**Chapter 8**
**Basics of accounting and finance**

A) basics of accounting
**Introduction**:-
Accounting is famously known as the language of business
As the basic function of any language is to serve as the means of communication, like this accounting is also recognized as a language because it acts a communication medium between each and everything about business activities like profitability solvency and the future prospects to the user of business.

Accounting provides following information to the businessman :-

1. Types and amount of earning
2. Types and amount of the Expence
3. The amount of loss or profit
4. Amount and size of increase or decrease of capital
5. Nature and values of liabilities

Meaning of accounting:-
Accounting is the process of recording financial transactions dealing to a business. The accounting process includes summarizing, analyzing, and reporting these transactions to respected agencies, regulators, and tax collection entities.

Accounting is the process of systematically recording, measuring, and communicating information about financial transactions.

**Purpose of accounting:-**
The purpose of accounting is to provide all the transaction record, all the financial transaction records to know the current position of the business, weather the business is in profit or in loss

Accounting provides following things to a business man

- Available resources
- How resources are employed
- Result achived by the resources

**Accounting process or cycle:-**
An accounting cycle is a complete sequence that begins with the recording of the transaction and ends with the prepration of final record
**Steps of accounting process:-**

1. **Identification: -** identifying financial transaction and events
2. **Measurement: -** measurement of transaction in terms of money
3. **Recording: -** recording the financial transaction in journal books
4. **Classifying: -** Classifying them through ledger
5. **Summarising: -** Summarising the transaction by preparing trial balance, trading account, profit and loss
6. **Analysing and interpreting**
7. **Communicating**

**Book Keeping**

Bookkeeping is the recording of financial transactions, and is part of the process of accounting in business. Transactions include purchases, sales, receipts, and payments by an individual person or an organization/corporation.

There are several standard methods of bookkeeping, including the single-entry and double-entry bookkeeping systems. While these may be viewed as "real" bookkeeping, any process for recording financial transactions is a bookkeeping process.

**Bookkeepers** are individuals who manage all financial data for companies. Without bookkeepers, companies would not be aware of their current financial position, as well as the transactions that occur within the company.

**Book keeping involves following**

1. Identification of transaction
2. Measuring transaction in means of money
3. Recording the transaction
4. Classifying the transactions

**Objectives of book keeping**

1. Providing permanent record of the transactions
2. Helps in determining if a business is in profit or is in loss
3. Giving opportunities to review business policy

**Account keeping v/s book keeping**

| Bookkeeping | Accounting |
|---|---|
| Book-keeping consists of recording financial transactions in a logical fashion | Accounting concerns itself with summarizing of such recorded financial transactions |
| It is the basis of the process of accounting | Accounting is the basis for the Business Language |
| Financial statements are not a part of the bookkeeping | Preparing financial statements is the ultimate aim of accounting |
| Managers do not take decisions on the basis of bookkeeping records | Accounting records are used to assist managers in making decisions |
| Bookkeeping does not have any branches | Accounting has branches such as Cost Accounting, Management Accounting, etc |
| It is done by bookkeepers, who do not require any special skill or knowledge | Accountants, on the other hand, require special accounting knowledge and skills |

**Double-Entry System**

The double-entry system of accounting or bookkeeping means that for every business transaction, amounts must be recorded in a minimum of two accounts. The double-entry system also requires that for all transactions, the amounts entered as debits must be equal to the amounts entered as credits.

**The Basics of Double Entry**

In the double-entry 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 or accounting makes it easier to prepare accurate financial statements and detect errors.

**Features of Double Entry System**

**Two parties**: Every transaction involves two parties – debit and credit. According to the main principles of this system, every debit of some amount creates corresponding credit or every credit creates the corresponding debit for the same amount.

**Giver and receiver**: Every transaction must have one giver and one receiver.

**Exchange of equal amount**: The amount of money of a transaction the party gives is equal to the amount the party receives.

**Separate entity**: Under this system business is treated as a separate entity from the owner. Here the business is considered as a separate entity.

**Dual aspects**: Every transaction is divided into two aspects. The left side of the transaction debit and the right side is credit.

**Results**: Under double entry system totality of debit is equal to the totality of credit. In it ascertainment of the result is easy.

**Advantages of Double Entry System**

Under this method both the aspects of each and every transaction are recorded. So it is possible to keep complete account.

1. Since both the aspects of a transaction are recorded, for each debit there must be a corresponding credit of an equal amount. Therefore, total debits must be equal to total credits. In fact, it is possible to verify the arithmetical accuracy of the books of accounts by ascertaining whether the two sides become equal or not through a process known as trial balance.
2. Under this system profit and loss account can be prepared easily by taking together all the accounts relating to income or revenue and expenses or losses and thereby the result of the business can be ascertained.
3. A balance sheet can be prepared by taking together all the accounts relating to assets and liabilities and thereby the financial position of the business can be assessed.
4. Under this system mistakes and deflections can be detected - this exerts a moral pressure on the accountant and his staff.
5. Under this system necessary statistics are easily available so that the management can take appropriate decision and run the business efficiently.
6. All the necessary details about a transaction can be obtained quickly and easily.
7. The total amount owed by debtors and the total amount owed to creditors can be ascertained easily.
8. Sale, purchase of goods, stock, revenue, expenses and profit or loss of different years can be compared and the success or failure of the business measured. Thereafter the causes of failure can be found out and necessary remedial measures taken to ensure success of the business.

**Dis-Advantages of Double Entry System**

1. Under this method each transaction is recorded in books in two stages (journal and ledger) and two sides (debit and credit). This results in increase of number and size of books of account and creation of complications.
2. It involves time, labor and money. So it is not possible for small concerns to keep accounts under this system.
3. It requires expert knowledge to keep accounts under this system.
4. As the system is complex, there is greater possibility of committing errors and mistakes.
5. It is clear from the above discussion that the advantages of double entry system far outweigh its disadvantages. So, it is regarded as the best system in the modern world.

**Meaning of financial account or statements**

A business man always want to know the position of his business at the end of the accounting period for this purpose he makes financial statements

These financial statements include
1. Trading Account
2. Profit and Loss Account
3. Balance Sheet

**Trading account**
The account which is prepared to determine the gross profit or gross loss of a business concern is called **trading account**.
It shows the result of the buying and selling goods for a particular period. It explains wheather the business was profitable or not

**Components of Trading account: -**
Credit side
Debit side

**Features of Trading Account**
1. It is the first stage of final accounts of a trading concern.
2. It is prepared on the last day of an accounting period.
3. Only direct revenue and direct expenses are considered in it.
4. Direct expenses are recorded on its debit side and direct revenue on its credit side.
5. All items of direct expenses and direct revenue concerning current year are taken into account but no item relating to past or next year is considered in it.
6. If its credit side exceeds it represents gross profit and if debit side exceeds it shows gross loss.

**Purpose and importance of trading account**
1. To know the gross profit or loss
2. Determining the net sale
3. Succeed or failure of a business
4. Percentage of loss or profit
5. To control the expense
6. Measuring the efficiency
7. Provide information about stock

**Trading Account**
**for the year ended .....**

| Dr | | | | | Cr |
|---|---|---|---|---|---|
| Particulars | Rs | Rs | Particulars | Rs | Rs |
| To Opening Stock | | | By Sales | ----- | |
| To Purchases | ----- | | Less Sales returns | ----- | ----- |
| Less Purchase returns | ----- | ----- | | | |
| **To Direct Expenses** | | | By Closing Stock | | ----- |
| To Carriage inward | | ----- | Gross loss (Transferred to P&L A/C) | | ----- |
| To Wages | | ----- | | | |
| Gross profit (Transferred to Profit &Loss A/c) | | --- | | | |

1. In the heading of trading account for the year ended.... are used
2. No separate column in final account
3. No column for L.F. is prepared in final report

**Profit and Loss Statement (P&L)?**

The profit and loss (P&L) statement is a financial statement that summarizes the revenues, costs, and expenses incurred during a specified period, usually a fiscal quarter or year. The P&L statement is synonymous with the income statement. These records provide information about a company's ability or inability to generate profit by increasing revenue, reducing costs, or both. Some refer to the P&L statement as a statement of profit and loss, income statement, statement of operations, statement of financial results or income, earnings statement or expense statement.

**The advantages of a profit and loss account**

- it's a useful tool for measuring performance and expenditure.
- An accurate P and L account can tell you where you're losing money, where you're making it, and how to improve performance.
- It can help you identify trends, forecast and predict future performance, and be better prepared for the rocky terrain that is business management.

**The disadvantages of a profit and loss account**

- Having managed a small business in a former life (I mean that metaphorically by the way), the main disadvantage that comes to mind when thinking about profit and loss accounting is accuracy
- Data on depreciation and asset value is usually subjective or volatile, and it is difficult to attribute accurate values to these fields. Nevertheless, these factors weigh heavily on a P+L account.
- Also, when a manager is constantly using a profit and loss account to make his/her business decisions, choices end up being made on a relatively small sample of data, with only the short-term in mind.

**Balance Sheet**
A balance sheet is a statement of the financial position of a business that lists the assets, liabilities, and owner's equity at a particular point in time. In other words, the balance sheet illustrates your business's net worth.

**Charachterstics**

1. The preparation of Balance Sheet is not for a period, but at a particular date.
2. The preparation of the balance sheet is possible only when profit and loss account for the period is prepared because it reflects the financial position of the company adequately. That is why the Profit & Loss Account, Balance Sheet and Cash flow Statement are collectively called as Final Accounts.
3. The totals of the two sides, i.e. assets and liabilities of the balance sheet must tally as Assets = Liabilities + Capital. If not so, then there must be an error.
4. The balance sheet reflects the nature and value of assets and liabilities and the position of capital on a given date.

**Financial Management**

Financial Management is a vital activity in any organization. It is the process of planning, organizing, controlling and monitoring financial resources with a view to achieve organizational goals and objectives. It is an ideal practice for controlling the financial activities of an organization such as procurement of funds, utilization of funds, accounting, payments, risk assessment and every other thing related to money.

In other terms, Financial Management is the application of general principles of management to the financial possessions of an enterprise. Proper management of an organization's finance provides quality fuel and regular service to ensure efficient functioning. If finances are not properly dealt with an organization will face barriers that may have severe repercussions on its growth and development.

**objectives**

1. To ensure regular and adequate supply of funds to the concern.
2. To ensure adequate returns to the shareholders which will depend upon the earning capacity, market price of the share, expectations of the shareholders.
3. To ensure optimum funds utilization. Once the funds are procured, they should be utilized in maximum possible way at least cost.
4. To ensure safety on investment, i.e, funds should be invested in safe ventures so that adequate rate of return can be achieved.
5. To plan a sound capital structure-There should be sound and fair composition of capital so that a balance is maintained between debt and equity capital.

**Wealth Maximization**

It simply means maximization of shareholder’s wealth. It is a combination of two words viz. wealth and maximization. A wealth of a shareholder maximizes when the net worth of a company maximizes. To be even more meticulous, a shareholder holds share in the company/business and his wealth will improve if the share price in the market increases which in turn is a function of net worth. This is because wealth maximization is also known as net worth maximization.

**Calculating wealth**

Wealth is said to be generated by any financial decision if the present value of future cash flows relevant to that decision is greater than the costs incurred to undertake that activity. Increase in wealth is equal to the present value of all future cash flows less the cost/investment. In essence, it is the net present value (NPV) of a financial decision.

Increase in Wealth = Present Value of cash inflows – Cost.

**Where,**

$$\textbf{Present Value of Cash Inflows} = \frac{CF_1}{(1 + K)^1} + \frac{CF_1}{(1 + K)^2} + \ldots\ldots\ldots + \frac{CF_n}{(1 + K)^n}$$