

Fundamentals of Accounting



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Glimpse of the Session

- **Definition**
- **Systems of Accounting**
- **Functions of Accounting**
- **Basis of Accounting**
- **Classification of Accounts**
- **Golden Rules of Accounting**
- **Examples**
- **Books of Accounts – Manual Vs Software**
- **Financial Statements -- Meaning and contents**
- **Reporting**

Accounting Definition

- Recording
- Classifying
- Summarizing
- Analyzing
- Interpreting
- Communicating

Transactions & Events in Monetary Terms

Examples of Events/Transactions

- Received Loan from Uncle of Rs.8,00,000 through Cheque
- Opened Bank Account & deposited Cheque
- Purchased Land for Rs.4,00,000
- Given Advance for purchase of Godown Building Rs.75,000
- Bought a Motorcycle for Rs.50000
- Given loan to friend Rs.1,00,000
- Started small business by investing Rs.50000 for Tables/ Chairs/Furniture
- Purchased Goods for Rs.1,00,000
- Sold 80% of those Goods for Rs.1,20,000
- Friend repaid Rs.75,000 out of loan given by you within 1 month
- Paid Income Tax on Profit made during period
- Received Advance amount of Rs.50,000 from Customers to whom you promised to supply after 1 month

Recording

- Process in which the financial transactions and events that are identified are recorded in Books
- These typically would be
 - Cash Book/ Bank Book
 - Purchase and Sales Books
 - Bills Receivable and Bills Payable Books
 - Purchase and Sales Return Books
 - Journal Book (*other than above*)

Classifying

- Process where transactions or entries of one or similar nature are grouped.
- The book containing classified information is called “Ledger”.
- For Example, there may be separate account heads for Sales, Purchases, GST, Salaries, Rent, Office Expenses, Taxes Paid, Advertisement expenditure etc.,

Summarizing

- Involves preparation and presentation of the Classified Data in a manner useful to various internal and external users.
- Leads to the preparation of the following financial statements
 - ***Trial Balance***
 - ***Profit and Loss Account***
 - ***Balance Sheet***
 - ***Cash-Flow Statement***

Analysis & Interpretation

- Includes analyzing and then interpreting the financial data to make a meaningful judgement of the profitability and financial position of the business.
- The financial statement should explain not only
 - ‘*what had happened*’ but also
 - ‘*why it happened*’ and also
 - ‘*what is likely to happen under specified conditions*’

Communicating

- It is concerned with the transmission of analyzed and interpreted information to the end-users to enable them to make rational decisions
- This includes preparation and distribution of accounting statements/Annual Reports

Users of Financial information

INTERNAL USERS

- Board of Directors
- Partners
- Managers
- Officers
- Employees

EXTERNAL USERS

- Investors
- Lenders
- Suppliers
- Government
- Customers

Functions of Accounting

Measurement

Measures past performance of the business entity and depicts its current financial position

Forecasting

Helps in forecasting future performance and financial position of the enterprise using past data

Decision-making

Provides relevant information to the users of accounts to aid rational decision making

Comparison & Evaluation

Assesses performance achieved in relation to targets which is important for predicting, comparing and evaluating the financial results

Control

Defines weaknesses of the operational system and provides feedbacks regarding effectiveness of measures adopted to check such weaknesses

Govt. Regulation & Taxation

Provides necessary information to the government to exercise control on the entity as well as in collection of tax revenues

Basis of Accounting

Cash Basis

Accrual Basis

Comparison of Methods

CASH BASIS

- Recognizes revenues when cash is received and expenses when they are paid.
- Does not recognize accounts receivable or accounts payable
- Beneficial in terms of tracking how much cash the business actually has at any given time
- Since the transactions are not recorded until the cash is received or paid, the business's income is not taxed until it is in the bank

ACCRUAL BASIS

- Revenues and expenses are recorded when they are earned or Due, regardless of when the money is actually received or paid
- Gives a more realistic idea of income and expenses during a period of time, therefore providing a long term picture of the business that cash accounting can't provide
- Most widely followed method, mandatory for Companies etc.,

DOUBLE ENTRY SYSTEM OF BOOK KEEPING

- This is the system of Keeping the Books of Accounts world wide and now India is also following the same
- It is based on the principle that *“every business transaction has two accounts in opposite directions and if a complete record is to be made of each such transaction, it would be necessary to Debit one account and Credit one Account.”*
- So *“every Debit has corresponding Credit and every Credit has corresponding Debit **with equal amount**”*

Classification of Accounts

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graph TD; A[Classification of Accounts] --- B[Personal]; A --- C[Real]; A --- D[Nominal];
```

Personal

Real

Nominal

Personal Accounts

- **Natural personal accounts:** The elements or accounts which represent persons. E.g. Kumar's A/c, Asha A/c etc.
- **Artificial personal accounts:** Personal accounts which are created artificially by law, such as corporate bodies and institutions, are called Artificial personal accounts. Ex. Private Ltd Companies, LLPs, Clubs, Societies/Schools etc.
- **Representative personal accounts:** Accounts which represent a certain person or a group directly or indirectly. E.g. Outstanding expense a/c, Prepaid expense a/c

Golden Rule for “*Personal Accounts*”

Debit the Receiver

Credit the Giver

Example :

Paid M/s Mitra Agencies Rs.25,000 by Cheque

Accounts Involved	Debit/Credit	Rule Applied
<ul style="list-style-type: none">• Mitra Agencies A/c• To Bank a/c	<ul style="list-style-type: none">• Debit• Credit	<ul style="list-style-type: none">• Personal a/c- Debit the Receiver• Personal a/c- Credit the Giver

Real Accounts

- All assets of a firm, which are tangible or intangible, fall under the category “*Real Accounts*”.
- **Tangible real accounts** are related to things that can be touched and felt physically. Few examples of tangible real accounts are Building, Machinery, Stock, Land etc.
- **Intangible real accounts** are related to things that **can't be** touched and felt physically.
Few examples of such real accounts are Goodwill, Patents (new Invention), Trademarks (Brand Name such as Chutneys, Chermas, Bata, Titan etc.)

Golden Rule for “*Real Accounts*”

Debit what comes in

Credit what goes out

Example :Purchased Furniture for Rs.10,000 in cash

Accounts Involved	Debit/Credit	Rule Applied
<ul style="list-style-type: none">• Furniture a/c• To Cash a/c	<ul style="list-style-type: none">• Debit• Credit	<ul style="list-style-type: none">• Real a/c-Debit what comes in• Real a/c-Credit what goes out

Nominal Accounts

- Accounts which are related to expenses, losses, incomes or gains are called Nominal accounts.
- Nominal accounts do not really exist in physical form, but behind every nominal account money is involved. E.g. Purchase A/c, Salary A/c, Sales A/c, Commission paid A/c, Commission received A/c
- The final result of all nominal accounts is either profit or loss which is then transferred to the capital account.

Golden Rule for “*Nominal Accounts*”

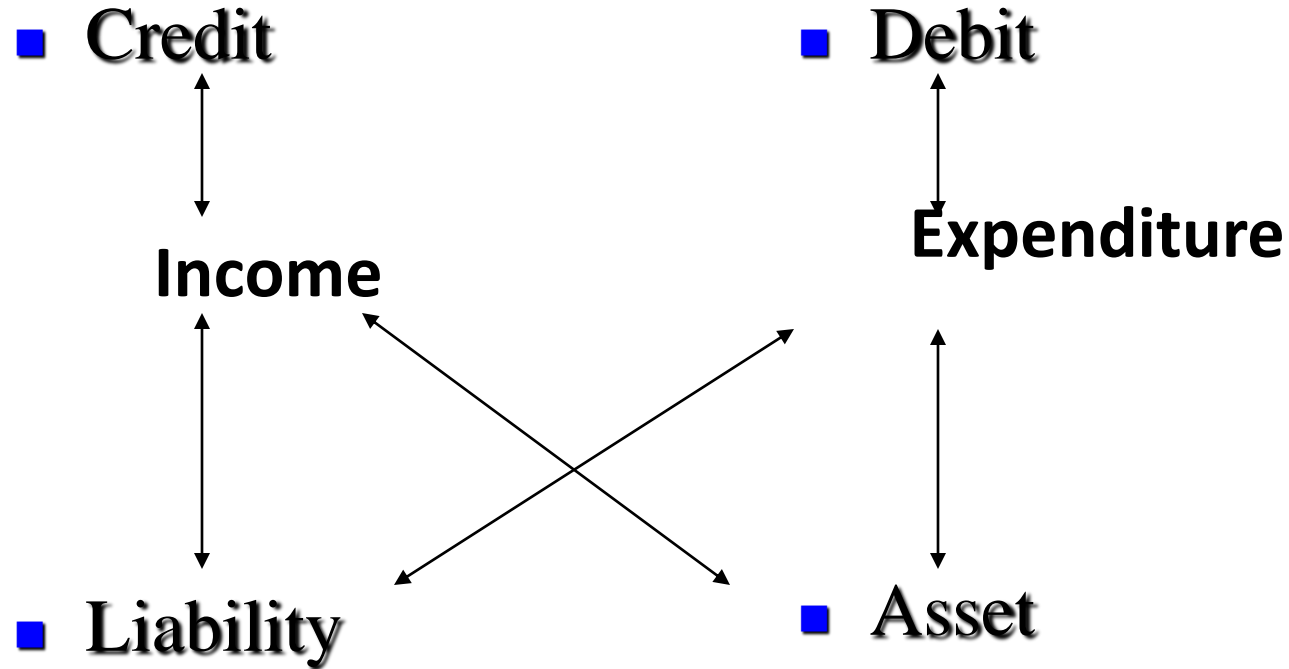
Debit all expenses and losses

Credit all incomes and gains

Example : Paid Salaries of Rs.20,000 in cash

Accounts Involved	Debit/Credit	Rule Applied
<ul style="list-style-type: none">• Salaries a/c<ul style="list-style-type: none">• To Cash a/c	<ul style="list-style-type: none">• Debit<ul style="list-style-type: none">• Credit	<ul style="list-style-type: none">• Nominal a/c- Debit all expenses• Real a/c- Credit what goes out

Basic Accounting Rules



Rules of Accounting

Type of Account	Debit	Credit
Personal	The Receiver	The Giver
Real	What Comes In	What goes out
Nominal	All Expenses & Losses	All Incomes & Gains

Flow of Accounting

Understanding the Transaction

↓
Voucher Entry

↓
Posting

↓
Balancing

↓
Trial Balance

↙
P & L Account

↘
Balance Sheet

→

Financial Statements

Financial Statements are Summary-level reports about an organization's financial results, financial position and cash flows.

Useful for:

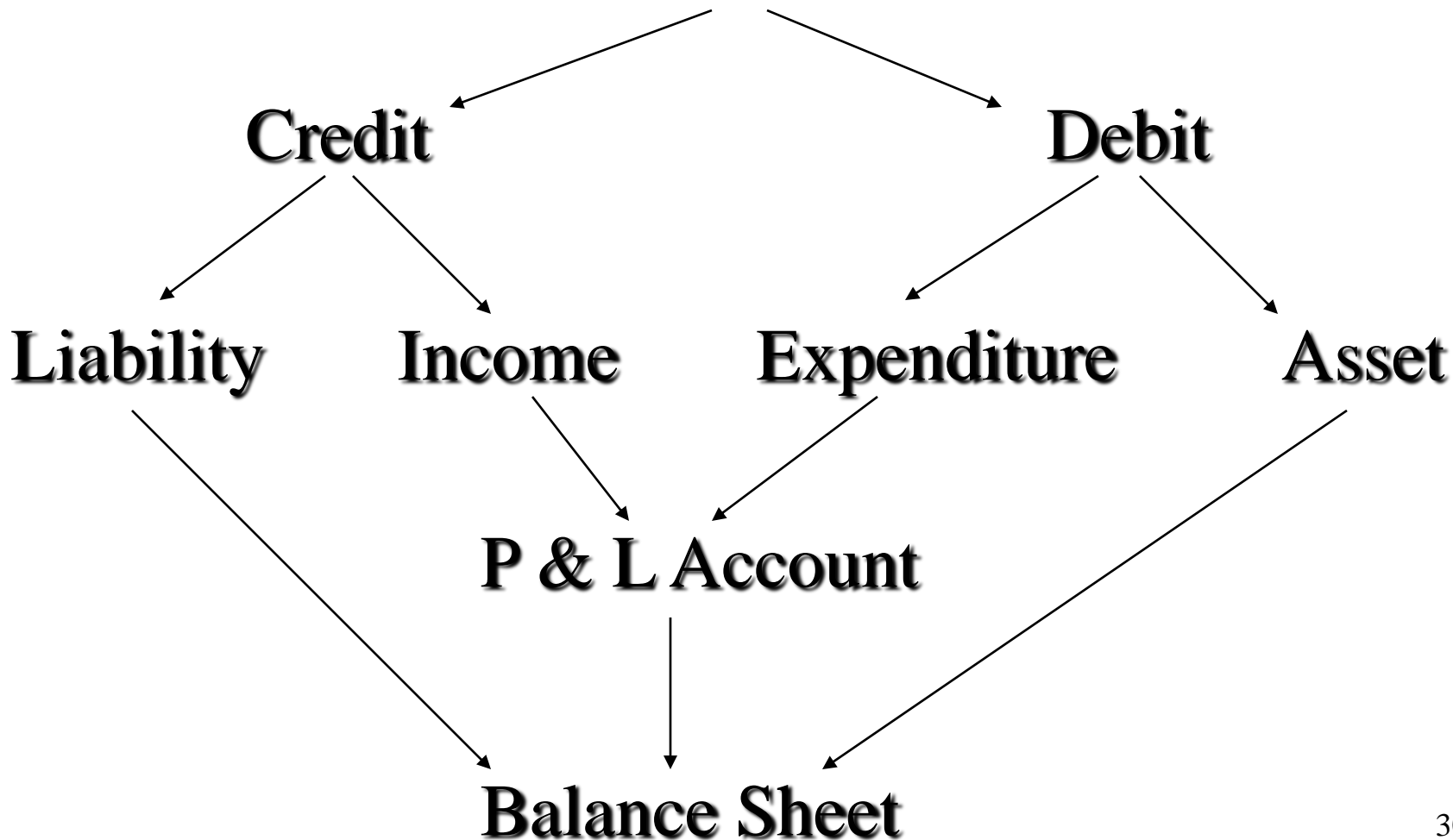
- Determine the ability of a business to generate cash, and the sources and uses of that cash.
- Determine whether a business has the capability to pay back its debts.
- Track financial results on a trend line to spot any profitability issues.
- Investigate the details of certain business transactions

Standard contents of a set of financial statements:

- Balance Sheet : Shows the entity's assets, liabilities, and shareholders' equity as of the report date.
- Income Statement : Shows the results of the entity's operations and financial activities for the reporting period. It includes revenues, expenses, gains, and losses.
- Statement of Cash Flows : Shows changes in the entity's cash flows during the reporting period.
- Supplementary Notes : Includes explanations of various activities, additional detail on some accounts, and other items as mandated by the applicable accounting framework, worldwide

Structure of Accounting

Ledger Accounts



Ledger Grouping

Income Groups

**Expenditure
Groups**

Liability Group

Asset Group

Profit and Loss Account(P&L)

- Financial statement that summarizes the revenues, costs, and expenses incurred during a specified period, usually a year or even Quarterly (*for Stock Exchange Listed Companies*).
- This Statement provide information about a company's ability or inability to generate profit by increasing revenue, reducing costs, or both.
- P&L Management refers to how a company handles its Profit or Loss through revenue and cost management, by taking suitable decisions.

Profit & Loss Account Group

Income

Direct Income
Indirect Income
Sales Accounts

Expenditure

Direct Expenses
Indirect Expenses
Purchase Accounts

Balance Sheet

- A balance sheet is a financial statement that reports a company's assets, liabilities and shareholders' equity at a specific point in time, and provides a basis for computing rates of return and evaluating its capital structure.
- It is a financial statement that provides a snapshot of what a company owns and owes, as well as the amount invested by shareholders.

Balance Sheet Group

Liabilities :

Capital

Reserves & Surplus

Loans (Liability)

- **Secured Loans**
- **Unsecured Loans**

Current Liabilities

- **Bank OCC/Bank OD**
- **Provisions**
- **Sundry Creditors**

Assets :

Fixed Assets

Investments

Current Assets

– **Bank Accounts**

– **Cash in Hand**

– **Sundry Debtors**

– **Deposit (Assets)**

– **Loans & Advances
(Asset)**

Computerization of Accounts

- Like all functions which are being automated now, Accounting is also automated through Computerization & Specific Accounting Softwares
- Computerized Accounting System is Accounting Information System which processes financial transactions and events as per Generally Accepted Accounting Principles (which we saw earlier) to produce Reports as per User Requirement
- Based on the size of organization, there may be 'Single User' software or there may be a 'Server having Software' with number of users
- 'Tally' and 'Focus' are most widely used Softwares in India

Manual Accounting



- It is a system of accounting that uses physical account books for keeping financial records.
- All the calculation is performed manually.
- Entries are made in Book of Original Entry.
- The final result is to provide the Financial Statements at the end of the year.

Computerized Accounting



- It is a system of accounting that uses an accounting software for recording financial transactions electronically
- Only data input is required, the calculations are performed by computer system.
- Entries are recorded in software like Tally, Focus, Quick Books etc.
- The final result is to provide Financial Statements at any time given in a year.

Cash Flow Statement

- **Cash Flow Statement summarizes the amount of cash and cash equivalents entering and leaving a company during a particular period of time**
- **The cash flow statement (CFS) measures how well a company generates cash to pay its debt obligations and fund its operating expenses.**

Annual Report

- An annual report is a publication that public corporations must provide annually to shareholders to describe their operations and financial conditions and contains detailed financial and operational information.
- The intent of the required annual report is to provide public disclosure of a company's corporate activities over the past year.
- The report is typically issued to shareholders and other stakeholders who use it to evaluate the firm's financial performance.

TO BE CONTINUED.....
ANALYSIS OF FINANCIAL
STATEMENTS

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