Financial Accounting - 1

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Dear Friends,

In this and a few more blogs, we shall discuss how a business must be able to maintain its accounts. We believe that a proper understanding of financial accounting system is essential for running any business. We shall use the backdrop of an imaginary Women Self Help Group (SHG), who wanted to start a small grocery shop to raise some additional income for their households.

We shall use this context to offer a strong foundation in Financial Accounting, so that you may run your business with proper understanding and appreciation of everything that goes on while you run your business, along with your family responsibilities.

Let us first understand why it is important to know these matters. We all know the importance of money in our lives, and for most of us, it is necessary to keep track of our money. Similarly, for any business, keeping track of its money or finances is very important. Therefore, the first objective of Financial Accounting is to keep proper record of all business transactions ***in monetary terms.*** In a way, finances or matters related with funds is ***the language of business!*** Anybody who wants to provide you with any material thing (goods) or offer any intangible help (services), for some monetary gain, is virtually doing some business. Accountants call this 'exchange of goods or services'. Each such exchange is called a 'Transaction'. As we all know, there is an old adage – *'Artham Anartham'.* This means that money is at the root of all problems in material life. Yet, we cannot do without money. So, the best thing to do is to keep proper record of all monetary transactions. This is the first purpose of Financial Accounting – **"Recording all transactions correctly".**

But this is not enough. As we all know, as the month end nears, our coffers get depleted, and we become cautious in spending. Eventually, we feel that we need an idea of our normal monthly expenses and try to match them with our income, so that we may be able to save something for special needs like festivals or college admissions or (God forbid) medical expenses. Therefore, we also wish that our Financial Accounting system would enable us to **"Provide some summary statements of our financial position and how we are doing"**.

Very soon, we realise that apart from ourselves, others are also interested in knowing how we are doing. For example, we have to have a bank account, and we may approach the bank for a loan to help our business to grow. The bank would like to know our financial position, whether we are making profits or not, have we got enough assets to offer the bank as sureties against the loan we are seeking? Similarly, as the business grows, you would get to know that there are several government and private agencies as well as individuals who have an interest in '***how we are doing'***. Therefore, the third objective of Financial Accounting is to **"Provide reliable information to users who need such information"**.

In short, Financial Accounting helps a business to:

- Recording all transactions correctly.
- Provide some summary statements of our financial position and how we are doing
- Provide reliable information to users who need such information.

Let us spend a little time to know a little more details of these external people who may have an interest in our business. First and foremost, come our customers. They receive and consume whatever goods and / or services we have on offer. Next in line are our own employees. How are they external to us, you may ask. Well, they are certainly deeply engaged in our business, and we depend a lot on them, but they are still separate from the business, like the shareholders or even the outright owners are separate entities relative to the business. The next in line are our suppliers, who provide us with the necessary inputs like raw materials, transportation services etc. If we get some goods or services for which payments are due, those suppliers become our creditors. These are people who have a direct connection with the business. An important party in this category are our bankers or financiers, who are current or future suppliers of the funds necessary to run our business.

Then, there are others who have a distant relationship, like our shareholders, and those among the general public who invest their savings in the share market, and may be willing to buy our shares. These people are covered by the general term 'investors'. Finally, there are the regulators, set up by the government, as well as the general civil administration with responsibilities of overseeing that all business enterprises conduct their business in accordance with the prevailing laws. Over the years, in most countries, a share market or stock market develops, for buying and selling of shares. Since this involves a lot of money, governments come in, and they frame rules and regulations for managing these share markets. In India, SEBI (Securities and Exchange Board of India https://www.sebi.gov.in) is responsible for this. We would learn more about shares later.

As per rules of SEBI, all companies are to be registered with the appropriate governmental authorities, and they must regularly (annual and half-yearly) prepare and submit their financial position reports. In addition to these reports, companies are also required, by law, to provide much other information, which are known as 'Statutory Disclosures'.

Now, these annual or half-yearly submissions pose some challenges that must be uniformly addressed. As you know, in business, many transactions occur that are incomplete. For example, we may sell something, but do not get paid immediately. Or, we may give out a part of our building or rent, expecting some rental income. So, let us take a concrete example: we sold something in March 2021, but we shall be paid in April 2021. Do we show this transaction in March or April? We buy a building for running our business, and we hope to use this building for the next 20 years. Use of the building is a necessary expense for running the business, and we must account for it. But at the end of the first year, how much of this building have we used for running our business?

These are some of the typical issues that we must learn to address correctly. Over the years, some rules have been framed, and we must follow them. In India,these rules are framed by the Indian Accounting Standards Boardhttps://icai.org/post/accounting-standards-board under the statutory body - ICAI - The Institute of Chartered Accountants of India, set up under an act of the parliament.

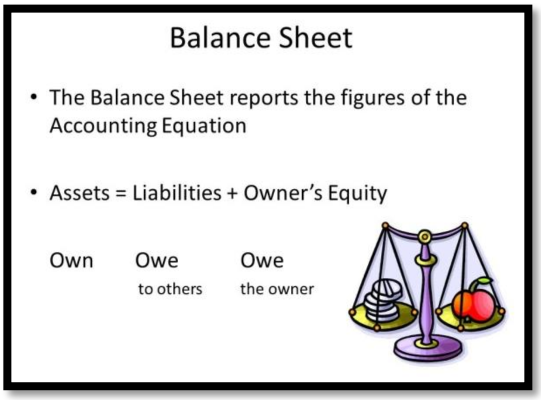
Now it is time for us to know what are the annual reports required. They are:

(1) Statement for cash flows (2) Income statement and (3) Balance sheet

The statement for cash flows tells us how much cash or funds we received during a specified period, and how we used them. This is why it is also called ‘source and use of funds’.

The income statement, also known as Profit and Loss statement, tells us <u>*what happened over a period of time*</u> – a year, or half-year or a month; in terms of our income and expenditure, and whether we made or lost money during this period.

The balance sheet essentially tells us, <u>*at a particular point in time, what are all the resources or possessions the company has*</u>; and **on whose behalf does the business hold on those assets.** In other words, who all have claims on these assets and how much?



In accounting parlance, the resources or possessions are called **‘Assets’** and the obligations or claims are called **‘Liabilities’**. The funny part for a company is that its assets are ***always*** equal to its liabilities, simply because it holds all those assets **on behalf of the claimants.**

An interesting point to note is that the balance sheet shows the status as on a certain date, while the income statement and the statement for cash flows give us the information over a period of time. Therefore, balance sheet is like a snapshot or a ***‘Stock’.*** The latter two are like the Highlights of a cricket game (a video) of all important things that happened during the period. Accountants call it a ***‘Flow’.***

We shall consider some examples in our next lesson. Till then, please feel free to send me any questions at s_banerji@amrita.edu.