**Financial & Management Accounting**

**Unit -2 (I)**

**Accounting Equation**

The accounting equation is a basic principle of accounting and a fundamental element of the balance sheet. The equation is as follows:

|  |
| --- |
| **Total Assets** = Current Assets + Non-Current Assets |
| **Total Liabilities** = Current Liabilities + Non-Current Liabilities |
| **Total Shareholders’ Equity** = Share Capital + Retained Earning |

**Assets = Liabilities + Shareholder’s Equity**

This equation sets the foundation of double-entry accounting and highlights the structure of the balance sheet. Double-entry accounting is a system where every transaction affects both sides of the accounting equation. For every change to an asset account, there must be an equal change to a related liability or shareholder’s equity account. It is important to keep the accounting equation in mind when performing journal entries.

The balance sheet is broken down into three major sections and its various underlying items: Assets, Liabilities, and Shareholder’s Equity.

Below are some examples of items that fall under each section:

* **Assets:** Cash, Accounts Receivable, Inventory, Equipment
* **Liabilities:** Accounts Payable, Short-term borrowings, Long-term Debt
* **Shareholder’s** Equity: Share Capital, Retained Earnings

The accounting equation shows the relationship between these items.

**Rearranging the Accounting Equation**

The accounting equation can also be rearranged into the following form:

**Shareholder’s Equity = Assets – Liabilities**

In this form, it is easier to highlight the relationship between shareholder’s equity and debt (liabilities). As you can see, shareholder’s equity is the remainder after liabilities has been subtracted from assets. This is because creditors – parties that lend money – have the first claim to a company’s assets.

For example, if a company becomes bankrupt, its assets are sold and these funds are used to settle debts first. Only after debts are settled are shareholders entitled to any of the company’s assets to attempt to recover their investments.

**Dual Aspect of Accounting**

The **dual aspect concept** states that every business transaction requires recordation in two different accounts. This concept is the basis of double entry accounting, which is required by all accounting frameworks in order to produce reliable financial statements. The concept is derived from the accounting equation, which states that:

**Assets = Liabilities + Equity**

The accounting equation is made visible in the balance sheet, where the total amount of assets listed must equal the total of all liabilities and equity. One part of most business transactions will have an impact in some way on the balance sheet, so at least one part of every transaction will involve either assets, liabilities, or equity. Here are several examples:

* **Issue an invoice to a customer:** One part of the entry increases sales, which appears in the income statement, while the offset to the entry increases the accounts receivable asset in the balance sheet. In addition, the change in income triggered by the increase in sales appears in retained earnings, which is part of the equity section of the balance sheet.
* **Receive an invoice from a supplier:** One part of the entry increases an expense or an asset account, which can appear in either the income statement (for an expense) or in the balance sheet (for an asset). The offset to the entry increases the accounts payable liability in the balance sheet. In addition, the change in income triggered by the recordation of an expense appears in retained earnings, which is part of the equity section of the balance sheet.

If an organization were not to observe the dual aspect concept, it would use single-entry accounting, which is essentially a checkbook. A checkbook cannot be used to derive a balance sheet, so an entity would be limited to the construction of a cash-basis income statement.

If management wants to have its financials audited, it must accept the dual aspect concept and maintain its accounting records using double-entry accounting. This is the only format that auditors will accept if they are to issue opinions on financial statements.

**Journal Entry**

A journal entry is used to record a business transaction in the accounting records of a business. A journal entry is usually recorded in the general ledger; alternatively, it may be recorded in a subsidiary ledger that is then summarized and rolled forward into the general ledger. The general ledger is then used to create financial statements for the business.

The logic behind a journal entry is to record every business transaction in at least two places (known as double entry accounting). For example, when you generate a sale for cash, this increases both the revenue account and the cash account. Or, if you buy goods on account, this increases both the accounts payable account and the inventory account.

**How to Write a Journal Entry:**

* The structure of a journal entry is:
* A header line may include a journal entry number and entry date.
* The first column includes the account number and account name into which the entry is recorded. This field is indented if it is for the account being credited.
* The second column contains the debit amount to be entered.
* The third column contains the credit amount to be entered.
* A footer line may also include a brief description of the reason for the entry.



**Types of Journal Entries**

There are several types of journal entries, including the following:

**Adjusting entry**. An adjusting entry is used at month-end to alter the financial statements to bring them into compliance with the relevant accounting framework, such as Generally Accepted Accounting Principles or International Financial Reporting Standards. For example, you could accrue unpaid wages at month-end if the company is on the accrual basis of accounting.

**Compound entry**. A compound journal entry is one that includes more than two lines of entries. It is frequently used to record complex transactions, or several transactions at once. For example, the journal entry to record payroll usually contains many lines, since it involves the recordation of numerous tax liabilities and payroll deductions.

**Reversing entry**. This is typically an adjusting entry that is reversed as of the beginning of the following period, usually because an expense was to be accrued in the preceding period, and is no longer needed. Thus, a wage accrual in the preceding period is reversed in the next period, to be replaced by an actual payroll expenditure.

**Ledger Posting and Trial Balance**

**Ledger Posting**

Ledger posting is very important part of accounting system. As we know that to reach to any financial result, we have to go through so many process. For example, first of all, we must know to maintain proper account records. To maintain proper account records, one must know proper accounting system. And proper accounting system includes following important steps to be followed:-

1. To prepare the vouchers.
2. To enter the vouchers in to different type of day books.
3. Posting the entries from day books to ledger.
4. Totaling and balancing of ledgers.
5. To prepare the trial balance
6. To prepare Trading Account, Profit & Loss Account and Balance Sheet.

**What is ledger?:-** In brief, Ledger is a summary of all accounts heads maintained by the business firm.

**How to post the entries from day book to ledger:-** Following  are the procedures of posting of entries from day books to ledger:-

1. First of all, we have to open the accounts heads in ledger books. Ledger books contains similar type of pages having serial numbers. It also contains an index in beginning of ledger books. The name of account head is written in index of ledger and the same account head is written on any page of ledger. Then, the page number of that particular account head is written against that account head in index.

**For Example:-** Suppose, we want to open a Conveyance Expenses Account head in ledger. In this case, first, we shall write Conveyance Expenses Account in Index of ledger under ‘C’ alphabet and then we shall choose any page in ledger and on that page also, we shall write Conveyance Expenses Account. The page number, on which this Conveyance Expenses Account is written,  should be written in index of ledger against Conveyance Expenses Account.  So, when ever, we want to see the details of conveyance expenses account in ledger, first we shall open the index under alphabet ‘C’ then we will find out the page number of Conveyance Expenses Account and reach to particular page very easily. Same way, any number of accounts heads can be opened.

1. As we know that the ledger contains the columns like date, particulars, ledger folio, amount Dr., amount Cr. and balance Dr. or Cr. There is simple procedure of posting the entries from day book to ledger. All entries relating to the accounts heads, which are debited, should be posted to debit side of ledger account. Similarly, the credit entries of any account head should be posted in to credit side of that particular ledger account.

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**Trial Balance**

A trial balance is a bookkeeping worksheet in which the balances of all ledgers are compiled into debit and credit account column totals that are equal. A company prepares a trial balance periodically, usually at the end of every reporting period. The general purpose of producing a trial balance is to ensure the entries in a company’s bookkeeping system are mathematically correct.

Preparing a trial balance for a company serves to detect any mathematical errors that have occurred in the double-entry accounting system. If the total debits equal the total credits, the trial balance is considered to be balanced, and there should be no mathematical errors in the ledgers. However, this does not mean there are no errors in a company’s accounting system. For example, transactions classified improperly or those simply missing from the system could still be material accounting errors that would not be detected by the trial balance procedure.

Multiple entries in various accounts will make a Ledger.  Taking all the ledger balances and presenting them in a single worksheet as on a particular date is Trial Balance.

To understand  a trial balance, we must first understand the following:

* Double entry system – Recording two entries for a single transaction that is equal and opposite in nature
* Journal – All transactions recorded in double entry system of bookkeeping
* Ledger – Summary of all journals of a similar nature.



**Illustration**

Let’s say we buy a book for say Rs. 1000 on credit. Now we receive the book and have to pay money. So this transaction has two activities.

Buying the book

Taking credit from seller

In accounting language, recording of this transaction by segregating into two activities is double entry system of bookkeeping.

In the above example let’s assume an organization is trading in books, then the Journal entry will be

|  |  |  |  |
| --- | --- | --- | --- |
| **Purchase A/c** | Dr | 1000 |  |
| **To Creditor A/c** |  |  | 1000 |

**Concept of Trial Balance**

Let’s say you record all your activities in a diary. At month end you summarize your diary and classify it into various categories. Now you make a sheet and divide the categories into productive / non productive. That’s exactly what businesses do.

* Recording of transaction is a Journal entry.
* Summarizing them and categorizing them are Ledgers.
* Creating a worksheet and classifying the ledgers is a Trial Balance.
* A trial balance is a sheet recording all the ledger balances categorized into debit and credit. A typical trial balance will have name of ledger and the balances. This is prepared as at a particular date which can be financial year end or calendar year.

**Advantages of Trial Balance**

**Arithmetical accuracy**

Given the nature of double entry system, every transaction will result in two entries of equal and opposite nature. Hence at any point in time all debit ledger totals will match to credit ledger totals. Since Trial Balance lists all the accounts as on a particular date, the debit total of a trial balance must match to the credit total.

Therefore a Trial Balance is an indicator of the Arithmetical accuracy of the books of accounts.

With softwares being used for accounting, the above advantage of the trial balance is not very relevant. As data entry systems does not allow entries to be posted if there is a difference in the debit and credit amount hence leaving no room for error.

**Bird’s-eye view**

A trial balance is a summary sheet listing all ledges and balances. Hence it provides a bird eye view of the accounting transactions of an organization.

**Prerequisite for preparation of Financial statements**

An organization needs to know profit or loss and financial position at year end. And thus to prepare financial statements, Trial Balance is prerequisite. All stakeholders also need this information. It is the first step towards closure of accounts for a particular period.

 (Unit will be continued)