Basics of Accounting

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Overview

- Accounting
- Accounting Standards
- Accounting Cycle
- Methods of Accounting and Book keeping
- History
- Conventions
- Concepts
- Financial Statements
- Ratio Analysis

What is Accounting??

It is the systematic

- recording,
- reporting, and
- analysis of financial transactions of a business.

Accounting allows a company to analyze the financial performance of the business, and look at statistics such as net profit.

"Accounting

is

about

ACCOUNTABILTY"

Who is an Accountant?

- The person in charge of accounting is known as an accountant.
- This individual is typically required to follow a set of rules and regulations, such as the Generally Accepted Accounting Principles (GAAP).

Accounting Standards

- Accounting Standards aim at standardizing different accounting policies and practices.
- **GAAP** is a term used to refer to the standard framework of guidelines for financial accounting used in any given jurisdiction; generally known as **Accounting Standards**.

Accounting Standards

- Country based GAAPs
  - Commercial GAAPs - Cost Accounting Standards, AS issued by ICAI
  - Non Commercial GAAPs - ASLB, IPSAS, GASAB

- International GAAP

Various Indian Accounting Standards

- Accounting Standards issued by ICAI
- Companies (Accounting Standard) Rules, 2006
- Accounting Standards for Local Bodies issued by ICAI
- Standards issued under Sec 145 of the Income Tax Act
- Cost Accounting Standards
- GASAB
- IPSAS

Golden Rules in Accounting

- To identify the effect of a transaction on a account there are rules:
  - **For Personal Account:**
    - **Debit:** **the receiver**
    - **Credit:** **the giver**

  -**For Real Account:**
    - **Debit:** **what comes in**
    - **Credit:** **what goes out**

  -**For Nominal Account:**
    - **Debit:** **all expenses and losse**
    - **Credit:** **all incomes and gains**

Process of Accounting/Accounting Cycle

1. Recognize or identify the transaction or event.
2. Record the transaction by making entries in the appropriate journal, such as the sales journal, purchase journal, cash receipt or disbursement journal, or the general journal.
3. Post general journal entries to the ledger accounts.
4. Prepare the trial balance to make sure that debits equal credits.
5. Prepare the financial statements.

Types of Accounts

There are 3 types of accounts

- Personal accounts
- Real accounts
- Nominal accounts

Methods of Accounting

There are 2 accounting methods

- **Cash Method of Accounting**
  - Revenue recognition: Revenue is recognized when cash is received.
  - Expense recognition: Expense is recognized when cash is paid
- **Accrual Method of Accounting**
  - Revenue Recognized: Revenue is recognized when both of the following conditions are met:
    a. Revenue is earned.
    b. Revenue is realized or realizable.
  - Expense Recognized: Expense is recognized in the period in which related revenue is recognized

What is Book Keeping??

Bookkeeping is the practice of recording transactions.

Methods of Book Keeping

- **Single Entry Book Keeping** - One sided accounting entry
- **Double Entry Book Keeping** - An accounting technique which records each transaction as both a credit and a debit.

History of Accounting

- Accounting started with currency system 5000 years back
- In India, early references to accounting concepts are found in the Vedas. **Vikraya** is found in the Atharvaveda and the **Nirukta** denoting ‘sale’.
- Standard making started in 1934 after great depression of USA, Securities act 1933, Securities Exchange Act 1934
- Accountant’s International Study Group 1966 to 1973

Accounting Concepts

1. Business Entity Concept
2. Money Measurement Concept
3. Going Concern Concept
4. Accounting Period Concept
5. Accounting Cost Concept
6. Duality Aspect Concept
7. Realisation Concept
8. Accrual Concept
9. Matching Concept

Accounting Conventions

- Convention of Consistency.
- Convention of Full Disclosure.
- Convention of Materiality.
- Convention of Conservatism

Branches of Accounting

- Financial Accounting
- Management Accounting
- Tax Accounting
- Fund Accounting
- Forensic Accounting

Important Accounting Terminologies

- Debtors
- Creditors
- Assets
- Liabilities
- Income
- Expenses
- Account

Financial (Accounting) Statements

- There are two main purposes of financial statements:

(1) To report on the financial position of an entity (e.g. a business, an organisation);

(2) To show how the entity has performed (financially) over a particular period of time (an "accounting period").

Financial Statements

- The Balance Sheet
- The Profit and Loss Account
- Statement of Cash Flows

Finalization of Accounts

1. Refers to the preparation of Profit and Loss Account and the Balance sheet as per the Legislative Framework.
2. Adjusting Entries are to be passed.
3. The revised Trial Balance is generated.
4. Financial Statements are prepared.
5. Relevance of Accrual Concept, Matching Concept, Accounting Period Concept, Conservatism Concept at the time of finalization.

Balance Sheet

- **Assets = Liabilities + Stockholders' Equity**
- The balance sheet states what the firm owns and how it is financed.

Things to Remember – B/S

- When analyzing a balance sheet, the financial manager should be aware of three concerns:-

  1- Accounting Liquidity

  2- Debt versus Equity

  3- Value versus Cost

Income Statement

- **Revenue – Expenses = Income**
- The income statement measures performance over a specific period of time, say, a year.

Things to Remember – P&L

- When analyzing an income statement, the financial manager should keep in mind the followings:-

1- GAAP

2- Noncash items

3- Time and Costs

Statement of Cash Flow

<u>Uses of Fund</u>

- Assets - ↑
- Liabilities and Stock Holder's Equity - ↓

<u>Sources of Fund</u>

- Assets - ↓
- Liabilities and Stock Holder's Equity - ↑

Components of Cash Flow Statement

3 components of Cash Flow Statement

1- Cash flow from Operating Activities

2- Cash flow from Investing Activities

3- Cash flow from Financing Activities

Ratio Analysis

Ratios are an expression showing the relationship between two figures in the financial statement.

Expression of Ratios

- It may be expressed in terms of
- Fractions like 1/2,1/3 or
- Rates like two times, three times or
- Percentage like 10%, 20%, etc.

There are three types of ratio:-

1) Balance Sheet ratios.
2) Revenue Statement ratios.
3) Combined ratios.

Important Ratios

Balance Sheet Ratios	Revenue Statement Ratios	Combined Ratios
i) Current ratio ii) Quick ratio iii) Proprietary ratio iv) Debt Equity ratio	i) Gross profit ratio ii) Operating ratio iii) Stock- turnover ratio iv) Net profit ratio	i) Return on Investment ii) Return on Proprietor's Fund iii) Return of Equity Capital iv) Earning per share v) Price earning ratio vi) Dividend Payout ratio vii) Debt Service ratio viii) Debtor's turnover ratio ix) Creditors Turnover ratio

Current Ratio

- Current ratio = Current Asset/Current Liabilities
- It Indicates short term solvency or short term financial strength of company.
- It shows whether the company is capable of paying off its short term commitments easily out of its current assets
- Too high & too low ratios not desirable. A high current ratio indicates presence of idle funds whereas low ratio indicates inadequacy of funds.

Quick Ratio

- Quick ratio = Quick Asset/Quick liabilities
- It Indicates immediate solvency / financial strength of company.
- It shows whether the organization is in a position to pay its liabilities within a very short period of time out of assets which can realize money quickly.

Proprietary Ratio

- Proprietary Ratio = Share holders Funds / Total Assets
- Total Assets = Fixed Assets + Investments + Current Assets.
- It Indicates long term solvency or long term financial strength of company.
- Proprietors funds should be equal to atleast fixed assets but it may not be possible in all industries.

Debt Equity Ratio

- Debt Equity Ratio = Debt Funds / Equity Funds
- It indicates borrowing capacity of organization & emphasizes that more the borrowing, the more is the rate of return for owners.
- However there should be a suitable compromise as far as this ratio is concerned.
- In earlier years business should have more owned funds whereas after establishment i.e. in subsequent years business should resort to more external funds.

Gross Profit Ratio

- Gross Profit ratio = GPX100/ Sales
- It shows the trading efficiency of management.
- It should be sufficient enough to cover operating and non- operating expenses to assure final profits.

Stock Turnover Ratio

- Stock – Turnover Ratio = Cost of goods sold / Average Stock
- It shows amount blocked in stock & how fast it can be converted into sales & finally cash.
- It indicates efficiency of company in inventory management.
- Sometimes too high ratio also indicates a possibility of stock out.

Return on Investment or capital employed

- ROI = NP before tax & Interest/ Capital Employed
- It Indicates management efficiency in utilizing shareholder's & borrowed funds. & is a clear index of earning capacity.
- Higher ratio indicates higher returns & hence can attract additional funds from lenders.
- Higher earning power indicate more punctual repayment of interest & principal amount.

Return on Proprietors Funds

- Return on net worth = NP after tax and interest / Net Worth

- It indicates profitability on proprietor's funds and efficiency of company in utilizing shareholder's fund.

- It is used by share holders before investing additional funds into business.

- Higher profitability attracts higher funds from shareholders & can also increase market price of shares in anticipation of higher dividends & bonus shares.

Return on Equity Capital

- Ret on Eq,Capital = Profit after tax – Pref Dividend / Equity Capital
- It indicates earning for equity holders and management's efficiency in utilizing equity capital.
- Dividend percentage is also determined on the basis of above ratio after taking decisions of retention of some portion of profit for expansion of diversification schemes.

Earnings per share

- EPS = (NP after tax - Pref Div) / No. of eq. Shares

- It indicates absolute earning per share which affect a market prices of shares.

- High EPS encourages prospective investors.

Price Earning Ratio

- Price Earning ratio = MPS / EPS
- It indicates market price as compared to earning per share.
- Lower ratio generally attracts investors for purchase of share.

Dividend Payout Ratio

- Dividend – payout ratio = (DPSX100) / EPS
- It indicates extent of dividend declared out of earnings.
- Lower ratio indicates greater portion kept for self financing.
- Short term investors are always interested in higher ratio & vice versa for long terms investors.

Debt service coverage ratio

- DSCR = (NP bef int tax and dep) / Interest + Instalment due in next year
- It indicates ability to meet current interest & instalment due.
- It is an index of long term solvency.
- Higher ratio indicates more safety for lenders.

Debtor Turnover ratio and collection period

- Drs turnover ratio = Sales / Average receivables
- It indicates efficiency of company in management of account receivables.
- Higher the index, better is the ratio & result.

Creditors turnover ratio and average payment period

- Crs Turnover ratio = Purchase / Average Payables
- It helps to know creditor's velocity i.e. average period offered by suppliers for making payment.
- Lower the turnover, better is the result as it indicates more period offered by suppliers to make payment.

Importance of Ratios in financial statement analysis

- Liquidity Position and working capital financing
- Minimum permissible bank finance
- Profitability ratio
- ROCE, dividend payout ratio, pe ratio and the investors preferences.

About the Author

- *CA. Rajkumar S Adukia is an eminent business consultant, academician, writer, and speaker. He is the senior partner of Adukia & Associates.*

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- *Mr. Adukia, a rank holder from Bombay University completed the Chartered Accountancy examination with 1st Rank in Inter CA & 6th Rank in Final CA, and 3rd Rank in Final Cost Accountancy Course in 1983.*

- *He started his practice as a Chartered Accountant on 1st July 1983, in the three decades following which he left no stone unturned, be it academic expertise or professional development.*

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About the Author

- *He has been coordinating with various Professional Institutions, Associations, Universities, University Grants Commission and other Educational Institutions.*

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