Financial Accounting
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Lecture – 1
1.1 Introduction to Financial Accounting

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Hi, welcome to the course on Financial Accounting. In this very first video, I will introduce you to the concept of accounting; I will give you an overview of the contents in the course, and you know some peripheral discussion around accounting. So, let us get started.

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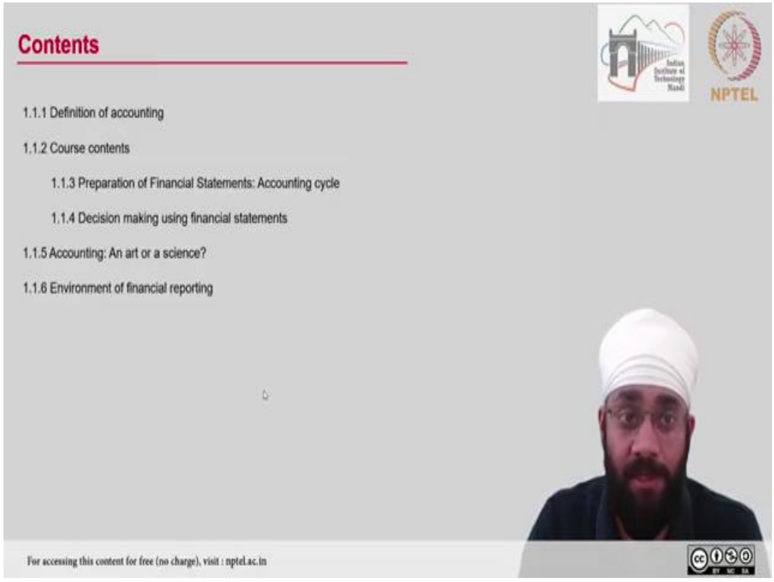

Here is a quick overview of the contents in this video. We will discuss the definition of accounting which will give you some idea about what we are going to do in this course. We will discuss about the course contents which are bucketed into two, and we will discuss couple of more concepts on whether accounting is a science or is it an art. And finally, we will talk about environment in which the financial accounting discipline functions, the peripheral concept, the eco system in which the accounting works.

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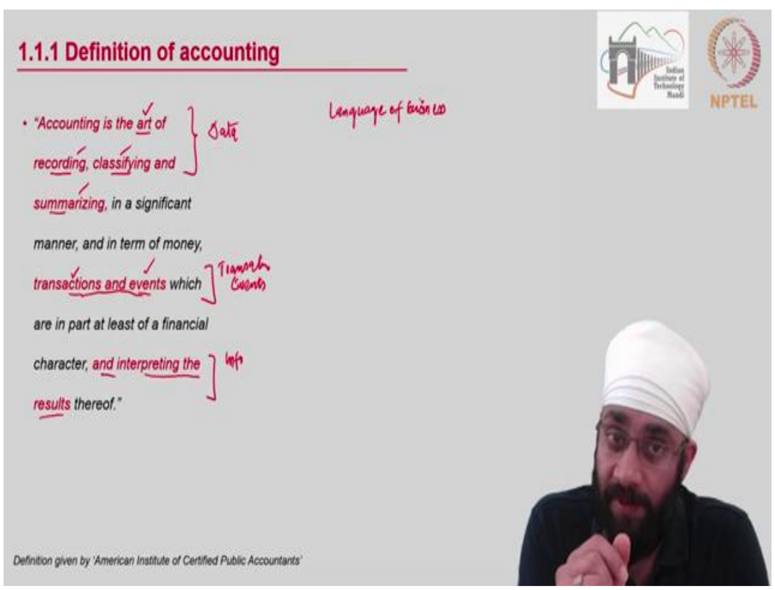

So, definition of accounting is as follows: accounting is the art of recording, classifying, and summarizing. And I have highlighted some of the text because I wanted to have a discussion on that. So, first of all you see that accounting is written to be an art. And later in this video, we are also going to discuss how accounting can also be thought of as a science. So, to begin with, let us talk about accounting as an art, and what we do using this art is as follows: we record, we classify, and we summarize.

Now, these three words are of very high importance in accounting, because this is the basis—this is actually the function of accounting—we record, classify and summarize. And throughout this course, we are going to be discussing what do we record, how do we record, how do we classify, and, how do we summarize: that is what the course is about. So, let us move ahead and talk about what is it that we are recording, classifying and summarizing.

Transactions and events. And I am skipping the text in black intentionally, because I want you to focus on the text in the red. So, we are going to be recording, classifying and summarizing the transactions and events. Now, what are transaction? In general terminology, common language, transaction is when two people are talking i.e. verbal transaction in a way. But in business when money is being exchanged, goods are being exchanged, we refer to that as a commercial transaction. So, according to in this definition, transactions refer to business transactions.

And what are events? Events refer to various financial milestones that you achieve in business; there is a way to record all of that as well. So, we are going to be recording, classifying and summarizing transactions and events. And then we are going to interpret the results of you know this recording, classifying and summarizing right. So, what is happening really is through this process you are generating a lot of data about these transactions and events. Let me just write it here, transactions and events- and then you are going to convert this data into information, so that it is useful. So, you know that's what accounting is, in brief.

So, accounting is thought of as the language of business; language of business. If any of you are coders or any of you are into foreign languages just think of accounting as a country or a software or a development platform where you need some technical language to develop a website, or in a country you need to talk to people, talk to organizations and you need to know that language.

Similarly, in order to record, summarize and classify the transactions in a business, you need to know this language which is called accounting- that's it! That's a quick definition, a quick understanding of what accounting is. Let's move forward.

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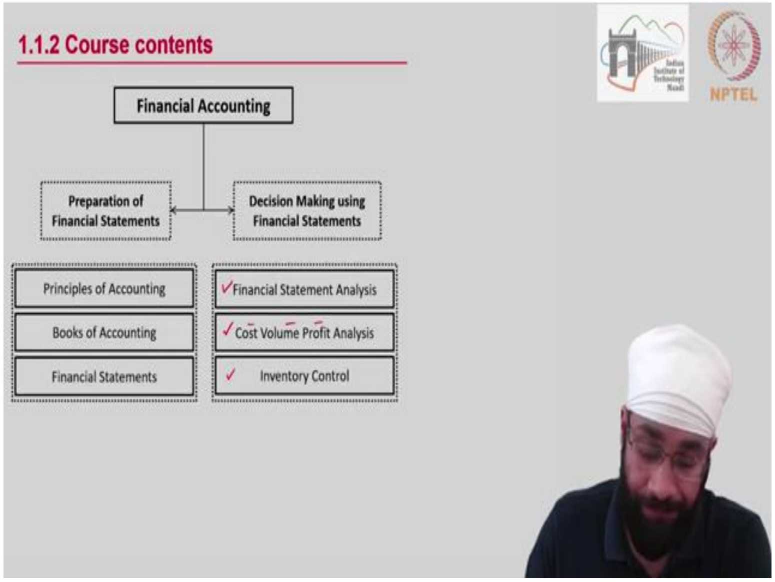

The course is divided into two major parts. The first part is preparation of financial statements. Now, there are three major financial statements that a company has to disclose to the public and I am referring to a public company. And what is a public company, what is a private company - all of that will be discussed in the course as we move forward.

So, the first section in the course, we will talk about preparation of financial statements; and the other section is about using the data from these statements and making decisions by converting the data into information. So, in the first bucket, we are going to be talk about principles of accounting. These are some rules using which the recording, classifying and summarizing of transactions take place. And this recording of transactions takes place in books of accountings. There are multiple books of accounting and we are going to learn in the course how to prepare these books and how finally the numbers in financial statements are arrived at. So, that is the first bit of the course which is really the back-end of accounting. Whatever you see in the financial statements, there is a lot going on in the background and that background is the first section here.

In the second section, we have you know various tools to analyze the financial statements, we are going to look at the data the numbers in the financial statements; the summary – after recording, classifying and summarizing, we have a summary of data using that data can we figure out how well the business is doing, or what are the alarming areas in the business, where you need to pay more attention and so on.

We will also do an analysis of cost, volume and profit; this is also called break even analysis this comes much later in the course. And finally, an inventory control technique to manage the stock in the business, to be in more efficient in the business, will be undertaken. So, this is the overview of the course.

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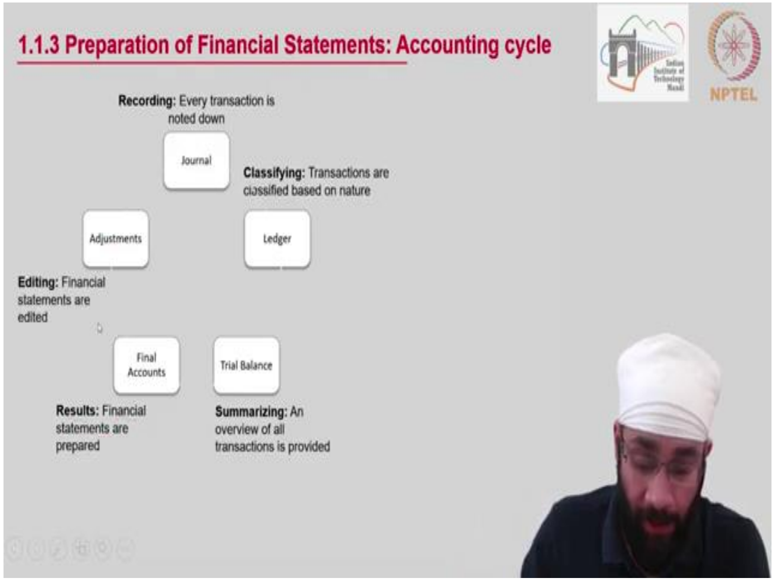

Let’s move further. When we were talking about the definition of accounting we said there is recording, classifying and summarizing. Now, on the screen you see a process (Figure 1): it starts with journal, then you have ledger, trial balance, final accounts, an then some adjustments, this is called accounting cycle.

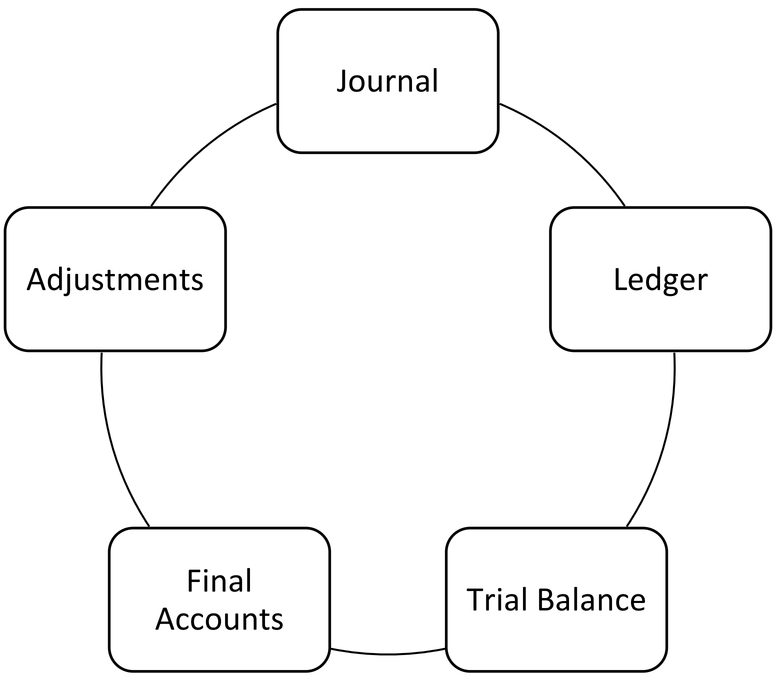

Figure 1: Accounting Cycle

When a transaction or an event takes place in the business, it goes through these five steps, and finally, shows up in the final financial statements of the company. Let us look at these steps one by one.

So, the very first step is recording: accounting is an art of recording. What do you record? You record every transaction. But where do you record it? You record it in a book called journal. What is a journal? In common parlance, journal is a rough notebook. Let us take an analogy in the school. You take a rough notebook with you. In all the subjects, whatever is taught in a class, you write it in the rough notebook. At home, for homework, you have a dedicated notebook for every subject that is taught in the school. So, journal is a rough notebook in the business. A customer comes, transaction happens, it is noted down in a rough notebook. That is a way to understand what journal is.

Second is ledger. What is a ledger? Ledger is about classifying. Accounting is an art of recording and classifying. What is classifying? Now, imagine you have this journal, where you write all the transactions in the business. And if it is a large business, hundreds of transactions or maybe thousands of transactions are taking place in a given day. So, if you have to figure out of the thousand transactions, how many transactions were done with a particular customer or vendor or any party to business, what do you do? If you have a list of thousand transactions, at the end of the day you are going to look through the list and then identify the transactions related to person A, and then write that in a new book that is a fair notebook, as the analogy goes. So, the ledger is a book where you classify your transactions based upon their nature. Nature of transaction etc. we are going to discuss as we move forward in the course.

Third book of accounting is called a trial balance. Say out of thousands of transactions, you have classified one thousand transactions into say 10 categories of 100 transactions each. 10 categories mean 10 different people that you have transacted with in a single day. So, now you have 10 different fair notebooks with 100 transactions written in there.

Now, if you have to figure out, after 100 transactions with a person A – first person – what is the final outcome? Do I have to pay him money or does he have to pay me money? What do you do? You are going to look through all the transactions: there will be some cash you paid to him for things you bought from him, or some cash you receive from him for things he bought from you and so on. Net, net, do you have to pay to him or do you have to recover money from him?

In order to do that, you flip another page and write for person A net effect of the 100 transactions is that I have to recover these many rupees from him right. Now, this new notebook or another page that you flip is called trial balance. Here you are summarizing.

So, accounting is an art of recording, classifying, and summarizing. We have done those first three steps in the definition of accounting. So, after you have recorded, classified and summarized the transactions, the next thing is to conclude that if we have done 1000 transactions with 10 people during the day where we owe money to some people and we have to recover money from other people, in the end what is the net result. All in all, do I have to pay money to outside people or do I have to recover money? So, then you are talking about the results of these processes of recording, classifying, and summarizing, and you have the financial statements that are ready.

And then there are some adjustments that need to be made in the final accounts which I will discuss as we move along in the course. After adjustments you have the data which is prepared after having gone through all those transactions in a day.

Now, business is not run for a day, business is run forever: that is the intention. So, every day you will have hundreds of transactions, thousands of transactions, and every day you would want to know the result of the business, what is the final outcome of the business, am I making profit? Am I losing money? What is it?

So, businesses need to maintain these transactions through these processes using these books of accounts. And after having the final accounts, you convert the data into the information which is the second part of the course. So, the first part of the course is about recording, classifying, and summarizing the transactions that take place in the business, so that you have the final outcome in the financial statements. The next step is an analysis which I will talk about later.

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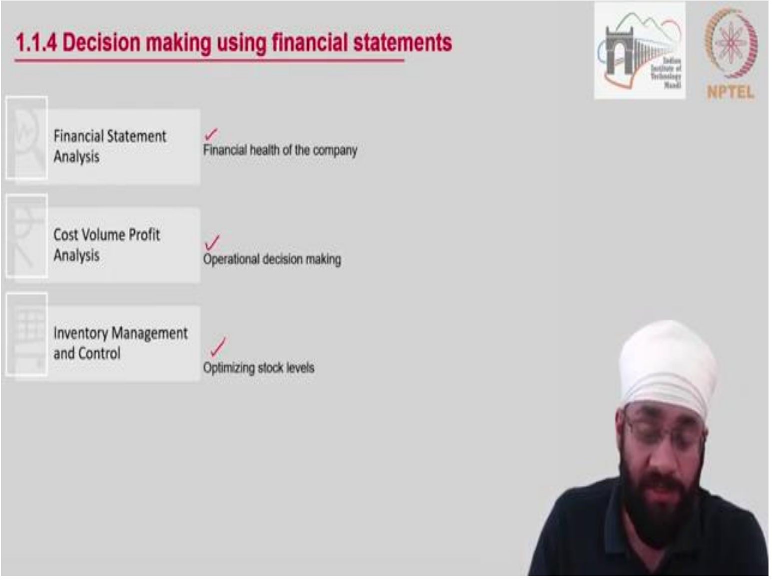

Once you have these financial statements ready with you, the second part is about figuring out the financial health of the company. You want to take various operating day-to-day decisions about what level to operate at, meaning, how many units should I produce, will I be making profit or not- break-even analysis, as I mentioned earlier, and then you have questions of how do I maintain an optimum stock level, how much stock should I have with me at all times, so that when the customer comes I do not send him back without selling things to him. So, these are the two parts of the course.

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Let us get to the next section in this video which is about discussion on is accounting is an art or a science? We called accounting an art in the definition, but accounting is also a science. Accounting is a science because in order to write the transactions in journal, ledger and trial balance which is recording, classifying, and summarizing, we use a system called double entry system.

And this, this double entry system is hundreds of years old: it was invented in 1400s and it is a way to scientifically record and verify the transactions. So, this is the system which you could learn, and you will be able to converse with everybody else who has learnt this system in the same language.

So, there will not be any difference of opinion about a specific word in this language, a specific code in the language. So, it is a standard system using which these books are prepared, and I am going to teach you this process, this system, in this course- the double entry system.

The second question is you know accounting is an art, because there are various subjective calls qualitative judgments that you have to make in the business as well. In order to prepare the books of accounts- in order to you know record the transactions, classify and summarize them- I keep saying that because it is important to have it printed in your mind because that is all you are going to do in this course. So, after having the financial statements, you need to analyze that. And after the analysis, you are going to arrive at certain numbers, for example, let me just throw in something called current ratio. Current ratio tells me how much do I owe to people outside the business, and how much do I have to recover from people outside the business, and all of this within a period of 1 year. So, this ratio tells if I owe people money or I have to recover money from people. Thus, if the number is 2, the ratio which of say recoverables divided by payables: it is all up to you to interpret this number, and then come to a conclusion about the business. You have to decide, is this good for me or not: that is the qualitative part of accounting. And, hence, we call it an art as well. Therefore, there is a debate on whether accounting is science or an art, we say it is both: part art, part science. Let us move forward.

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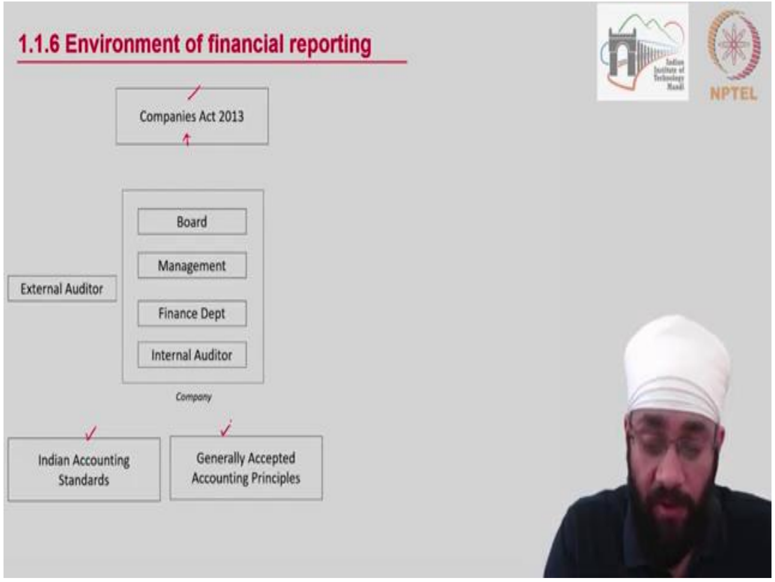

So, finally, in this video the last section is on talking about the environment, the ecosystem of financial reporting. For a company we know how things work as far as finance is concerned. The top decision making body in any company is the board of directors right. Board of directors are elected by shareholders; a lot of peripheral information there, I will do a separate video in the course talking about what is a company and other details.

So, your company, you got a board, and then you have a management team which is selected by the board. These people are typically employees of the business. The management in the organization hierarchy is: finance department- there are people who are experts in the process of accounting, they know the double entry system and everything. So, finance department prepares the reports which are based upon the data which is recorded in the books of account. And then there is somebody called internal auditor who will see if we have recorded these transactions according to the principles of double entry system. Also there are local, or state level, or national level, international level regulations which prescribe how you should prepare the books of accounts. So, internal auditor vouches for all of that for the company internally. And then the matter goes to external auditor who will say alright, I am not party to this company. So, as an independent agency let me vouch for this company if they have prepared their financial statements in a proper manner right. So, these are the people or bodies inside and outside an organization which deal with financial statements.

And then every company cannot have their own sets of rules and policies and regulations. So, there are broader rules for all the companies that exist and I am talking specifically in Indian context. There is an act called Companies Act 2013. It was earlier Companies Act 1956, various amendments were made from time to time, and now it is called a Companies Act 2013. And even after 2013, there have been some amendments. This is a proper act: this is an act like any other act passed in the parliament. It deals with how the companies should be formed, run, closed down, how the dispute should be resolved, how people should be hired, and how finances should be prepared: all nitty-gritties of functioning of company financial reporting by the company- all of that is prescribed in this act.

In addition to this act or as a part of this act, there are certain accounting standards which are given. Now, what do you mean by accounting standard? Accounting standard simply means that we know all the companies are going to write this transaction in this way or if this type of event occurs in a company, this is how it should be recorded and all the companies should record it in the same way. So, basically standardizing the way to write or record that transaction in the books of accounts.

And finally, you have a bunch of generally accepted accounting principle these are more like you know conventions agreed upon, principles using which the whole double entry system is put into effect. So, this is the ecosystem where a company functions- you have got some internal people, and outside person who vouches for your financial statements, you got an act and there are accounting standards in the act.

And you know in addition to these there are enforcement agencies which I am not mentioning here because we were mostly dealing with the preparation of the financial statements, but there are you know other regulatory agencies which would you know for example, Security Exchange Board of India- it regulates the financial markets. Anyway, we are not talking about the financial market so I did not bring that up here.

But you know briefly mentioning that industry-wise, sector-wise regulating authorities, for example IRDA - Insurance Regulatory and Development Authority, Reserve Bank of India etc., exist. So, depending upon are you a bank, an insurance company, or a financial markets company that deals in financial markets, there are different regulators which also play a part in telling the companies to record their transaction in a specific way.

In this course, we are going to stay generic, the idea is for us to understand go through the process of preparing the financial statements, and then look at any company- does not matter which sector it belongs to. There will be sector specific rules, but the way financial reports are prepared and stated are uniform across all the sectors. Only few exceptions with respect to treatment of certain transactions or events occur is the subject matter of advanced level courses.

So, to summarize, we have discussed the definition of accounting. The key takeaway is that accounting is about recording, classifying and summarizing the transactions happening in a business and then taking analyzing and interpreting that data to get information so that decision making can be facilitated.

Great, I will see you in the next video.