Financial Statements Analysis and Reporting
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Lecture - 02
Accounting Process

Welcome students! So, I was talking to you about the different type of accounting systems in my previous lecture. And, today we will talk about some other aspects of GAAP; generally accepted accounting principles. And, today I will talk to you about the double entry accounting system.

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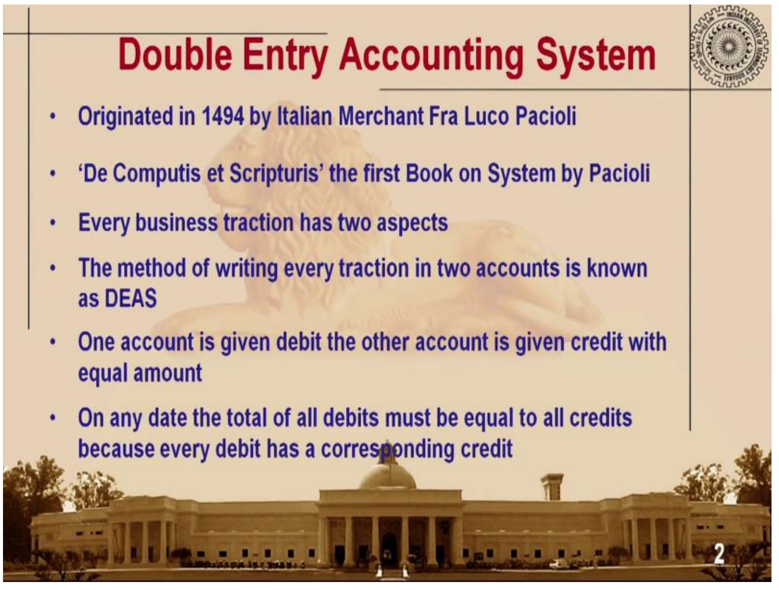

Double entry accounting system is basically the foundation of overall accounting system. Today's financial statements when the businesses prepare, firms prepare, they are by following the double entry accounting system. Double entry accounting system means this system says, or as per this system we assume that every transaction has two aspects. One aspect is the debit and the other aspect is the credit.

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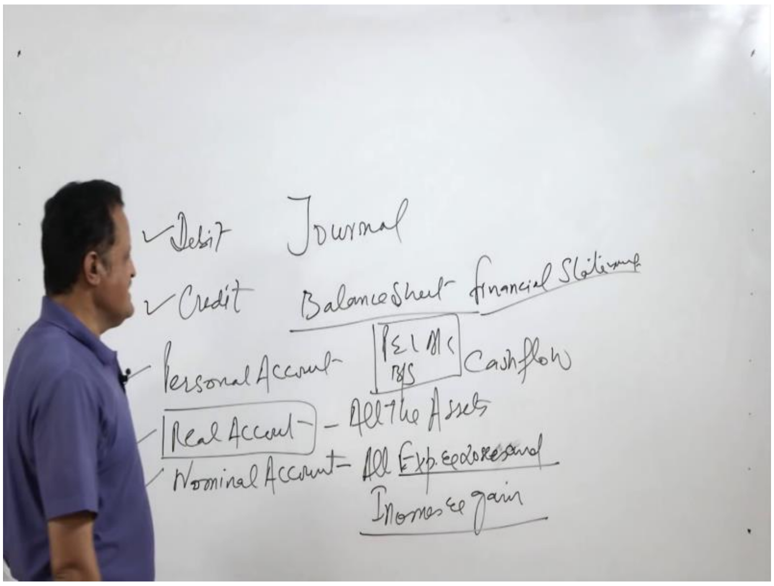

We assume that whenever we make any transaction in the business, two accounts are affected. There are two accounts, minimum two accounts, which are affected. Say for example, any company purchases the raw material. Now, raw material is coming into the firm. And, in lieu of that money is going out. So, it means they are the two parts of that transaction. And this way, every transaction has two parts. And, both these parts we have to recognize and then give debit or credit effect to one of the accounts. One account will be given the debit effect; second account will be given the credit effect. And that way, the transaction will be completely recorded in the first book of accounts. So, this is a double entry accounting system.

Let us go back to the history of this little word. This system was originated in 1494 in the 15th century by an Italian merchant Fra Luco Pacioli. Fra Luco Pacioli was an Italian merchant and he identified the system, he invented this system. Before that, we had the single entry accounting system. Today also the single accounting system is in vogue. It is in practice. But very few organizations, may be you can call it as the charity organizations, those organizations whose purpose is not business, whose purpose is not earning profits or doing any business, who are say simple organizations, who are the organizations doing the, you can call it as who are working on the charitable purpose; may be some NGOs or some charitable organizations. They may follow the single entry accounting system. But, today’s business follows the double entry accounting system. And, this was invented long back when it is going on.

This merchant also wrote a book which is called as “De Computis Et Scripturis”, which was the first book on the double entry accounting system, which you can see is the backbone of the say financial statements, the today’s accounting. And, this double entry system, as I told you has two aspects. One aspect I told you that it has the debit and second aspect I told you it has the credit effect because whenever we make any transaction, something comes to us and something goes out of us. It is a natural phenomenon also. And that way, we will have to recognize these two important aspects.

And, the method of writing every transaction is debiting one account and crediting other account is called as double entry accounting system. And finally, on any date when we try to check both the sides, then the total of the debit side should be equal to the total of the credit side. If that happens, it means we have done everything right, everything correctly, everything rightly. And, no account or any part of the transaction has been left unrecorded in the books of accounts.

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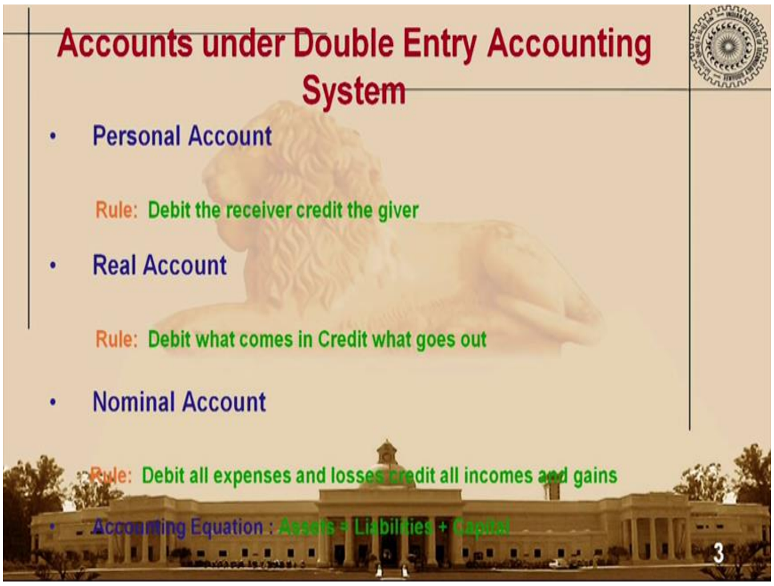

Now, we talk about the three different types of accounts, which we normally use for preparing the financial statements. These are three accounts; as I have written here; means personal account, then we have real account and then we have nominal account. These are the three accounts, which we normally recognize in every transaction.

And, I would like to share with you that in the entire, this world, business world, entire world, all through the world in any business form, in any business organization, may be it is a transnational company, multinational company, it is a single man; means controlled organization, which we call it as sole proprietorship. All the businesses only have three accounts; personal account, real account and nominal account. There is no fourth account. All the transactions we have to record under the three accounts; personal, real and nominal accounts.

Now, what is a personal account? Accounts of all the natural human beings and all the organizations. May be it is a business form, it is a bank, it is any supplier or any other company or any other organization, they all are considered as personal account. Natural human beings accounts and the artificial persons means any organization, any firm or any undertaking.

Second account is a real account. This account takes into consideration all the properties or all the assets. This account takes care of all the properties, all the assets; plant, building, machinery, furniture, even cash. All these assets, all these properties are covered under real accounts and they are recorded under the real accounts; all kind of the properties, all kind of the assets.

Then, we have the nominal account. Under this account, we record all expenses and losses, expenses and losses and incomes and gains. Any expense or loss happening to the business or any income or gain happening to the business will be recorded under the nominal account.

So, we have the three accounts. One is the personal account covering all the natural and artificial persons, then we have the real account covering all the properties or assets of the organization including cash and third one is the nominal account, which is taking care of all the expenses and losses and incomes and the gains. They are being, they will be treated and they will be taken care of under this nominal account.

Now, why this three accounts are important to be recognized because whatever the financial statements we are going to prepare, they will be prepared under these three accounts. And, as I told you that every transaction has the two aspects. One is the debit effect and second is the credit effect. So, in that case say for example, now you have to record any transaction in the books of accounts of the firm. In that case, which account will be given the debit effect and which account will be given the credit effect. So, for that we have three rules associated to the three accounts, for the personal account.

Therefore, the rule is rule of recording the business transactions is debit the receiver, credit the giver. If any person is the receiver or any business is the receiver of something, then his accounts will be debited and if any person is the giver of something, his or her account will be credited then, the real account. In case of the real account, the rule is debit what comes in. If something is coming into the firm that will be debited; for example, there is a company XYZ Limited. They purchase raw material. Now, they are purchasing raw material for 1000 rupees. So, material worth rupees 1000 will be coming into them and cash 1000 rupees, in lieu of that will be going out. So, something is coming in, something is going out. So, material will be debited; material account will be debited and the cash account will be credited. So, material; we do not write material in the transaction, we write it as purchases. Purchase of anything is generalized as the purchases. So, we will write it as purchase account debited to; means the cash account, purchase account will be debited and the cash account will be credited.

Similarly, we have the third account which is the nominal account. And, in the nominal account as I told you we have, we take care of two things. One is the all expenses and losses and second is the all incomes and gains. So, all expenses and losses will be debited; means they will be given the debit effect. And, the all incomes and gains will be given the credit effect. So, whenever recording any transaction of the business in the books of accounts of that business, we will have to take care of the three accounts. First, in any transaction we have to recognize that what are the two best accounts affected in that transaction. And then, we have the second step is to identify whether that account is the personal account or the real account or the nominal account.

So, it may be possible that one account may be the personal account; second account may be the real account. Or it may be possible that the one account is the real account, another account is the nominal account. So, you have to simply recognize that what are the two best accounts in that transaction and which account I have to debit, give the debit effect and to which account I have to give the credit effect. And accordingly, we will have to record their transaction in the books of accounts, which I will discuss with you later on that how to record the transaction.

But, you keep in mind that these are the three important accounts and these three important rules of recording the business transactions. And, in that situation whatever the transactions come before you, you have to record them in the books of accounts because accounting itself has a process. You will have to start from the first book of accounts and go up to the last book of accounts, which is the balance sheet.

So, first book of accounts is called as the journal. I would say that it is called as journal. And, last is the balance sheet. Balance sheet is the last financial statement. We call it as the last financial statement. So, as I was talking to you that we have to learn to prepare the three financial statements. So, one financial statement will be profit and loss account, second will be the balance sheet and the third will be the cash flow statement, which will be prepared out of these two statements. Profit and loss are the basic statements. From these two statements, we will be preparing the third statement which is called as the cash flow statement. So, we will move within the processes. You will learn everything.

Then apart from these three accounts, we have the one more thing which is called as accounting equation. You should be aware about the accounting equation because it is a very important equation. And, when we are preparing the balance sheet, we are preparing the balance sheet by following the accounting equation.

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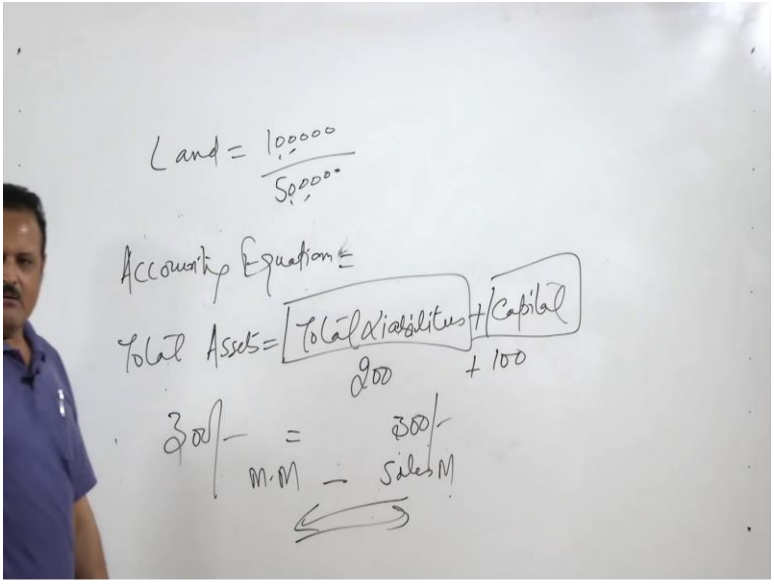

Accounting equation is assets of any firm. Assets means total assets are equal to the total liabilities plus capital. So, if this, these two things are equal to each other, then you can say the business is in the balanced state. But, for example, if this side is more than this side in the balance sheet, then you can say that business is now moving towards the say unexpected phase, not a desirable phase, not a desirable situation. And, in that case it means we are talking about that the liabilities of the business are more than what the business has as its properties or as its assets. So, we have to be careful.

But, if the reverse happens, the total assets are more than the total liabilities plus capital. In that case, the situation is very good. But, normally in the balance sheet that situation does not come in the public arena. And, here we normally keep both the sides balanced means whatever the total means; this side indicates whatever the resources we have generated. May be you have the two sources of generating the furniture resources for the firms. Number one is the funds provided by the owner of the business or the owners of the business and the second thing is the borrowed funds. You can borrow from the banks, financial institutions or from the other sources.

So, the total investment we are making say for example, the total investment is we have our own capital in the business is say 100 rupees. And, 200 rupees we have borrowed from the bank or financial institutions. So, in that case it means I have invested 300 in the business and, if I have invested 300 rupees in the business. It means I should have the properties or assets worth 300 rupees. Otherwise, if this side is showing that I have invested 300 rupees. But, here I have the properties worth only 200 rupees. It means my liabilities are more than my properties, my assets. And, the business is passing through a very difficult state. And if this continues, then the company has to be closed or it will be forced to be closed.

But if happens like this that for example, you have the assets of 400. And this side, the liabilities are only of 300, then it is very good situation. But, this normally we do not allow to happen. If it happens also, then the extra output of the business is kept in the other books of accounts. And here, only we show 300 is equal to 300, and the balance sheet is balanced. So, this is based upon this equation, accounting equation. And, accounting equation is the crux of the overall accounting system. Finally, we have to reach the start from the transaction and we have to reach up to the accounting equation by preparing the balance sheet.

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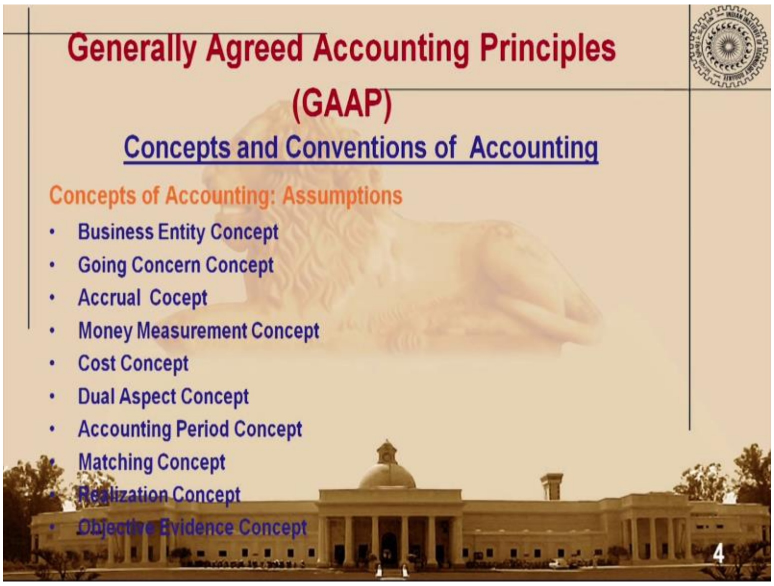

Now, next part of the GAAP is or the foundation of accounting is it is normally divided into four, five parts. One part is the concepts of accounting, second part is the convention of accounting, third part are the accounting standards. And two parts, I have already talked to you. That is the three types of the accounts and the three rules of passing the general entries or recording the business transactions in the books of accounts. Now, we will talk about the concepts of accounting, conventions of accounting and then for the, about the accounting standards.

Now, here we have one, two, three, four, five, six, seven, eight, nine, almost ten concepts of accounting; concepts means which the entire discipline of accounting is based. Means for example, how to treat the different type of the business informations, how to convert them into the transactions and then the transactions into the accounting entries. So, we means all through the word assume that what I mean to say something about other person also assumes in the same manner, third person also assumes in the same manner. So, concepts means are the common assumptions, that in the business, these are the common assumptions. And, these assumptions sometime make the accounting language also.

So, these are the ten concepts. First concept is the - I will take it quickly and you can refer it in the books also. So, quickly I will take it up the different kind of the concepts. First concept is the business entity concept.

So, we assume that every business is a separate independent entity. So, for example, you talk about three types of the business organizations. Sole proprietorship, business controlled or owned by one single individual, partnership firms, where you can have more than one owner of the business. And then, third one is the company firm of organizations. So, in the company firm of organizations especially the public limited companies in the sole proprietorship, the owner as well as the business are the one as the same thing. Business is recognized by owner and owner by the business. So, liabilities of the owner are the business liabilities and the business liabilities are the owner’s liabilities.

But in case of the other firms of organization, partnership firms, private limited companies and public limited companies, it is not the same. Especially in the public limited companies, for example, these companies which you see in the market; Reliance Industries, Infosys, say Wipro or so any, any number of the companies you talk about, which whose name is Reliance Industries Limited. If the word limited is there, they are called as public limited companies. And, where, the companies which are private limited companies, the word ABC private limited is mentioned. So, when we are finding a company, for example, Reliance Industries Limited. It means it is a public limited company, where the ownership is held by the initial promoters as well as the general public. So, it is a public limited company.

So, in that case first concept of about that company is business entity concept. Business entity means that business has its own entity, has its own existence. Business is not known by its owners or the shareholders. Shareholders may change, owners may change, but the business will continue. And, it has its own identity. It has own; Reliance Industries has its own identity. Where, the Reliance industry is not known by Mukesh Ambani. Mukesh Ambani is the chairman of the company or the one owner of the company. But apart from the Mukesh Ambani, there are many people. Thousands of the shareholders in the market, so business will be known by its own identity and own existence.

Second concept is the going concern concept. We treat that business has unlimited life. People may join the firm; they may leave the firm. Somebody today is the owner and somebody tomorrow will be the owner. So owners will change, management will change, but the business will continue, it is compared like a flowing river which continues to flow, which continues to move and it has unending life.

Accrual concept. Accrual concept: as I was talking to you in my previous lecture. Accrual means any transaction will be treated as happened. When it has happened means we do not link the business transactions with the movement of cash. Cash may move or cash may not move. That is not required.

If anything, say for example, any firm has purchased raw material. Now, a raw material can be purchased in credit also and in cash also. If you buy the raw material in cash, yes, cash is moving out from the firm and material is coming in. But, if the raw material is purchased on credit, it means if it is a cash system of accounting, we will not recognize that transaction or we will not record in the books of accounts. But, we are following a accrual system of accounting. So, any transaction is expected or is treated to have accrued or taken place. If the, even one part of that is complete, the receipt of the material, cash is not paid, no problem. So, it means accrual concept is that without even the movement of cash, the transaction will be treated as has happened.

Money measurement concept. Only those transactions are important for us which can be measured in terms of money. For example, material: you can easily make out. If you are buying a material of say 1,00,000 rupees. It means your pay, you pay cash, you do not pay cash at the time of purchase. That is immaterial. But, material can be converted into money or in the monetary value. So, we will recognize that transaction. But, for example, now you talk about the other two people. One is the marketing manager and other is the sales manager. Now, they do not talk to each other. They do not have the good talking terms. Now, it is a big impact. The firm may be suffering because of their bad relations or something like that. But, we will not recognize this type of the happening in the business because it has no monetary value.

Next thing is the cost concept; means whatever we record in the books of accounts, we record it at the cost price. Cost price means that price at which any asset or a property of the business has been purchased for the first time. Now, for example, the business has say an asset like land. And, land was purchased say 5 years back for 1,00,000 rupees. And, today the price of this land is say 5,00,000 rupees. But, in our books of accounts till the business adjusts, we will keep on showing the land at 1,00,000. And, we will not show it at the revalued or the renewed price. So, this is the cost concept; means we followed the historical costing concept in accounting. We do not change the value of the assets with the passage of time. Value of asset may go up or go down, but that is none of our concern. We record it at the cost, at the historical cost at which it was acquired.

Now, next thing is the dual aspect concept. As the name itself says double entry accounting system. So, dual aspect concept means every transaction has two aspects. One effect of that transaction will be debit; other effect of that transaction will be credit. Then, we have accounting period concept. Yes, it is very interesting concept. Accounting period concept means as I told you that business is having, this is like a going concern. It has unending life; it has unlimited life. So, it means if you want to know the results of the business, you have to wait till the time the business is closed. And that may be 100 years, 200 years or 500 years. So, we will be able to know that how much money we invested 500 years back, and after 500 years what is the size of the business.

So, we will be knowing that we have earned this much on our investment of, initial investment, which we made 500 years back which is not possible. So, what we do for measuring the profit or the loss of the business? And, knowing the financial position of the business, we have a accounting period of 12 months; accounting period of 12 months. And that period of 12 months can be any period. That period of 12 months can be any period.

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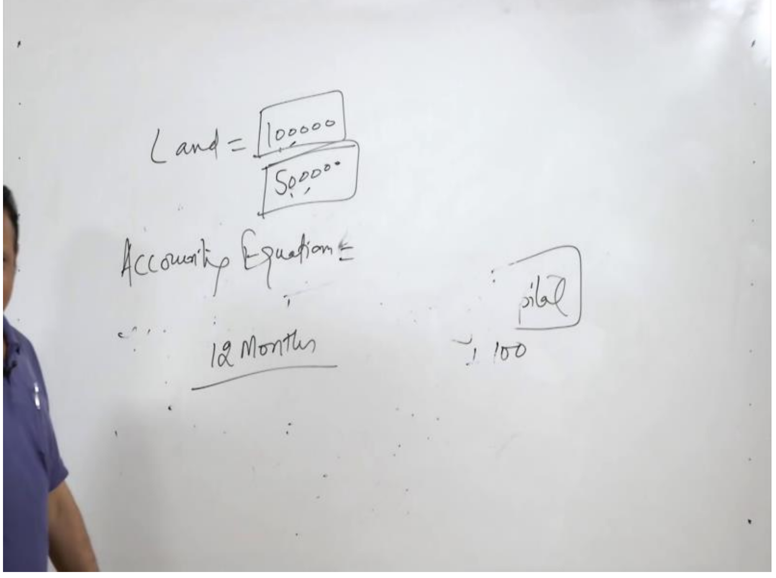

Some firms might have it from as a calendar year from January to December, their accounting period; some firm might have the financial year from the April to March; some firms might have October to September; some firms might keep it as from July to June. Depending upon their business, depending upon their convenience, depending upon their performance, they can have. They can select a period of 12 months. And after every 12 months, we will measure the performance of the business. We will get to know that what, whether the business is earning the profit or incurring a loss. If there is a profit how much profit is there, if there is a loss how much loss is there. Accordingly, means, similarly the financial position of the business; that as I told you the accounting equation that both the sides are equal. Your assets are equal to the liabilities plus capital; that we keep on ensuring after every 12 months. So, that is period. That period is known as the accounting period.

Then, we have the matching concept. Matching concept means it is again like the two sides liabilities should be equal to the assets or assets should be equal to the liabilities. So, we will have to match it. And, balancing both the sides means both the things at one point of time. And, whatever is there means both the sides are matching with each other; that we will have to ensure.

Realization concept; realization concept means that we do not record the transactions on the realization of cash on it. But, we record the transactions when it happens. When any transaction has taken place and any cash has become due to be paid that may be paid after 6 months, 3 months or 5 months. But that transaction is called as that has happened. And, we do not wait till the realization of that cash against that transaction. Say for example, we sold some material in the market. So, we will not wait till the realization of the cash from that transaction. We will record that transaction. And, realization of the cash is not important for us.

And, the last concept is objective evidence concept. Objective evidence concept means that whenever we record any transaction in the books of accounts, we need some proof of it. We need some evidence of it. Objective evidence, say for example, we have sold some finished goods, some material to some buyer in the market and he has not paid us, to us. So, in that case we had issued him a invoice bill, and that invoice will be; one copy of that will go to the buyer and one copy of the invoice will be with us. And, on the basis of that invoice we will be demanding that money from him on any future date, when he is asked to pay or after the credit period he is given, he has to pay it back. And, it means that will be on the basis of that invoice.

Similarly, if you buy something and we make the payment to the supplier, then against that payment, we should have some voucher; means objective evidence. And, in the accounting language you call it as voucher. And, we will have to keep the invoice which we received and then the receipt, in lieu of that money which we had paid to that supplier from whom we had purchased the raw material. So, it means only those transactions will be recorded in the books of accounts, which have objective evidence. Without objective evidence, no transaction has any material value for us. It will not be recorded in the books of accounts. And, it has no importance for the business.

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After these concepts, these ten concepts, we will be talking about the next part. That is the conventions or traditions of accounting. So, like concepts; concepts are assumptions of accounting and conventions are traditions of accounting.

So, you can call them as they are kind of accepted principles, generally accepted principles of accounting; GAAP. And, we are discussing the GAAP. We have already talked about the three different types of accounts, the rules of recording the business transactions under these three accounts. Then, we talked about the second part, the concepts. And, now we will be talking about the conventions of accounting or the traditions of accounting, which we generally observe, which we generally follow when we record the business transactions and prepare the financial statements. So, that will be talking to you in my next lecture. I will stop here for now.

Thank you very much.