).

Liability

Obligations contracted by an organization. Just like the Assets, liabilities can be current and non-current

Equity

Amount of money or resources endowed to an organization

Asset

The assets side of the Balance Sheet is divided in Current Assets (which usually have a life cycle of one accounting year) + Non-Current or Long-Term Fixed Assets (with a life cycle of more than one accounting year)

(The Accounting Equation)

Asset = Liability + Equity

According to the accounting equation assets have to equal the liabilities plus equity. When it doesn't happen your balance sheet will need to be reconciled

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Accounting Equation

Meaning of Accounting Equation

- The accounting equation shows the assets of the business to which creditors have a claim as the business promises them a payment in exchange for their goods or services taken.
- In case of loans taken from banks or any other individual, creditors need interest on the investment made by them and their principal amount after the due period. The accounting equation is written as:

  Assets = Liabilities + Equity

- The accounts will balance only if all transactions are recorded correctly with the double-entry effect (which ensures that nothing is eliminated).
- Nowadays, with computerised accounting, every transaction made automatically creates a double effect and the balance sheet is generated and the status is shown on a daily basis.

Debit and Credit

Double-entry System of Accounting

- Double-entry bookkeeping, in accounting, is a system of book keeping where every entry to an account requires a corresponding and opposite entry to a different account.
- **The double-entry has two equal and corresponding sides known as debit and credit. The left-hand side is debit and right-hand side is credit.**
- In double-entry accounting system, there are always two or more accounts involved for every business transaction that occurs.
- The fundamental concept of accounting is that every transaction creates an equal and opposite effect in at least two different accounts and establishes the accounting equation (Assets = Liabilities + Equity).

Double-entry System of Accounting

Illustrations:

1. Goods sold for Rs. 10000 against cash.

Cash A/c	Dr.	10000
To Sales A/c		10000

(Being goods sold)

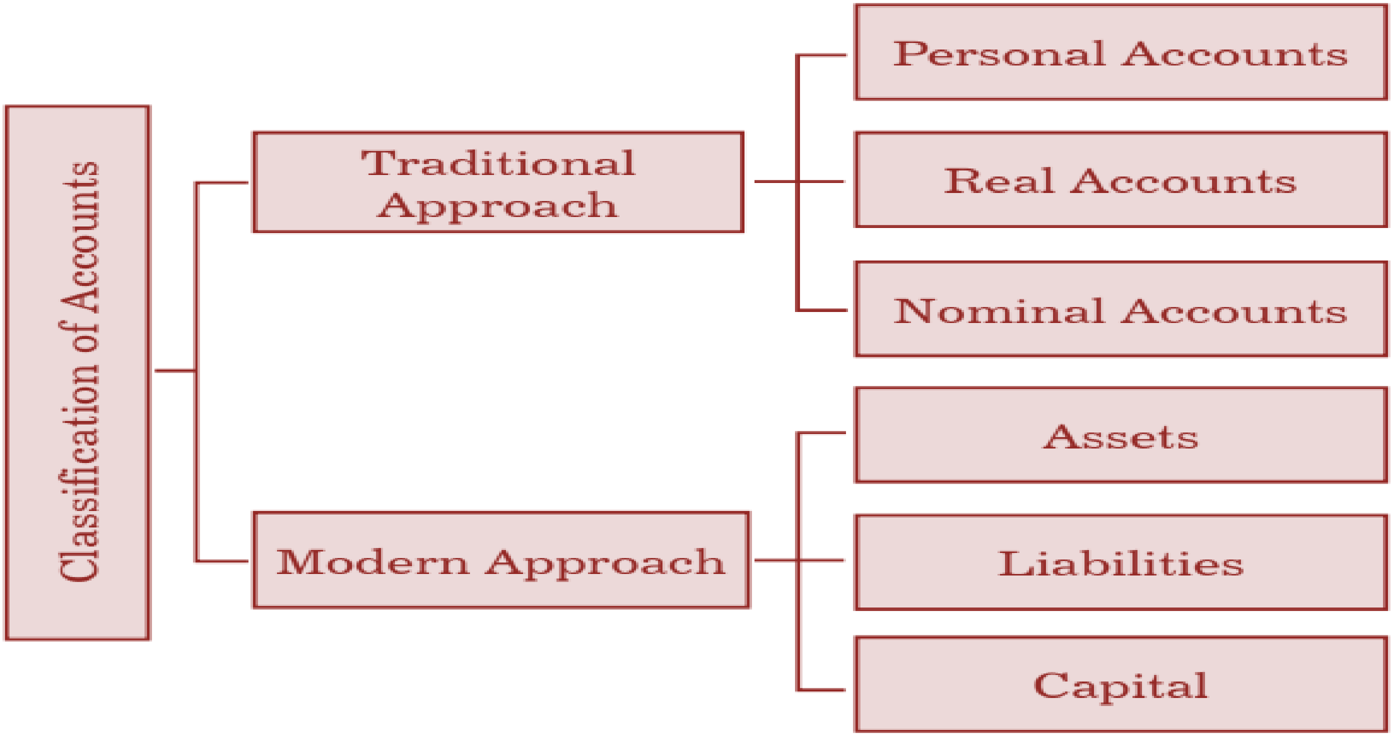
2. Settled bills payable worth Rs. 25000 against cash

Bills Payable A/c	Dr.	25000
To Cash A/c		25000

(Being bills payable settled)

Classification of Accounts

- There are two classifications of accounts, one is the traditional classification and the other is the modern classification as shown below:



Classification of Accounts – Traditional Approach

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Types of Accounts

Real Account	Personal Account	Nominal Account
All Assets	**All Parties**	**All Items of P&L**
(Tangible and Intangible)	(Debtors and Creditors)	(Income and Expenses)
Rules	**Rules**	**Rules**
Debit what comes in	Debit the receiver	Debit all expenses and losses
Credit what goes out	Credit the giver	Credit All incomes & gains

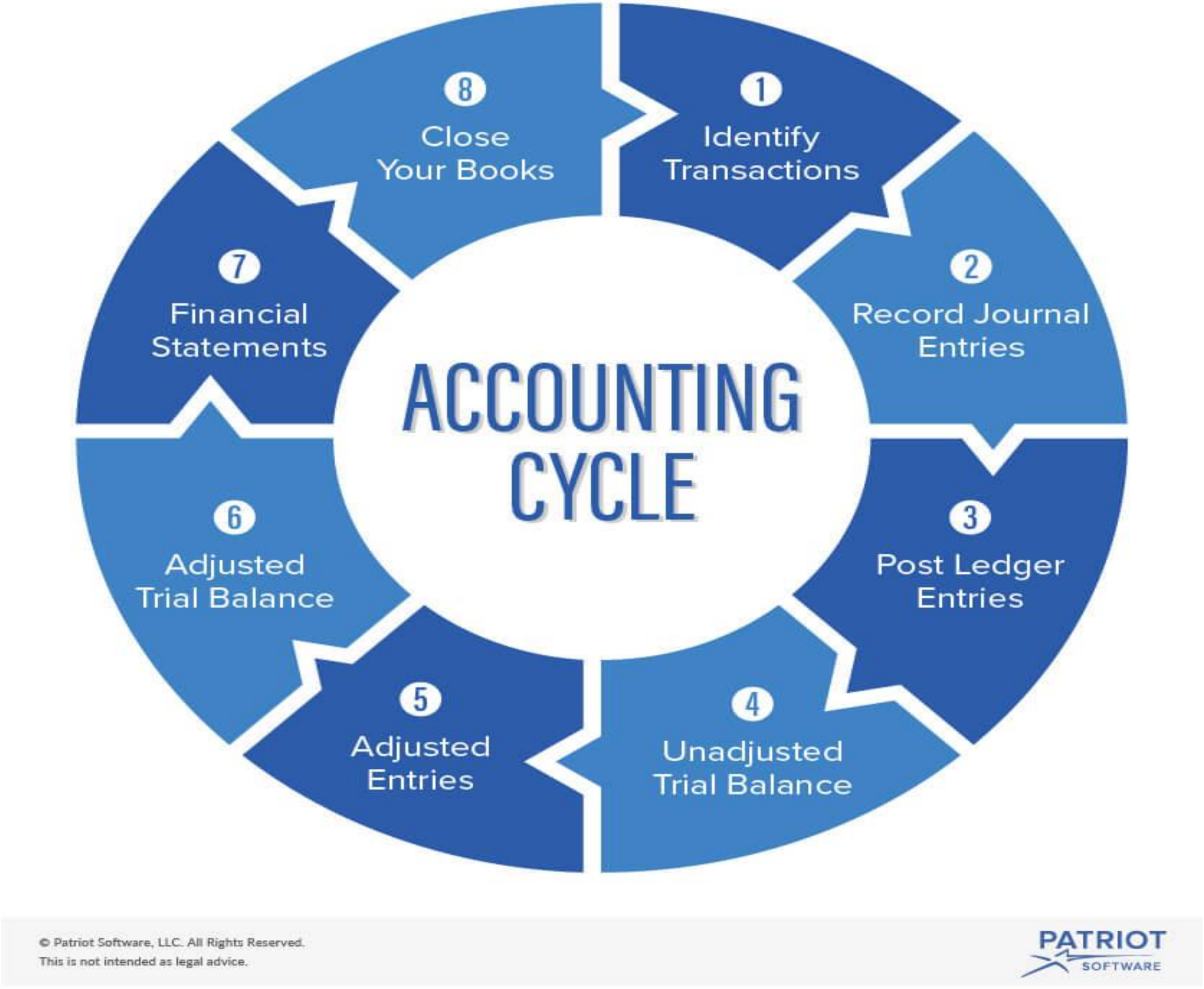
Classification of Accounts – Modern Approach

- **Assets:** These are all individual assets accounts whose balances are carried forward to the next accounting period. There can be tangible and intangible assets, i.e., assets that can be seen such as land, building, machinery, furniture, and assets that cannot be seen but have a market value like goodwill, patent, trademark, etc.
- **Liabilities:** These are all the liabilities of the business and appear on the liability side of the balance sheet. Individual liability accounts are accounts payable account, loan from bank, debenture account, etc. The balances of these accounts are carried forward to the next accounting period.
- **Capital:** Capital refers to the funds that are raised by a firm by issuing shares. The value of capital is derived by multiplying the face value of a single share by the number of shares issued (fully subscribed).

Accounting Cycle

- **The entire process starting from the point when a business transaction occurs till it gets included in the financial statements is called the Accounting Cycle.**
- The accounting cycle of every business starts with the beginning of the accounting period and ends with end of the accounting period, as the books of accounts can be closed only after the accounting period is over.
- For every business, the accounting period - Financial Year :April to March is taken.
- Many transactions undergo changes during the year, so adjustments are made and at the end of the year the accounts are finalised and frozen.
- Every business is required to finalise its accounts and pay taxes within the stipulated time given by taxation authorities.

Accounting Cycle



Recording Transactions - Journal

- Following are the functions of journal:
  - Journal helps in maintaining chronological records of monetary transactions.
  - Journal uses the double-entry system of book keeping.
  - Journal enables an organisation to maintain permanent record of each financial transaction at one place.
- The format of journal is given as follows:

Date	Particulars	Ledger Folio (L.F.)	Amount (Debit)	Amount (Credit)

Procedure for Journalising

Step 1: Identify the elements in the accounting transaction whether its asset/liabilities/equity/income/expenses.

Step 2: Apply the golden rules of debit and credit for the accounts.

Step 3: Write the date in the date column and the complete journal entry in the Particulars column.

Step 4: Mention the amount in the debit and credit columns.

Step 5: Write the narration for the entry (description).

Case Study – SATYAM COMPUTERS

Case Study – SATYAM COMPUTERS

1987
- Satyam computers was founded by Ramalinga Raju
- He started the Satyam computers with 20 employees

1991
- Converted into Public Ltd Co. and listed in BSE, NSE
- First Indian company to be listed in three international exchanges NYSE,DOWJONES & EURONEXT

2000
- Declared one of the 100 most pioneering technology companies by World Economic Forum

2007
- Become the 1st Asian company to features in the training magazine's list of top 125 companies for learning

2008
- 4^{th} fastest growing IT company in India
- Satyam network covers 66 countries and 53,000 employees across the globe

Case Study – SATYAM COMPUTERS

FABRICATED BALANCE SHEET

Items Rs. in crore	Actual	Reported	Difference
Cash and Bank Balances	321	5361	5040
Accrued Interest on Bank Fixed Deposits	Nil	376.5	376
Understated Liability	1230	None	1230
Overstated Debtors	2161	2651	490
Total	Nil	Nil	7136
Revenues (Q2 FY 2009)	2112	2700	588
Operating Profits	61	649	588

Thank you

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