Basics of Accounting

Introduction:

Accounting is the language of finance. It conveys the financial position of the firm or business to anyone who wants to know. It includes recording, summarizing, reporting and analyzing financial data. Let us try and understand the components of accounting to understand what it really means:

Recording: The primary function of accounting is to make records of all the transactions that the firm enters into. Recognizing what qualifies as a transaction and making a record of the same is called bookkeeping. Bookkeeping is narrower in scope than accounting and concerns only the recording part.

Summarizing: Recording for transactions creates raw data. Pages and pages of raw data are of little use to an organization for decision making. For this reason, accountants classify data into categories. These categories are defined in the chart of accounts.

Reporting: Management is answerable to the investors about the company's state of affairs. The owners need to be periodically updated about the operations that are being financed with their money. For this reason, there are periodic reports which are sent to them. These financial statements are regulated by government bodies to ensure that there is no misleading financial reporting.

Analyzing: Lastly, accounting entails conducting an analysis of the results. After results have been summarized and reported, meaningful conclusions need to be drawn. Management must find out its positive and negative points. Accounting helps in doing so by means of comparison. It is common practice to compare profits, cash, sales, assets, etc with each other to analyze the performance of the business.

Double Entry System of Book Keeping

Double Entry Accounting is the scientific, self-sufficient and accurate system of accounting which states that every transaction has a corresponding and an opposite effect of at least two accounts. The double entry system of accounting has two sides, namely Debit and Credit. As there are two sides, there are two effects, one on the debit side and another on the credit side. Since the debit account offsets the credit account, the total of both the sides become equal at the time of preparation of the financial statements. The Double-Entry system has the following **accounting equation:**

Assets = Equity + Liabilities

Features of Double Entry System:

- **Two Parties:** There are two parties involved, one is the debit and the other one is credit. The account receiving the benefit will be debited and the one giving the benefit will be credited. Hence, every debit of an amount will have a credit effect of the same amount and vice versa.
- **Exchange of Equal Amount:** An equal amount will be debited and credited. Say, Ronak purchases goods from Ram for Rs. 1000. Hence, in the books of Ronak, he will enter Purchase Account debited to Ram's Account of Rs. 1000.
- **Separate Entity:** Business and owner are treated as two separate entities.
- **Two Sides:** The left side is called the Debit side and the right side is called the credit side.
- **Debit Equals Credit:** The total of the debit side equals the total of the credit side.

Process of Bookkeeping under Double Entry System:

- **Journal:** The transactions are firstly recorded in the book named Journal. There is a subdivision after this step, meaning thereby that various other subsidiary books come into the picture. The purchase transactions are recorded in the purchase Ledger, sales in the sales journal, etc. The maintenance of subsidiary books depends on the size and nature of the business organization.

- **Ledger:** After then, from the journal, the effect of the same is given in different ledgers. The transactions of a particular person or thing are collected and recorded in one particular statement called an Account. A ledger is a book in which these classified accounts are kept. Say all the transactions of Mr. A will be recorded in the account of Mr. A.

- **Trial Balance:** In this stage, there is a preparation of a balanced statement called Trial Balance by which the arithmetical accuracy is verified.

- **Financial Statement:** At the end, Financial Statements are prepared in order to know the full year's progress, Income Statement **(profit or loss Account)** and the financial position **(Balance Sheet)** of the business.

Rules on Double Entry System

PERSONAL ACCOUNTS: Debit the Receiver. Credit the Giver

REAL ACCOUNTS: Debit what comes in, Credit what goes out

NOMINAL ACCOUNTS: Debit the Expenses and Losses, Credit the Incomes and Gains

Some Special Terms In Accounting:

DEBIT SIDE

Expenses and Losses- The nature of these two is Debit or recorded on the debit side. Any increase in this would debit the same and vice versa.

Assets- The nature of this is Debit or recorded on the debit side. Any increase in this would debit the same and vice versa.

CREDIT SIDE

Incomes and Gains- The nature of these two is Credit or recorded on the credit side. Any increase in this would credit the same and vice versa.

Liabilities- The nature of this is Credit or recorded on the credit side. Any increase in this would credit the same and vice versa.

Advantages of Double Entry Accounting:

- **Easy Record Maintenance:** The records are easily maintained as there are similar dual and opposite effects. So, if one wants to check any data, he can easily assess it.

- **Complete Accounts of Transactions:** Due to the dual and the simultaneous effect in this system, there are a complete set of books of accounts of each party.

- **Determining Results Becomes Easier:** Since the preparation of the final accounts at the end of the year tallies the debit and the credit side, the profit or loss and the financial position of the assets and the liabilities is clearly reflected. Hence, if any entry is recorded only once, there will be a difference on the opposite side of the same amount.

- **Clarity Regarding Assets & Liabilities:** There is a clarity regarding the position of the assets and the liabilities. Say for an example, in past year the company had creditors of raw materials of Rs. 1400000 and in the current year it has increased to Rs. 1820000. The increase in 420000 may be due to the increase in sales. So, one can analyze that the increase is worth or not, means due to such an increase whether the company is producing products using those raw materials sufficiently or not.

- **Increase in Income and a Decrease in Expenditure:** If a proper analysis is done of the incomes and expenditures, one can come to know the growth of the one’s business. One can simply compare the incomes and expenses of the current year with that of past years. This may bring to the conclusion to plan for the strategies for the forthcoming financial years.

- **Detection & Prevention of Frauds:** There are very few chances of errors and mistakes as there two effects of a single transaction. So, if there is only one entry of a single transaction, the trial balance and the financial accounts will not tally. Also, if there any fraud intentionally or unintentionally committed, it can be easily prevented.

- **Information Easily Available:** The beauty of the double entry system is the dual effect and proper system of maintaining the books of the accounts. So, any information whenever required of whichever year is easily available.

- **Utility:** The books of accounts maintained under this system are highly useful to the management, analysts, auditors, executives, ultimately to the company as a whole. This is highly useful to them because from recording Journal to the Financial Statements, every transaction is clearly dated and named. So, any years data is easily available.

Disadvantages of Double Entry Accounting:

- **Paperwork:** Since one transaction goes through four stages (process), the handling of so many books becomes too voluminous. Also, if there is no accuracy in maintaining the data in one place or misplaced, it becomes very difficult to obtain the data if needed urgently.

- **Complexity:** If one is not thorough with the rules of Double Entry System, one may get confused at any point of time. Say for example there are some journal entries which have an effect before an effect of the other transaction. Say, for example, the bad debt provision for the current year is to be reduced to 20% and the creditors of Rs. 2000 have wrongly recorded as debtors. So, firstly there has to be the deletion of the extra Rs. 2000 from the debtors and then the debt provision entry is to be done. Hence such complexity arises.

- **Expensive:** The person who is not literate enough to write his own books of accounts or whose business is too voluminous hires an accountant. Also, in big companies, there are various people involved in the accounting field which is expensive.

- **Qualified Persons Required:** It requires the knowledge of the experts to record and maintain the books under this system. The qualified and skilled experts may not be easily available, also they charge high fees for that.

- **Mistakes may Happen:** As discussed earlier, if one is not familiar and clear about the rules of Double Entry System, one may apply wrong facts due to which the entire accounting process may turn out incorrect. Hence, due to sheer negligence and misconceptions, the mistakes can turn out to be a very big issue leading to big losses.

- **Small Business Do Not Prefer this:** It is too obvious that the small business concerns will not generally prefer this method of accounting. Complexity and complicatedness are one of the reasons. Also, the reasons can be that their business transactions are too less, they can manage their accounts on their own or simply may not afford an accountant and many such alike reasons.

- **Secracy Not Maintained:** Since the Double Entry System involves substantial effort, time and accuracy, there is a clear record and entry of each and every transaction except non-monetary ones. Therefore, there is a difficulty in maintaining secrets.

Objectives of Finanacial Managem ent

Financial Management means planning, organizing, directing and controlling the financial activities such as procurement and utilization of funds of the enterprise. It means applying general management principles to financial resources of the enterprise.

Financial management is one of the functional areas of business. Therefore, its objectives must be consistent with the overall objectives of business. The overall objective of financial management is to **provide maximum return to the owners** on their investment in the long- term. This is known as **wealth maximisation**. Maximisation of owners' wealth is possible when the capital invested initially increases over a period of time. Wealth maximisation means maximising the market value of investment in shares of the company.

Wealth of shareholders = Number of shares held ×Market price per share.

In order to maximise wealth, financial management must achieve the following specific objectives:

- To ensure availability of sufficient funds at reasonable cost (liquidity).
- To ensure effective utilisation of funds (financial control).
- To ensure safety of funds by creating reserves, re-investing profits, etc. (minimisation of risk).
- To ensure adequate return on investment (profitability).
- To generate and build-up surplus for expansion and growth (growth).
- To minimise cost of capital by developing a sound and economical combination of corporate securities (economy).
- To coordinate the activities of the finance department with the activities of other departments of the firm (cooperation).

Profit Maximisation:

Very often maximisation of profits is considered to be the main objective of financial management. Profitability is an operational concept that signifies economic efficiency. Some writers on finance believe that it leads to efficient allocation of resources and optimum use of capital.

It is said that profit maximisation is a simple and straightforward objective. It also ensures the survival and growth of a business firm. But modern authors on financial management have criticised the goal of profit maximisation.

Objections against the Profit Maximisation Objectives:

- The concept is **ambiguous or vague**. It is amenable to different interpretations, e.g., long run profits, short run profits, volume of profits, rate of profit, etc.

- It ignores the **timing of returns**. It is based on the assumption of bigger the better and does not take into account the time value of money. The value of benefits received today and those received a year later are not the same.

- It ignores the quality of the expected **benefits or the risk** involved in prospective earnings stream. The streams of benefits may have varying degrees of uncertainty. Two projects may have same total expected earnings but if the earnings of one fluctuate less widely than those of the other it will be less risky and more preferable. More uncertain or fluctuating the expected earnings, lower is their quality.

- It does not consider the effect of **dividend policy** on the market price of the share. The goal of profit maximisation implies maximising earnings per share which is not necessarily the same as maximising market-price share. According to Solomon, “to the extent payment of dividends can affect the market price of “the stock (or share), the maximisation of earnings per share will not be a satisfactory objective by itself.”

- Profit maximisation objective does not take into consideration the **social responsibilities** of business. It ignores the interests of workers, consumers, government and the public in general. The exclusive attention on profit maximisation may misguide managers to the point where they may endanger the survival of the firm by ignoring research, executive development and other intangible investments.

Wealth Maximisation:

Prof. Ezra Solomon has advocated wealth maximisation as the goal of financial decision-making. Wealth maximisation or net present worth maximisation is defined as follows: “The gross present worth of a course of action is equal to the capitalised value of the flow of future expected benefits, discounted (or as capitalised) at a rate which reflects their certainty or uncertainty.
Wealth or net present worth is the difference between gross present worth and the amount of capital investment required to achieve the benefits being discussed. Any financial action which creates wealth or which has a net present worth above zero is a desirable one and should be undertaken.

Any financial action which does not meet this test should be rejected. If two or more desirable courses of action are mutually exclusive (i.e., if only one can be undertaken), then the decision should be to do that which creates most wealth or shows the greatest amount of net present worth. In short, the operating objective for financial management is to maximise wealth or net present worth.”

Wealth maximisation is more operationally viable and valid criterion because of the following reasons:

- It is a precise and unambiguous concept. The wealth maximisation means maximising the market value of shares.

- It takes into account both the quantity and quality of the expected steam of future benefits. Adjustments are made for risk (uncertainty of expected returns) and timing (time value of money) by discounting the cash flows,

- As a decision criterion, wealth maximisation involves a comparison of value of cost. It is a long-term strategy emphasising the use of resources to yield economic values higher than joint values of inputs.

- Wealth maximisation is not in conflict with the other motives like maximisation of sales or market share. It rather helps in the achievement of these other objectives. In fact, achievement of wealth maximisation also maximises the achievement of the other objectives. Therefore, maximisation of wealth is the operating objective by which financial decisions should be guided.

The above description reveals that **wealth maximisation is more useful** if objective than profit maximisation. It views profits from the long-term perspective. The true index of the value of a firm is the market price of its shares as it reflects the influence of all such factors as earnings per share, timing of earnings, risk involved, etc.

Thus, the wealth maximisation objective implies that the objective of financial management should be to maximise the market price of the company's shares in the long-term. It is a true indicator of the company's progress and the shareholder's wealth.

However, "profit maximisation can be part of a wealth maximisation strategy. Quite often the two objectives can be pursued simultaneously but the maximisation of profits should never be permitted to overshadow the broader objectives of wealth maximisation.

- **Referrences:**
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