**Mechanics of Financial Accounting**
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Financial Accountants are score-keepers of organizations. They record all financial transactions as and when they are incurred. At the end of a period, they summarize these financial transactions and produce three important financial statements, namely Profit and Loss Statement or Income Statement, Balance Sheet and Cash Flow Statement. Accountants use an accounting equation to record the financial transactions. The equation is Assets = Liabilities + Equity and expanded version of this equation is Assets = Liabilities + Equity + Revenue – Expenses. The equation shows business units raise funds from three sources namely, Equity capital provided by the shareholders, profit earned and retained in the business (Revenue – Expenses) and through liabilities (loans and supplies through credit). The funds raised are used in various assets. This accounting equation results in a system of accounting called double-entry book-keeping system.

The equation contains few fundamental accounting terms. Assets are owned by the business and are used to produce goods and services. Liabilities are resources provided by non-owners and are to be repaid. Equity is owners' contribution into the business. Revenues are earned when firm sells goods or renders services. Expenses are incurred in the process of earning revenue. The difference between revenue and expenses is equal to profit or loss. A part of the profit is distributed to shareholders as dividend and balance profit is retained in the business. The retained profit is part of equity.

Financial transactions are recorded in the accounting equation using double-entry book-keeping system. Double-entry means every financial transaction impacts two of the five accounting terms (assets, liabilities, equity, revenue and expenses) and they are recorded under the two heads such that the equation always holds good. The following are few examples:

1. Owners brought Rs. 50 lakhs as capital into the business.
2. The firm raises Rs. 20 lakhs through loan.
3. The firm purchased good worth of Rs. 40 lakhs.
4. The firm sold good worth of Rs. 25 lakhs for Rs. 30 lakhs.
5. Rs. 2 lakhs is paid to employees towards salary.

The above five transactions are recorded as follows:

| | | Asset | = | Liabilities | Equity | Revenue | Expenses |
|---|---|---|---|---|---|---|---|
| 1. Owners brought Rs. 50 lakhs as capital into the business. | Cash | 50 | | | 50 | | |
| 2. The firm raises Rs. 20 lakhs through loan. | Cash | 20 | | 20 | | | |
| 3. The firm purchased good worth of Rs. 40 lakhs. | Cash | -40 | | | | | |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| | Goods | 40 | | | | | |
| 4. The firm sold good worth of Rs. 25 lakhs for Rs. 30 lakhs. | Cash | 30 | | | | 30 | |
| | Goods | -25 | | | | | -25 |
| 5. Rs. 2 lakhs is paid to employees towards salary | Cash | -2 | | | | | -2 |

Financial Statements can be drawn from the above recordings. Income statement or profit and loss account is a summary of Revenue and Expenses column. In the above simple example, the firm earned a revenue of Rs. 30 lakhs and spent Rs. 25 lakhs towards cost of sales and another Rs. 2 lakhs towards salary. The profit is Rs. 3 lakhs (30-25-2). The second financial statement is Balance Sheet and it is summary of other three columns. We have two assets (a) Cash and (b) Goods. There are five entries related to cash (three are positive values and two are negative values) and if we sum up these values, we get Rs. 58 lakhs. The balance in Goods account is Rs. 15 lakhs (we purchased goods worth of Rs. 40 lakhs and sold Rs. 25 lakhs worth of goods). Our Balance Sheet is as follows:

Balance Sheet

| Equity & Liabilities | | Assets | |
|---|---|---|---|
| Equity | 50 | Cash | 58 |
| Profit | 3 | Goods | 15 |
| Owners Capital | 53 | | |
| Loan | 20 | | |
| | 73 | | 73 |

Cash Flow Statement shows movement of cash and group them under three broad categories – Cash flow from operating activities, financing activities and investing activities. In the above example, the cash flow statements is prepared as follows:

| | | |
|---|---|---|
| Opening Cash Balance | | 0 |
| Cash received from customers | 30 | |
| Less: Cash paid to suppliers | 40 | |
| Less: Salary Paid | 2 | |
| Net Cash Flow from Operations | | -12 |
| Cash received from owners | 50 | |
| Cash received from lenders | 20 | |
| Net Cash Flow from Financing Activities | | 70 |
| | | |
| Closing Cash Balance | | 58 |

Accountants are score-keepers. Financial statements are language of business. Language requires some basic rules and regulations (grammar) for effective communication. Financial accountants follow a few concepts and conventions in preparation of financial statements. A few important concepts and conventions are as follows:

1. Entity Concept: Business is different from owners.
2. Going Concern Concept: It is assumed that business will have long life.
3. Money Measurement Concept: Accountant records transactions only when it has monetary impact.
4. Historical Cost concept: Accountants normally use historical cost for recording transactions related to assets and ignore current market value.
5. Conservatism concept: In recognizing revenue and profit, accountants are generally conservative. Accountants recognize profit or revenue only when there is a certainty but recognized losses and expenses the moment, there is a prospect.
6. Matching concept: For every revenue, accountants identifies all expenses related to the revenue to determine the profit.
7. Consistency concept: If there are options in treatment of accounting transaction and one of them is chosen, accountants need to follow the same consistently.
8. Materiality concept: At times, an asset is treated as expenses if the values are small e.g. stationery.

In addition to concepts and conventions, which are general or fundamental in nature, accounting bodies like Institute of Chartered Accountants of India prescribe standards. International Financial Reporting Standards (IFRS) is a recent development under which companies around the globe are required to prepare the accounting statements following IFRS.

Financial Statements are part of Annual Report. Annual Report consists of several useful information which includes Directors Report, Management Discussion and Analysis, Corporate Governance Report and many others. It also contains significant accounting policies and auditors certificate on financial statements. There are several users of financial statements. The users list include investors, lenders, suppliers of goods and services, tax authorities, employees, union, prospective employees, customers and managers. Accountants prepare financial statements based on users need. Managers get more detailed statements compared to financial statements provided to public.

**For additional reading, please refer Chapter 1 of the textbook: Narasimhan M S, Financial Statements and Analysis, Cengage Learning, New Delhi.**