Financial Accounting - 15

By
Dr.Sanjay Banerji
Founder Director/Dean of Amrita School of Business

Bala Sir congratulated the women for successfully completing the essentials of Financial Accounting, and decided to prepare a brief summary of the entire system.

1. We maintain the accounts *on behalf of the business, which is a separate entity.*
2. At the beginning, the promoters bring in some funds and the business issues shares to the promoters in exchange of this initial capital.
3. Right from this first ‘transaction’, the business has a balance sheet, where, we note down the assets on one side and the liabilities on the other side and both sides must always be equal. *This simply reflects the fact that all the assets held by any business at any point of time are owed by the business to others.*
4. As the business starts, many transactions happen, generating revenues and expenses. Net income is the excess of income over expenditure *over a period of time.*
5. The Board of Directors of a company has the authority to decide how to deal with the net income. They have two options – declare dividends for shareholders, and retain the earnings. If we ignore dividend pay-offs, retained earnings equal revenue minus expenses.
6. The balance sheet equation, with necessary additions / modifications takes the following form:

   Cash + non-cash assets + Expenses = Shareholders equity + Liabilities + Revenues

   Accountants’ task is to maintain proper record of all transactions that have an impact on this equation.
7. They have developed their own technique to do so. These are debits and credits. *Any increase in the LHS elements is called debit and any decrease in the LHS is called credit. Conversely, any increase in the RHS item is called a credit and any decrease in the RHS item is called debit.*
8. The beauty of this system lies in the fact that if we simply ensure that for every transaction record, the debits must equal the credits, the validity of the balance sheet equation is maintained.
9. Further, the accountants have also developed a standardized system of making ‘journal entries’ and T-accounts for each account. For all T-accounts, the LHS is debit entry and the RHS is credit entry. For journal entries, the structure is – Line 1: i. Sl.no. ii. Date iii. Brief description, iv. Debit (Dr) amount, and then on line 2: *with an appropriate indent* Credit (Cr) amount. Example:

# Date	Description	Debit	Credit
1. Oct. 1, 2021	Promoters' contribution	Dr Cash 60,000	
			Cr Shareholders' equity 60,000

10. There must at least be two entries, and the total debits and credits for each transaction must be equal.
11. At the end of a period, when we want to figure out how the business performed during the period, we calculate the closing balance for each T-account, which is simply the net of all debits and credits in that account.
12. At this time, accountants must diligently look for and record all 'hidden' items of income and expenditure that do not involve any cash transaction. Examples are interest receivable or payable, depreciation expenses, advance rental or insurance cover used up etc. These are known as adjusting entries.
13. We categorise each of these accounts as asset, liability, revenue or expense accounts.
14. The T-account for cash is used to prepare the cash flow statement.
15. The first two closing balances form the balance sheet and the last two closing balances form the income and expenditure statement, also known as profit and loss statement.

This concludes the series on Financial Accounting.