UNIT 2:

Financial Accounting

What Is Financial Accounting?

Financial accounting is a specific branch of accounting involving a process of recording, summarizing, and reporting the myriad of transactions resulting from business operations over a period of time. These transactions are summarized in the preparation of financial statements—including the balance sheet, income statement, and cash flow statement—that record a company's operating performance over a specified period.

Work opportunities for a financial accountant can be found in both the public and private sectors. A financial accountant's duties may differ from those of a general accountant, who works for themself rather than directly for a company or an organization.

What Is Double Entry?

Double entry is a bookkeeping and accounting method, which states that every financial transaction has equal and opposite effects in at least two different accounts. It is used to satisfy the accounting equation:

Assets=Liabilities+EquityAssets=Liabilities+Equity

With a double-entry system, credits are offset by debits in a general ledger or T-account.

Understanding Double Entry

In accounting, a credit is an entry that increases a liability account or decreases an asset account. A debt is the opposite. It is an entry that increases an asset account or decreases a liability account. In the double-entry accounting system, transactions are recorded in terms of debits and credits. Since a debit in one account offsets a credit in another, the sum of all debits must equal the sum of all credits.

The double-entry system of bookkeeping standardizes the accounting process and improves the accuracy of prepared financial statements, allowing for improved detection of errors. All types of business accounts are recorded as either a debit or a credit.

What is a Journal?

A journal is a subsidiary book of account that records monetary transactions according to accounting standards. These transactions get recorded in chronological order, and it gives details about the accounts that are affected by each transaction. It is known as the first step of the accounting process.

What are its features?

The features of a journal are as follows:

- **Chronology**: The journal entries get recorded in a date-wise order, and it helps in checking the transactions much more quickly.
- **Double Entry System**: Journal entries follow a system where every transaction is entered both on the debit and credit sides. It is an example of a dual entry system. One account gets debited and the other gets credited with the same value.
- **Daybook**: A journal records transactions on a day-to-day basis for consistency and ease.
- **Compound Entry**: A single entry can have two or more accounts on the same day, and a journal can also have more than one related transaction.
- **Explanation**: Each transaction includes a short description known as the narration (within brackets). It helps to explain the nature and purpose of the transaction.

What is a Ledger?

A Ledger is a principal book of account, and its primary purpose is to transfer transactions from a journal and then classify it into separate accounts. Ledger is also known as the book of final entry as it helps businesses prepare accounting statements like the Trial Balance.

What are its features?

The features of a ledger are as follows:

- **Two Sides**: Every Ledger has two sides – Debit and Credit. The debit entries come on the left side of a ledger, while the credit entries come on the right side.
- **Transaction**: Every transaction impacts two or more ledger accounts, and it is because the transaction is related to a particular person, asset, expense or income.
- **Balancing the ledger**: The total debit and credit sides of a ledger must always be the same. But that is not always the case since the debit side could be more than the credit side and vice versa. To balance the ledger, we have to record the difference between the two on the deficient side. When the debit side is more than the credit side, the balance gets recorded on the credit side, known as debit balance. Similarly, when the credit side exceeds the debit side, the balance is recorded on the credit side, known as a credit balance.

What are the differences between Journal and Ledger?

The main differences between Journal and Ledger are as given below:

Journal	Ledger
Definition	
Journal is a subsidiary book of account that records transactions.	Ledger is a principal book of account that classifies transactions recorded in a journal.
Order	
The journal transactions get recorded in chronological order on the day of their occurrence.	The ledger classifies the transactions from the journal under the respective accounts to which they are related.
Explanation	
Each journal entry has a detailed narration of the transaction.	The ledger accounts do not have a detailed narration of each transaction.
Result	
The journal does not reveal the total results of a transaction.	The Ledger accounts help reveal the result of transactions for a particular account.
Trial Balance	
The journal cannot help prepare the Trial Balance directly.	The ledger helps to prepare the Trial Balance.
Financial Statements	
The journal does not have a direct role in the preparation of financial statements like Profit and Loss Account or Balance Sheet.	The balances from different ledger accounts help to prepare financial statements like Profit and Loss Account or Balance Sheet.
Opening Balance	

A journal does not have an opening balance, and it is only concerned with the current transactions that occur on a day-to-day basis.	Some ledger accounts have an opening balance, which is the closing balance from the previous year.

Conclusion

Although there are significant differences between Journal and Ledger, both have a critical role in accounting. They have a vital role to play when preparing financial statements like Profit and Loss Account or Balance Sheet.

Purchase Book:

Purchase Book is prepared by the firms to record the credit purchase of goods. Purchase of goods for cash and purchase of other things other than goods are not recorded in the purchase book. Cash purchases are recorded in Cash Book and other things are recorded in Journals and respective Ledgers. The invoice received from suppliers with the net amount after trade discount helps to record the credit purchases in the Purchase Book.

Purchase Book is prepared because it becomes easier, and we can have a periodic total of credit purchase of goods. It helps to know and check the price charged for goods. It also reduces to burden to pass journal entries for each credit purchase of goods. The Purchase Book is totalled at the end of the specified period (week, month, or year), and it is posted to Purchase Account.

Format of Purchase Book:

Purchase Book

Date	Particulars (Name of the Supplier's Account to be Credited)	Invoice No.	L.F.	Details ₹	Purchase ₹	Input CGST ₹	Input SGST ₹	Input IGST ₹	Total ₹

The purchase book has ten columns:

1. Date: The date of the transaction is written in the first column.
2. Particulars: The name of the supplier, the name of the articles, and the quantities purchased are written in the particulars column.
3. Invoice Number: The invoice number of the goods purchased is written.

4. Ledger Folio(L.F.): At the time of posting the purchase in the ledger, the page number of the leger is written.
5. Details: The amount in respect of each article is written. If any trade discount is availed, it is deducted from the gross amount.
6. Purchase: The net amount of purchases, i.e., Purchases less trade discount is shown in this column.
7. Input Central GST (CGST): CGST is charged on those goods, which are purchased within the state, i.e., the seller and the buyer belong to the same state. A separate column is made to make entries for CGST. It is calculated on the net purchase value, i.e., Purchases less trade discount, and further shown on the debit side of the ledger account of Input CGST.
8. Input State GST (SGST): SGST is also charged on those goods which are purchased within the state, i.e., the seller and the buyer belong to the same state. A separate column is made to make entries for SGST. It is calculated on the net purchase value, i.e., Purchases less trade discount, and further shown on the debit side of the ledger account of Input SGST.
9. Input Integrated GST (IGST): IGST is charged on those goods which are purchased from outside of the state, i.e., the seller and the buyer does not belong to the same state. A separate column is made to make entries of the tax collected under IGST. It is also calculated on the net purchases value, i.e., Purchases less trade discount, and further shown on the debit side of the ledger account of Input IGST.
10: Total: Total amount of every transaction is shown in this column.
Illustration:
Prepare the Purchase Book for July 2022 of Sunita General Stores, Ranchi assuming CGST @ 5% and SGST @ 5%. The following information is given:

Date	Particulars
2022 July 2	Purchased from M/s. Sunil Lal, Main Road: 50 Bags of Baba Rice @ ₹900 per bag 30 Bags of Basmati Rice @ ₹ 750 per bag
July 5	Purchased from Shiv Lal, Upper Bazar: 75 tin of Mustard Oil @ ₹120 per tin 60 tin of Olive Oil @ ₹100 per tin Less: Trade Discount 6%
July 17	Purchased from Deva Store, Hyderabad: 100 packets of Good Day @ ₹22 per packet 85 packets of Rusk @ ₹15 per packet
July 22	Purchased from Amit General Store, Main road: 65 pieces of Lux soap @ ₹9 per soap 40 pieces of Dove soap @ ₹ 22 per soap 35 pieces of Johnson Baby soap @ ₹ 28 per soap Less: Trade Discount 10%

Solution:

Sunita General Stores, Ranchi
Purchase Book

Date	Particulars (Name of the Supplier's Account to be Credited)	Invoice No.	L.F.	Details ₹	Purchase ₹	Input CGST ₹	Input SGST ₹	Input IGST ₹	Total ₹
2022 July 2	M/s. Sunil Lal, Main Road, Ranchi:								
	50 Bags of Baba Rice @ ₹900 per bag			45,000					
	30 Bags of Basmati Rice @ ₹ 750 per bag			22,500					
				67,500					
	Add: CGST @5%			3,375					
	SGST @5%			3,375					
				74,250	67,500	3,375	3,375	-	74,250
July 5	Shiv Lal, Upper Bazar, Ranchi								
	75 tin of Mustard Oil @ ₹120 per tin			9,000					
	60 tin of Olive Oil @ ₹100 per tin			6,000					
				15,000					
	Less: Trade Discount @6%			900					
				14,100					
	Add: CGST @5%			705					
	SGST @5%			705					
				15,510	14,100	705	705	-	15,510
July 17	Deva Store, Hyderabad:								
	100 packets of Good Day @ ₹22 per packet			2,200					
	85 packets of Rusk @ ₹15 per packet			1,275					
				3,475					
	Add: IGST @10%			347.5					
				3,822.5	3,475	-	-	347.50	3,822.50
July 22	Amit General Store, Main Road, Ranchi:								
	65 pieces of Lux soap @ ₹10 per soap			650					
	40 pieces of Dove soap @ ₹ 22 per soap			880					
	35 pieces of Johnson Baby soap @ ₹ 28 per soap			980					
				2,510					
	Less: Trade Discount @10%			251					
				2,259					
	Add: CGST @5%			112.95					
	SGST @5%			112.95					
				2,484.9	2,259	112.95	112.95	-	2,484.90
July 31	**Total**				**87,334**	**4,192.95**	**4,192.95**	**347.50**	**96,067.40**

Sales Book:

Buying and Selling are the two main constituents of a business. Goods are sold by a company on either cash or credit basis. Recording of cash sales and credit sales takes place in different subsidiary books. All the credit sales of goods are recorded in the 'Sales Book', whereas all the cash sales of the goods are recorded in the 'Cash Book'. Importantly, the credit sales of anything other than goods, i.e., assets are directly recorded to 'Journal' and not in 'Sales Book'.

The following transactions are not recorded in the Sales Book:

1. Cash Sales: All the cash sales of the goods are recorded in the 'Cash Book', and not in the 'Sales Book'.
2. Sale of Assets: Any sale of assets either in cash or credit is not recorded in the 'Sales Book'.

The entries in the Sales Book are recorded on the basis of the sales invoices issued by the company to its customers at the time of sales. Generally, every company makes a minimum of two copies of the sales invoice. One is to give to the purchaser of the goods, and the other to maintain the internal records and pass respective entries in the Sales Book. Sales invoices contain all the important information related to sales, i.e., date, name of the customer, quantity of the goods sold, rate, gross amount, discount allowed, the tax levied, and the net amount of sales.

Format of Sales Book:

Date	Particulars (Name of the Customer Account to be Debited)	Invoice No.	L.F.	Details ₹	Sale ₹	Output CGST ₹	Out

Explanation of the Columns of the Sales Book:

1. Date: This column represents the date on which the sale of goods took place.

2. Particulars: The name of the customer along with the address of the firm, the quantity of goods sold, the rate at which the goods are sold, the discount allowed and tax levied on goods sold are shown in this column.
3. Invoice No.: Invoice no. mentioned on the sales invoice generated at the time of sale is mentioned in this column.
4. Ledger Folio(LF): This column is used to mention the ledger no. of the ledger account in which the entries have been recorded regarding that particular transaction.
5. Details: This column is used to show all the additions and deductions related to the sale of goods, i.e., discount allowed, taxes charged, etc.
6. Sale: The net amount of sales, i.e., Sales less trade discount is shown in this column.
7. Output Central GST (CGST): CGST is charged on those goods which are sold within the state, i.e., the seller and the buyer belongs to the same state. A separate column is made to make entries for CGST. It is calculated on the net sales value, i.e., Sales less trade discount and further shown on the credit side of the ledger account of Output CGST.
8. Output State GST (SGST): SGST is also charged on those goods which are sold within the state, i.e., the seller and the buyer belongs to the same state. A separate column is made to make entries for SGST. It is calculated on the net sales value, i.e., Sales less trade discount and further shown on the credit side of the ledger account of Output SGST.
9. Output Integrated GST (IGST): IGST is charged on those goods which are sold outside of the state, i.e., the seller and the buyer does not belong to the same state. A separate column is made to make entries of the tax collected under IGST. It is also calculated on the net sales value, i.e., Sales less trade discount and further shown on the credit side of the ledger account of Output IGST.
10: Total: Total amount of every transaction is shown in this column.

What Is a Cash Book?

A cash book is a financial journal that contains all cash receipts and disbursements, including bank deposits and withdrawals. Entries in the cash book are then posted into the general ledger.

How a Cash Book Works

A cash book is set up as a subsidiary to the general ledger in which all cash transactions made during an accounting period are recorded in chronological order. Larger organizations usually divide the cash book into two parts: the cash disbursement journal, which records all cash payments, and the cash receipts journal, which records all cash received into the business.[1]

The cash disbursement journal would include items such as payments made to vendors to reduce accounts payable, and the cash receipts journal would include items such as payments made by customers on outstanding accounts receivable or cash sales.

Trading and Profit & Loss Account

A business needs to prepare a trading and profit and loss account first before moving on to the balance sheet. Trading and profit and loss accounts are useful in identifying the gross profit and net profits that a business earns.

The motive of preparing trading and profit and loss account is to determine the revenue earned or the losses incurred during the accounting period.

The trading and profit and loss account are two different accounts that are formed within the general ledger. The two parts of the account are:

1. Trading Account

2. Profit and Loss Account

Trading account is the first part of this account, and it is used to determine the gross profit that is earned by the business while the profit and loss account is the second part of the account, which is used to determine the net profit of the business.

Also see: Balance Sheet vs Profit & Loss Account

Let us know more about these accounts in detail

1. Trading Account

Trading account is used to determine the gross profit or gross loss of a business which results from trading activities. Trading activities are mostly related to the buying and selling activities involved in a business. Trading account is useful for businesses that are dealing in the trading business. This account helps them to easily determine the overall gross profit or gross loss of the business. The amount thus determined is an indicator of the efficiency of the business in buying and selling.

The formulae for calculating gross profit is as follows:

Gross profit = Net sales – Cost of goods sold

Where

Net sales = Gross sales of the business minus sales returns, discounts and allowances.

The trading account considers only the direct expenses and direct revenues while calculating gross profit. This account is mainly prepared to understand the profit earned by the business on the purchase of goods.

Items that are seen in the debit side include purchases, opening stock and direct expenses while credit side includes closing stock and sales.

Closing entries for Gross Loss or Gross Profit

The following entries are passed

In case of Gross Loss

Profit and Loss A/c   Dr.

To Trading A/c

In case of Gross Profit

Trading A/c   Dr.

To Profit and Loss A/c

Preparing Trading Account

Trading account is prepared by closing all the temporary purchases and revenue accounts and making adjustments in the inventory accounts by the use of a closing journal entry

For the following question, prepare a trading account

Particulars	Amount	Particulars	Amount
Sales	2,05,000		

Sales returns	15,000
Purchases	49,000
Purchases returns	3000
Opening inventory	8000
Closing inventory	30,000
Trading Account	1,500

The format of trading account after passing the closing entry is as follows:

Dr.	**Trading Account for the year ended**		**Cr.**
Sales returns	15,000	Sales	205,000
Purchases	49,000	Purchase returns	3,000
Beginning inventory	8,000	Ending inventory	9,000
Balance c/d	145,000		
Total	**217,000**	**Total**	**217,000**
		Balance b/d	145,000

In this example, all accounts are closed and transferred to the trading account. The credit entry of 1,45,000 is the gross profit for the period.

2. Profit and Loss Account

Profit and loss account shows the net profit and net loss of the business for the accounting period. This account is prepared in order to determine the net profit or net loss that occurs during an accounting period for a business concern.

Profit and loss account get initiated by entering the gross loss on the debit side or gross profit on the credit side. This value is obtained from the balance which is carried down from the Trading account.

A business will incur many other expenses in addition to the direct expenses. These expenses are deducted from the profit or are added to gross loss and the resulting value thus obtained will be net profit or net loss.

The examples of expenses that can be included in a Profit and Loss Account are:

1. Sales Tax

2. Maintenance

3. Depreciation

4. Administrative Expense

5. Selling and Distribution Expense

6. Provisions

7. Freight and carriage on sales

8. Wages and Salaries

These appear in the debit side of Profit and Loss Account while Commission received, Discount received, profit obtained on sale of assets appear on the credit side.

Net profit can be determined by deducting business expenses from the gross profit and adding other incomes obtained

Net profit = Gross profit – Expenses + Other income

Closing Entries for Net Loss or Net Profit:

i. In case of Net Loss

Capital A/c – Dr.

To Profit and Loss A/c

ii. In case of Net Profit

Profit and Loss A/c -Dr.

To Capital A/c

Trading and Profit and Loss Account Format

Trading and Profit and Loss Account format is represented separately as follows:

Format for Trading Account

Trading account for the year ended………..

To opening stock		xxx	By Sales	xxxx	
To purchases	xxxx		Less returns	xx	
Less returns	xxx			--------	xxxx
	-------------	xxxx	By closing stock		xxx
To Direct expenses:			By gross loss (if loss)		xxx
Carriage inward		xxx			
Freight		xxx			
Octroi		xxx			
Dock dues		xxx			
Excise duty		xxx			
Royalty		xxx			
Motive power		xx			
Coal, gas, water		xxx			
Factory expenses		xxx			
To Gross Profit (if profit)		xxx			
		xxxxx			xxxxx

Format for Profit and Loss Account

Profit & Loss Account

Dr. (For the year ended…) Cr.

Particulars	Amount	Particulars	Amount
To Gross loss b/d	Xxx	By Gross Profit b/d	Xxx
To Salaries	Xxx	By Discount Received	Xxx
To Office rent, rates and taxes	Xxx	By Commission Received	Xxx
To Printing & stationery	Xxx	By Bank Interest	Xxx
To Telephone expenses	Xxx	By Rent received	Xxx
To Postage & telegram	Xxx	By Dividend on shares	Xxx
To Discount Allowed	Xxx	By Interest earned on debentures	Xxx
To Insurance	Xxx	By Profit on sale of asset	Xxx
To Audit Fees	Xxx	By Net loss	Xxx
To Electricity charges	Xxx		
To Repairs & renewals	Xxx		
To Depreciation	Xxx		
To Advertisement	Xxx		
To Carriage Outwards	Xxx		
To Bad Debts	Xxx		
To Provision for Bad debts	Xxx		
To Selling commission	Xxx		
To Bank Charges	Xxx		
To Interest on loans	Xxx		
To Loss on sale of asset	Xxx		
To Net Profit	Xxx		
	xxx		xxx

Other Important Topics in Accountancy

- Difference between Source Document and Voucher
- Purchase Book
- Features of Cash Book
- Ledger Account

Difference between Trading and Profit and Loss Account

The following points of difference exist between the Trading and Profit and Loss Account

Parameters	*Trading Account*	*Profit and Loss Account*
Meaning	Trading account used to find the gross profit/loss of the business for an accounting period	Profit and loss account or Income statement is used to find the net profit/loss of the business for an accounting period

Timing	Trading Account is prepared first and then profit and loss account is prepared.	Profit/Loss Account is prepared after the trading account is prepared.
Purpose	For knowing the gross profit or gross loss of a business	For knowing the net profit or net loss of a business
Stage	It is the first stage in the creation of the final account.	it is the second stage in the creation of the final account.
Dependency	It is not dependent on trial balance	It is dependent on trading account
Transfer of Balance	The balance in the form of Gross loss or Gross Profit of the trading account will be transferred to the Profit and Loss Account	The balance in the form of Net loss or Net Profit of the profit and loss account will be transferred to the Balance Sheet

What Is a Balance Sheet?

The term balance sheet refers to a financial statement that reports a company's assets, liabilities, and shareholder equity at a specific point in time. Balance sheets provide the basis for computing rates of return for investors and evaluating a company's capital structure.

In short, the balance sheet is a financial statement that provides a snapshot of what a company owns and owes, as well as the amount invested by shareholders. Balance sheets can be used with other important financial statements to conduct fundamental analysis or calculate financial ratios.

How Balance Sheets Work

The balance sheet provides an overview of the state of a company's finances at a moment in time. It cannot give a sense of the trends playing out over a longer period on its own. For this reason, the balance sheet should be compared with those of previous periods.

Investors can get a sense of a company's financial wellbeing by using a number of ratios that can be derived from a balance sheet, including the debt-to-equity ratio and the acid-test ratio, along with many others. The income statement and statement of cash flows also provide valuable context for assessing a company's finances, as do any notes or addenda in an earnings report that might refer back to the balance sheet.[1]

The balance sheet adheres to the following accounting equation, with assets on one side, and liabilities plus shareholder equity on the other, balance out:

$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$$

This formula is intuitive. That's because a company has to pay for all the things it owns (assets) by either borrowing money (taking on liabilities) or taking it from investors (issuing shareholder equity).

If a company takes out a five-year, $4,000 loan from a bank, its assets (specifically, the cash account) will increase by $4,000. Its liabilities (specifically, the long-term debt account) will also increase by $4,000, balancing the two sides of the equation. If the company takes $8,000 from investors, its assets will increase by that amount, as will its shareholder equity. All revenues the company generates in excess of its expenses will go into the shareholder equity account. These revenues will be balanced on the assets side, appearing as cash, investments, inventory, or other assets.

Balance sheets should also be compared with those of other businesses in the same industry since different industries have unique approaches to financing.