

Financial Accounting
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School of Management
Indian Institute of Technology, Bombay

Lecture - 01
Introduction and Scope of Accounting

Namaste to all of you, today we are going to start a new course on Financial Accounting. I am very much excited to meet you all and I am sure at your end also you are excited to take the new course on financial accounting.

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The slide features a light blue background. At the top, a dark red horizontal bar contains the text "Dr. CA. Varadraj Bapat" in white. To the right of this bar is a small blue circular logo. Below the bar, a bulleted list provides details about the speaker's qualifications and interests. At the bottom left is the NPTEL logo, and at the bottom center is the text "Building Blocks of Financial Accounting". A small number "2" is located at the bottom right.

Dr. CA. Varadraj Bapat

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- Teaching Interests: Financial/Management Accounting, Indian Economy, Indian Financial and Business Models
- Research Interests: Financial Accounting, Financial Disclosure, Bankruptcy Prediction, Financial Inclusion, Portfolio Management, Mutual Funds, Corporate Governance, Family Business, Green Accounting,

NPTEL Building Blocks of Financial Accounting 2

This is a brief introduction about myself I am Varadraj Bapat, I am a chartered accountant and cost accountant currently I am a faculty in finance at IIT Mumbai and I have teaching interest mainly in the area of accounting as well as to an extent in economics. I also have various research interest including in accounting, bankruptcy prediction, financial disclosures, financial inclusion, portfolio management, green accounting and so on.

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Dr. CA. Varadraj Bapat

- Others: Yoga, Spirituality, Sanskrit, Bharatiya Sanskriti, ABVP

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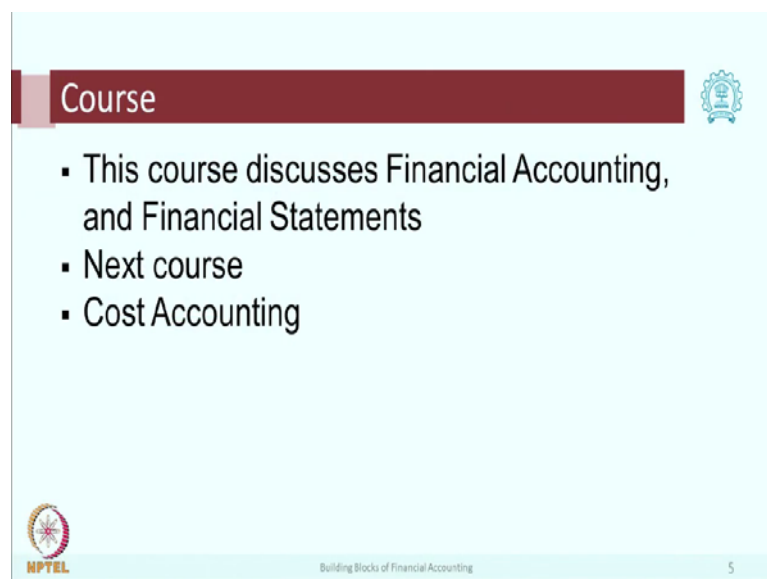
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 NPTEL Building Blocks of Financial Accounting 3


I am also interested in Yog Brahmaavidya as well as Bhartiya Sanskriti these are about my Facebook pages. For a more detailed study I have written a book on Financial Accounting a Managerial Perspective this mainly caters to those who are interested in the study of accounting, but tries to consider those students who may not have a commerce or accounting background, but today are interested in accounting education. Now the course is mainly going to discuss about financial accounting and financial statements.

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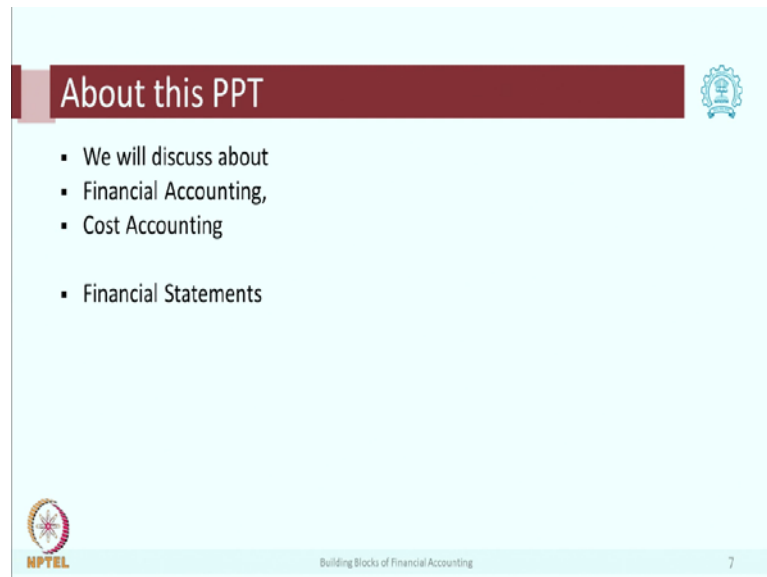
Course

- This course discusses Financial Accounting, and Financial Statements
- Next course
- Cost Accounting

 NPTEL Building Blocks of Financial Accounting 5

We also have one more course on cost accounting which will discuss about the accounting issues related to costs. You will need to submit various assignments in during the course we will be discussing about as and when the assignment becomes due.

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About this PPT

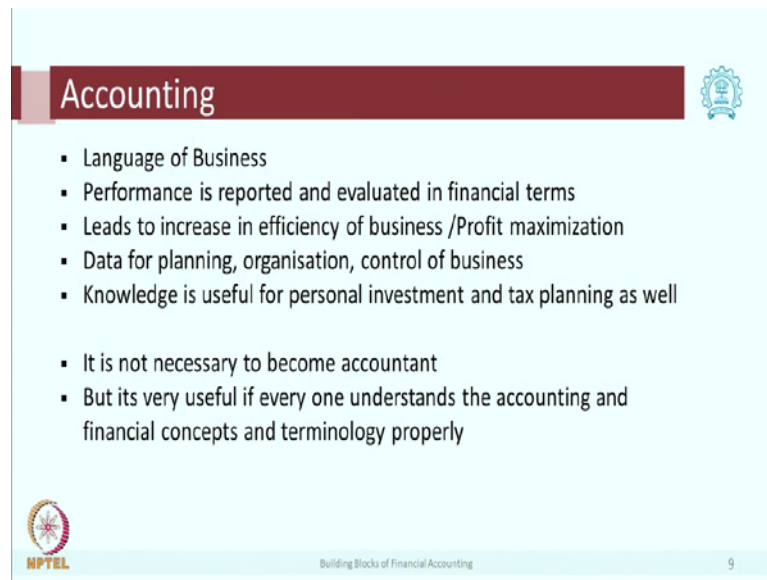
- We will discuss about
- Financial Accounting,
- Cost Accounting
- Financial Statements

NPTEL Building Blocks of Financial Accounting 7

So, now we will start in this PPT discussion on comparison between financial cost accounting and then we will also learn about financial statements. Now for those who do not have accounting as their basic background as far as the commerce and accountancy students are concerned anyway this course is going to be very much relevant. But even for others assuming that you are engineers or you are pharmacists or for that matter you are arts students or science students this course is equally going to be important for you because, when you join your career whether it is a job or whether for doing some business you are mainly being hired for your functional expertise.

But, as you move up the ladder actually your management and financial expertise becomes more than more importance; so, accounting will be very much useful to you because it will help you to build your understanding of finances it will also help you to analyze the performance of yourself as well as others which is very much important when you are in a managerial position.

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The slide features a dark red header with the word "Accounting" in white. To the right of the header is a small blue gear icon. Below the header, there are two bulleted lists. The first list contains five points, and the second list contains two points. At the bottom left is the NPTEL logo, and at the bottom center is the text "Building Blocks of Financial Accounting". The number "9" is in the bottom right corner.

Accounting

- Language of Business
- Performance is reported and evaluated in financial terms
- Leads to increase in efficiency of business /Profit maximization
- Data for planning, organisation, control of business
- Knowledge is useful for personal investment and tax planning as well

- It is not necessary to become accountant
- But its very useful if every one understands the accounting and financial concepts and terminology properly

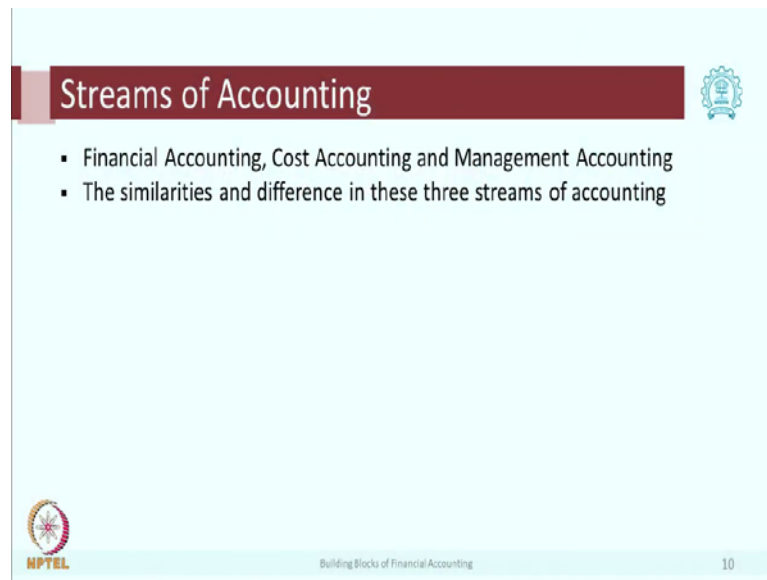
NPTEL Building Blocks of Financial Accounting 9

Now, we will discuss bit a as to what is accounting? In simple terms we can define accounting as a language of business where the performance is reported and evaluated in financial terms and if you are doing accounting properly it leads to improvement in the efficiency which will ultimately maximize the profits. Accounting data is very much useful for planning, organizing and controlling of all business operations.

And even for non business entities like government or NGO's. Now the knowledge of accounting is also useful for personal investment and tax planning decisions. Keep in mind that this course is not to make you an accountant, those of you who have taken accounting as your basic area you can learn more detailed accounting and can become accountants, but this course is for everybody. So, you may or may not be intending to be an accountant you can be a doctor, you can be a engineer, you can be a manager, you can be a pharmacists, but what this course enables you to is to understand some basic accounting and financial concepts these terminologies are going to be helpful to you in any area.


Because your performance is going to be evaluated in financial terms whoever you are and this course is mainly to make you understand those terminologies. Now there are three important streams of accounting.

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Streams of Accounting

- Financial Accounting, Cost Accounting and Management Accounting
- The similarities and difference in these three streams of accounting

 Building Blocks of Financial Accounting 10

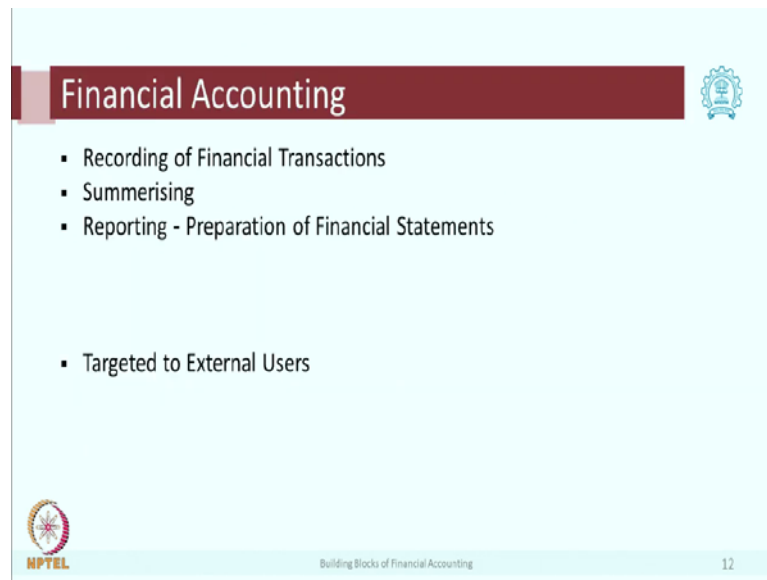
This slide features a title bar with the text 'Streams of Accounting' in white on a dark red background. Below the title bar, there is a bulleted list with two items. The first item is 'Financial Accounting, Cost Accounting and Management Accounting' and the second is 'The similarities and difference in these three streams of accounting'. At the bottom left is the NPTEL logo, and at the bottom right is the text 'Building Blocks of Financial Accounting' followed by the slide number '10'.

So, we will discuss with trying to understand what are these streams? The first one is financial accounting, then there is cost accounting and there is management accounting.

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A presentation slide titled "Financial Accounting" in a dark red header bar. To the right of the title is a small blue gear icon. Below the title, there is a bulleted list of topics: "Recording of Financial Transactions", "Summerising", "Reporting - Preparation of Financial Statements", and "Targeted to External Users". At the bottom left is the NPTEL logo, and at the bottom center is the text "Building Blocks of Financial Accounting". The slide number "12" is in the bottom right corner.

Financial Accounting

- Recording of Financial Transactions
- Summerising
- Reporting - Preparation of Financial Statements
- Targeted to External Users

NPTEL Building Blocks of Financial Accounting 12

Now, this particular course is on financial accounting. So, we will be going into what is financial accounting more in details, but right now we are just trying to differentiate the three main streams. So, what financial accounting deals with is about recording of financial transactions that is the first step, the next step is summarizing the transactions and the third step is reporting of the financial position that is usually by preparing financial statements. Now briefly, every business transaction needs to be recorded, if it has some financial implication.

Can you think of some business transactions for example, you might purchase raw material it is a business transaction, then you may do some processing, you may will go for selling of a finished product, you may incur expenses on travelling, you may be charged by bank charges by the bank as an expense, you may receive interest all of these are examples of business transactions and they need to be recorded. Even if you are a non business entity let us say you are an NGO or you are a government then also these transactions are there.

So, business or non business, but any transaction which has a financial implication needs to be recorded. So, the first step in financial accounting is recording of every transaction next step is about summarizing the transactions. Almost all of you would have your own bank account, so, you will be entering into various transactions with bank, I think you would have also seen passbook or a bank statement. Now what does the bank statement

give you? Bank statement or a passbook is a summary of your transactions with the bank.

Now, bank is having lakhs of customer and they are having variety of transactions, they are also having apart from customers various investment and loan related transaction, but what they are doing is there summarizing only the transactions related to a particular account holder and then they give you a passbook. So, the second step is summarizing the related transactions. In this case if as a customer of a bank you get a summary of your transactions it becomes useful to you, you are not interested in other transactions of the bank neither bank is authorized to pass you on the information of other customers.

So, they will just summarize the transactions about you that is the second step and in case of. So, in this example it was a personal transaction for a particular customer same way bank will summarize the transactions about loans at one place, transactions about their assets at one place, transactions about their salary expenditure at one place. So, they would be summarizing the related transactions in the second step. Those of you are aware of the terminologies used in accounting normally the first step is called as journalizing or recording the transactions in the journal, the second step is called as preparation of ledger accounts.

Now I am not using that jargon here, so to make it simple I have just tried to put two steps; as recording of transactions and the second step as summarizing of transactions. Now, in the third step reporting is done because, you already have summarized the transactions now, now at the end of accounting period it can be 1 year or it can be at the end of the month what we are interested in knowing the final balances. So, you may be wanting to know your profits, you may be wanting to know how much cash you have, you maybe wanting to know how much bank deposits you have.

So, you want to have a final summary of the balances which represent your financial position. So, in the third step reporting is done by preparing various financial statements. Keep in mind that the whole exercise of financial accounting is mainly for preparation of financial statements which are intended for external users.

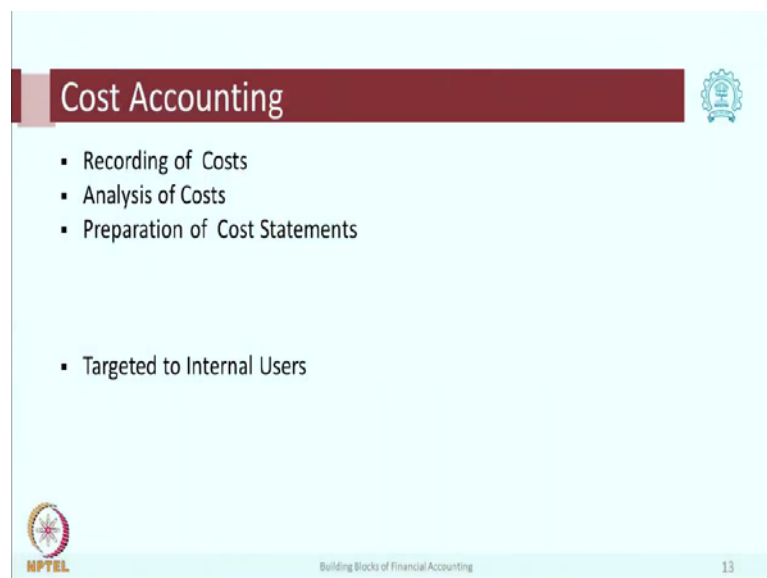
So, financial statements are passed on to outsiders of the business. Now who can be external users? As you are aware most of the people have to file income tax returns. So, along with income tax returns if you are a businessman you will need to give your

financial position. So, one of the users of financial statements are taxation authorities or government authorities there can be various other user for example, if you approach a bank for a loan bank will ask you to submit your financial statement or a balance sheet.

So, they are also your external users, in some cases customer ask for some statement, sometimes for vendor registration that is you want to be a supplier to a particular company that company ask for your financial statement. So, even your customers or your suppliers become the; become the parties who are interested in your financial statement, then employees might be interested. So, a variety of external users are provided financial statement; in case of many entities like listed companies those financial statements are put in public domain.

So, they are available for anybody who is interested in those financial statements. Internal users mind well are equally interested that can be management or that can be your board of directors or your owners, but in general financial statements are meant to be available for external user. That is why I have said that financial accounting is targeted to external users. I hope you are getting over all understanding as to the process or the steps of financial accounting. Now let us compare with second stream of accounting that is cost accounting.

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The slide is titled "Cost Accounting" in a dark red header bar. To the right of the title is a small circular logo. Below the title, there is a bulleted list of three items: "Recording of Costs", "Analysis of Costs", and "Preparation of Cost Statements". Further down, there is another bullet point: "Targeted to Internal Users". At the bottom left of the slide is the NPTEL logo, and at the bottom center is the text "Building Blocks of Financial Accounting". The page number "13" is located at the bottom right.

- Recording of Costs
- Analysis of Costs
- Preparation of Cost Statements

- Targeted to Internal Users

NPTEL Building Blocks of Financial Accounting 13

Now, when it comes to cost accounting these are the three important steps; the first is recording of costs. Now, you can see it very well matches with the financial accounting,

because there are also the first step was recording of financial transactions now it says recording of costs, the next one is analysis of cost and the third one is preparation of cost statements. Now you may be wondering that the first step in financial accounting which is recording of financial transactions appears to be very similar now it is recording of cost. So, is it the same thing? Many times yes.

Because most of the financial transactions may give you some cost and almost all the costs are financial transactions. For example, if you go out let us say to a restaurant, then you will incur some expenditure, it will be a financial transaction, it will also be a cost to you, you might be paying rent, rent is a financial transaction it is also a cost to you, you might be paying salaries again it is a financial transaction it is also a cost.

So, many times almost all cost are covered in financial transactions then do you need the step again? You have already recorded there in financial accounting, then why do you need to record? Actually the answer is you do to need to record more because in cost accounting you are recording with lot of more details. For example, in financial accounting you may be just recording the salary here you are also recording the time consumed on what work that particular employee is doing, you are also might be recording more details about the nature of work.

So, the recording of cost is actually more detailed recording, it further leads to analyzing the costs under different heads; for example, say manufacturing cost, production cost, marketing cost, admin cost and so on. Based on this analysis finally you come out with various financial statements like a cost sheet. Keep in mind that cost accounting is primary targeted to internal user. So, this is the confidential data, it is not given out to anybody, it's mainly for internal users.


So, I hope you would have I will just go back a bit. So, now, first we discuss financial accounting, then we discuss cost accounting. We will not going to too much details of cost accounting, because we are having a separate course on cost accounting where we will discuss further details about it. The third step in accounting or at third stream in accounting is known as management accounting. Now what is done in management accounting is it is a umbrella concept.

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Management Accounting

- Recording of Financial & other data
- Analysis of Financial and other information
- Preparation of Statements for Managerial Decisions

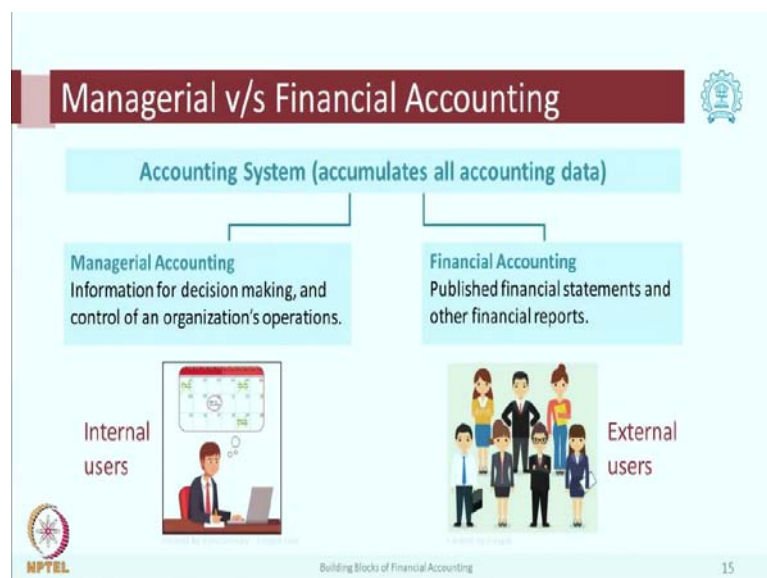
- Targeted to Internal Users - All levels of Management
- This is a broader concept encompasses Financial and Cost Accounting



Building Blocks of Financial Accounting 14

Now, you are recording both financial as well as other data, you analyze the financial data with other data that leads to preparation of various statements which are mainly used for managerial decisions. Now, this data again is a confidential, it is maintained for decision making of various levels of management it is not given to outsider, so, it is targeted to primarily internal users.

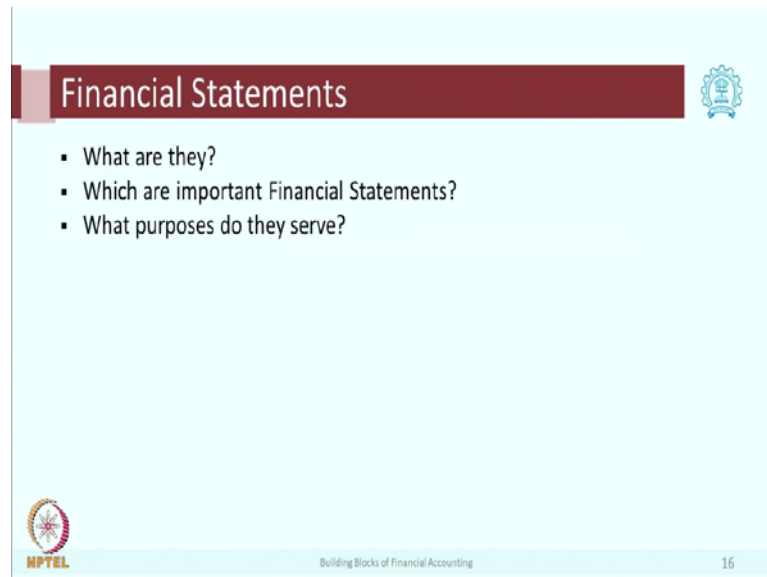
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Now we have restated the streams so on one hand you have got financial accounting which is published normally in public domain for external user, on the other side your

have got cost and management accounting many times its together called as managerial accounting which gives you information on decision making and it is mainly for internal user.

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The slide has a light blue background. At the top, there is a dark red horizontal bar with the title 'Financial Statements' in white. To the right of the title is a small blue gear-like logo. Below the title bar, there is a bulleted list of three questions. At the bottom left is the NPTEL logo, and at the bottom center is the text 'Building Blocks of Financial Accounting'. At the bottom right is the number '16'.

Financial Statements

- What are they?
- Which are important Financial Statements?
- What purposes do they serve?

NPTEL Building Blocks of Financial Accounting 16

Now, we will move to the next level I hope you have understood the main streams of accounting. Now in financial accounting as you we have seen the final target is preparation of financial statement. Now let us look at these things that what do you mean by financial statements, which are the important financial statements and what purposes these statements serve?

Now the first thing what are the important statements? I think many of you might have heard about them or might have been aware about them do you think of different financial statements? I think most of you are right there is a balance sheet, there is a profit and loss account, there is a cash flow statement and there are more statements which are considered as financial statements. Any statement which gives you financial information in a summarized form is considered as a financial statement, what purpose do they serve?

For example if you take balance sheet, what do you get from balance sheet? If you want to know the financial statement of that entity that how will be that entities is what assets they have, do they have any payables or liabilities all that information you will get from

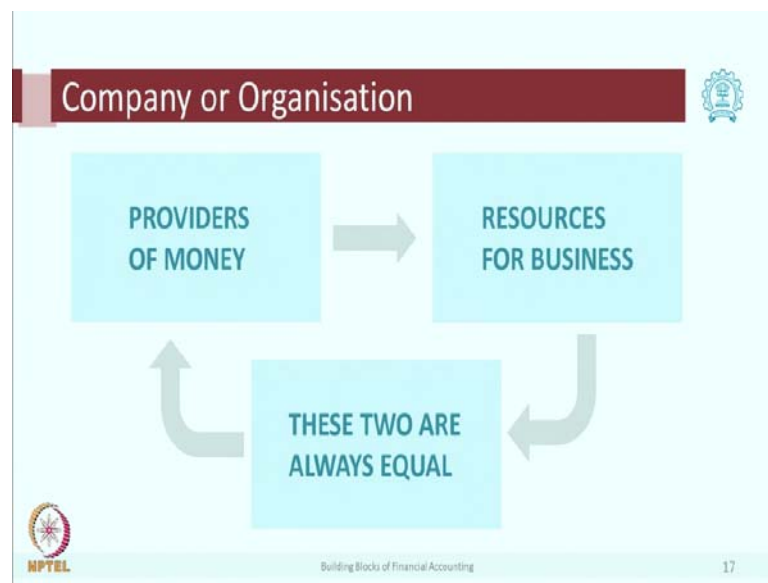
the balance sheet that is the purpose of balance sheet. We are going to discuss in detail in coming slide as to what does the balance sheet give you.

The next is profit and loss account, as the name suggest it gives you profit or loss at the end of some year or a month it also gives you what where the major streams of income or revenue, where have you spent all that money and finally, what you are left with in the form of profits at various levels? That is what is provided by P and L account we also have a statement known as cash flow statement.

Because many times you are interested in knowing how much cash the business has generated and where it has spend, what are the major sources of earning cash, what are the major sources of spending cash or major sources of making investments and so on. So, that all is summarized in cash flow statement, apart from that also there are some more statements like there can be fund flow statement, there are financial statements of subsidiary books, there are financial statements of a particular cash related transactions like say cash book.

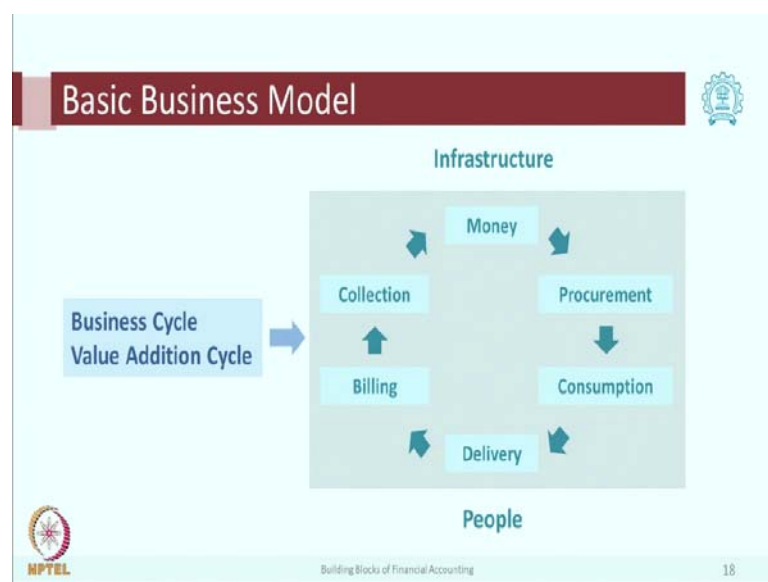
So, variety of financial statements are prepared and they can be in the category of financial statements. In this course we will mainly be talking about balance sheet p and l account and cash flow statement in coming weeks. Now to put it in a very much of a layman language, if you think of a company or for that matter any organization it need some resources for doing the business, so, you got resources, resources are provided by somebody.

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So, there are also providers for resources. So, for any organization these resources and providers for resources need to always match. Now while doing the operations normally you follow a basic business model.

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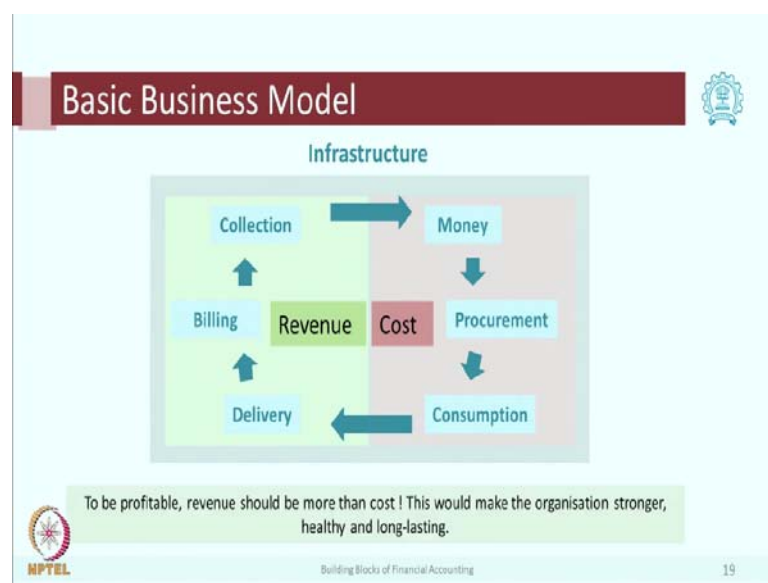


So, you start with some money, then you may have to do some procurement of raw material or procurement of essential items, then these are consumed in your operation, you get finished goods they are delivered, then you go for billing, collect the money back, so, you are back to money. So, what circle we have is normally known as a money

cycle it can also be called as a business cycle or as value addition cycle because what we are trying is if you are starting with x amount of money it goes through the whole process you would like to have x plus amount of money.

So, there should be some value addition in the form of generation of some extra cash, this is a basic business model. Now it is supported by infrastructure and it is operated by people because there are people who are essentially running the whole system they are also the part of business model or business cycle.

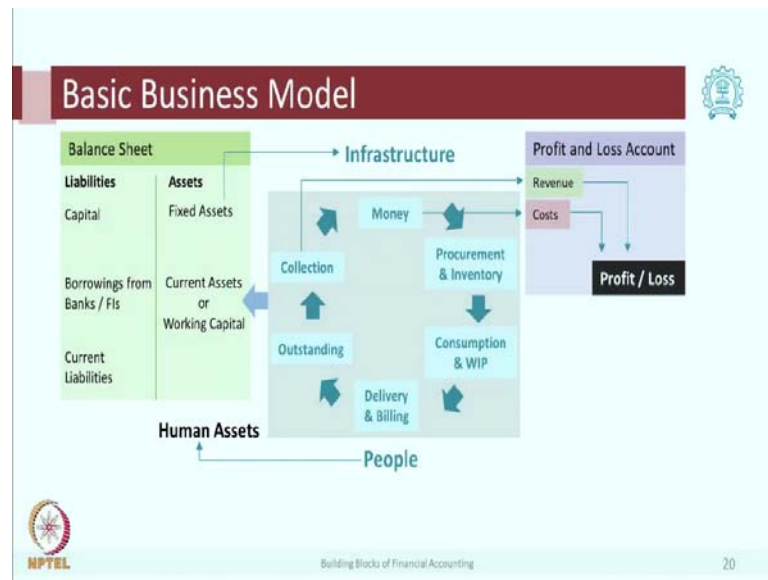
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Now, usually the costs are incurred in the beginning part, when you go for procurement on consumption of your resources and as you deliver it to the customer you start recovering money and that generates what is known as revenue. Now a statement is prepared to compare the cost and revenue.

Now, what that statement will be? I think most of you are guessing it right that is what is called as profit and loss account; it compares your cost and revenue. Now if you want to be profitable normally, you will need more revenues than the cost and if you are consistently profitable the business or the organization will become healthy and strong and it will also help you to last longer. Now this business model from this business model we will try to understand what is P and L and what is balance sheet? As we have just discussed a statement is prepared for comparing revenue and cost that is called as P and L account, it gives you net result in the form of profit or loss.

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On the other side you make a statement which lists out your resources, those resources are known as assets and there are providers for resources which are known as liabilities. Now, your assets are further categorized as fixed assets. So, whatever infrastructure you have is known as fixed assets because infrastructure is of permanent nature, it is not getting continuously consumed in your process, it acts as a catalyzed catalyzes catalyst it supports your process.

Now there are assets which are continuously moving in your business cycle these assets are known as current assets. So, we have got two major categories fixed assets and current assets that current those current assets are also sometimes known as working capital.

Now, can you think of any examples of fixed assets, I think one very easy example which would have come to your mind is a land or building. So, to run the business you will need some place in the form of building, you will also thinking you might also have thought of fixed assets like say vehicles there can be computers within the computer you will need software. So, hardware as well as software all these are examples of fixed assets. Now what could be the examples of current assets? Now current assets you can look at the money cycle and I think you will realize what could be the current assets.

So, when you do procurement you are purchasing raw material, then whatever raw material remains in your hand as a inventory or as a stock that is one current asset, then

you might consume the raw material and generate finished goods, some of the finished goods will be with you as a stock, again the stock of finished good is a example of current asset. Thus finished goods or whatever services you are providing are provided to the customers then customers may not pay you immediately, there might be some balances which are to be collected from the customers.

So, those receivable balances are also your current assets, whatever cash you have in hand or whatever cash you have got with banks with in the bank account all these are examples of your current assets. So, fixed assets current assets these are the major examples of assets. Can you consider people as in your assets? The answer is both yes and no because people are human assets are the most important assets for the business, this is the intellectual capital you have they are the people who are running the business. Unfortunately, human assets are not permitted to be shown on the balance sheet; can you think why they are not to be shown in balance sheet?

Because human assets are not owned by the entity or by that business, they are just working there may be as employees or as partners or owners, but they are not the assets which are owned. So, it is necessary that an item which is owned by that company or by that organization that can only be shown as an asset; seen people are not owned human assets are not shown as a part of balance sheet, that is why in the slide I have shown it, but I have shown it below the balance sheet ok.

So, these all these assets to together are the resources for the business, along with resource resources you will need the providers for resources because resources cannot come for free there would be somebody who have provided. Who have provided those? Then there are three four examples as you can see from the slide there is capital there are borrowings and there are current liabilities.

Now what is a capital? Capital refers to the money which owners have put in. What are borrowings? Borrowing refers to the money which the lenders have given you, for example, banks or financial institutions they have given you some amount of loan that is called as a borrowing. And what are current assets or current liabilities? The current liabilities are the moneys which are been generated from the money cycle. For example, if you have purchase something, but not paid them then those outstanding balances or payables are examples of current liabilities.

So, I think now at the first stage you would have seen: what are the important items on asset side and on liability side of the balance sheet. So, we will stop here and in the first session what we have discussed till now first we understood what is accounting, then we have tried to distinguish between financial accounting and management accounting. Financial accounting is mainly for external users and we are trying to record the cost and prepare statements.

In cost accounting it is mainly for internal users we record cost and provide various financial statements. In the next part we discussed about financial statements, so, we have discussed what is money cycle or business cycle and from business cycle how do you get P and L and balance sheet. In the next session we are going to continue this and go further into what is P and L and balance sheet.

So, I hope you have liked the first session, so please watch the second session as well
Namaste.