UNIT IV

FINANCIAL ACCOUNTING - I

DEFINITION OF ACCOUNTANCY

"Accountancy is the science of ***recording*** and ***classifying*** business transactions and events, primarily of financial character and the art of making significant ***summaries, analysis*** & ***interpretations*** of those transactions and events, & ***communicating*** the results to persons who make decisions or form judgments"

- Smith & Ashburne

USERS OF ACCOUNTING INFORMATION

The users of accounting can be divided in two board groups

(1). Internal users and

(2). External users.

Internal users	*External users*
Managers	Researchers
Investors	Government
Workers	Creditors

OBJECTIVES OF ACCOUNTANCY

- To keep permanent, accurate and complete record of business transactions
- To maintain records of incomes and expenses and losses in such a way that, the Net profit/Loss for any specified period is ascertained
- To maintain records of Assets and Liabilities and in such a way that, the Financial position of the business at any point is ascertained
- To provide information for legal & tax purposes.

ACCOUNTING PRINCIPLES

- Accounting principles are general rules adopted in accounting.
- These principles enables standardization in recording & reporting of financial information.
- Accounting principles may be defined as those rules of conduct or procedures which are adopted by the accountants universally while recording the accounting transactions.

Accounting principles are classified in to two categories

1. **Accounting concepts**
2. **Accounting conventions**

ACCOUNTING CONCEPTS

Accounting concepts means **conditions** or **assumptions** upon which accounting is based.

- Business entity concept
- Dual aspect concept
- Going concern concept
- Cost concept
- Money measurement concept
- Accounting period concept
- Matching concept
- Realization concept

Business Entity Concept:

- Business is treated as separate from the proprietor. This concept is important and implies that a business is separate and distinct from the persons who supplied capital to the firm. All transactions of the business are recorded in the books of the firm. If business affairs and private affairs are mixed, the true picture of the business will not be available.

- The proprietor is treated as a creditor to the extent of his capital. Capital is thus a liability to the firm and the proprietor is the creditor of the business. The proprietors—sole trader, partners of a partnership firm etc. may draw amount out of the business and this reduces the liability of the firm.

- Because of this concept, financial position of the business can be easily found out and earning capacity of the firm can be easily ascertained.

Dual Aspect Concept (Accounting Equation Concept):

This concept signifies that every business transaction involves a two-fold aspect:

(a) The yielding of benefit and

(b) The giving of the benefit

- Technically speaking, "for every debit, there is a credit". Therefore, we can say that every debit must have a corresponding credit and vice versa. This is the only system of modern account keeping.

- The underlying principle of Double Entry is very simple but wonderfully effective. "Double Entry book-keeping is a system of accounting by which receiving and giving aspects of each transaction are recorded at a time." As such transaction affects giving account and receiving account equally, the assets of a business entity will always be equal to its equities, i.e.,

Total Assets = Total Liabilities

Going Concern Concept:

- This concept relates with the long life of the business. A business is intended to continue for an indefinitely long period. All firms that continue to operate on a profitable footing are treated as going concerns.

- Accordingly, continuity of activity is assumed, thus accounting reports are fashioned as a going concern, just as against liquidation. The current disposal value is irrelevant for a continuing business. Thus under this assumption fixed assets are recorded at original cost and are depreciated in a proper manner.

- In Balance Sheet market price of fixed assets are not considered. While preparing final accounts, record is made for outstanding expenses and pre-paid expenses with the assumption that the business will continue.

Cost Concept:

- Under this concept fixed assets are recorded in the account books at the price at which they are acquired. The price paid to acquire the assets is termed as cost and this cost is the basis for all the subsequent accounting for the asset.

- When an asset is acquired for Rs 5,000, it is recorded in the account books at Rs 5,000 even though the market value may be different. But the asset is shown in balance sheet year after year, at cost price minus depreciation.

- This value is called book value. If the business pays nothing for an item it acquired, then this will not appear in the accounting records as an asset. Thus, all such events are ignored which affect the business but have no cost, for example, a favorable location, a good reputation with its customers, market standing etc.

Money Measurement Concept:

- Only those transactions, which can be expressed in monetary terms, are recorded in accounting though their quantitative records may also be kept. All business transactions should be expressed only in money. Thus transactions, which cannot be expressed in money, will not be recorded in accounting books.

- Thus, labour-management relations, sales policy, labour unrest, effectiveness of competition etc., which are of vital importance to business concern, do not find place in accounting. Another limitation of this concept makes the assumption that the money value is constant. It is contrary to fact as there are fluctuations in the money value. For instance, a land, purchased for Rs 10,000 in 1980, may cost four or five times in 2004. This is because of fall in money value.

Accounting Period Concept:

- Accounting is a continuous process in any business undertaking. Every businessman wants to know the result of his investment and efforts at frequent intervals. Accountants choose some shorter period to measure the result.

- Therefore, one year has been, generally, accepted as the accounting period.

- This period is called accounting period. Financial period chosen, in this regard, should be neither too long nor too short. Closing day of the accounting period is known as accounting date. At this date, accountant prepares income and position statements, shows the business operations, brings the changes of positions since the construction of last statements.

- One year accounting period is recognized by law and the taxation is assessed annually. Reports to the outsiders are provided on this accounting period.

Matching Concept:

- According to this concept, it is necessary to match the expenses incurred during the accounting period with the revenues recognized during the same period. Since profit is an excess of revenue over expenses, it becomes necessary to bring together all revenues and expenses pertaining to a particular period.

- In other words, expenses incurred in an accounting year should be matched with the revenues recognized in that year. Again, only such expenses as incurred in generating revenues during the period should be deducted from those revenues for deriving the amount of income or profit during the period.

Realization Concept:

- This concept revolves around the determination of the point of time when revenues are earned. A business firm invests money to purchase or manufacture goods for sale. To earn profit, sales have to be made. There can be no profit without realization of sale proceeds.
- According to realization concept, which is also known as the "revenue recognition concept", revenue is considered as being earned on the date on which it is realized, i.e., the date on which goods and services are transferred to customers either for cash or for credit. "Credit transactions create debtors and the promise of debtors to make payment is sufficient for the purpose of realizing revenue.
- The realization concept is important in ascertaining the exact profit earned during a period in a business concern. This concept is very important as it prevents firms from inflating their profits by recording sales and incomes that are likely to accrue.

ACCOUNTING CONVENTIONS

Accounting conventions refers to **Customs or Traditions** followed by accountants as a Guide in preparation of financial statements

- Convention of Consistency
- Convention of Disclosure
- Convention of Materiality
- Convention of Conservatism

Convention of Consistency:

- Rules and practices of accounting should be continuously observed and applied. In order to enable the management to draw conclusions about the operation of a company over a number of years, it is essential that the practices and methods of accounting remain unchanged from one period to another. Comparisons are possible only if a consistent policy of accounting is followed.

- If there are frequent changes in the treatment of accounts there is little or no scope for reliability. Comparison of accounting period with that in the past is possible only when the convention of consistency is adhered to.

Convention of Consistency:

- This convention plays its role particularly when alternative accounting practice is equally acceptable. Moreover, consistency serves to eliminate personal bias. But if a change becomes desirable, the change and its effect should be clearly stated in the financial statements. Accounts should lend themselves easily to comparisons and contrasts.

- This convention increases accuracy and comparability of accounting information for prediction or decision making. This convention does not prohibit changes. If there is any change, its effect should be clearly stated in the financial statements.

Convention of Disclosure:

- This convention requires that accounting statements should be honestly prepared and all significant information should be disclosed therein. That is, while making accountancy records, care should be taken to disclose all material information.

- This convention assumes greater importance in respect of corporate organizations where the management is divorced from ownership.

- The purpose of this convention is to communicate all material and relevant facts of financial position and the results of operations, which have material interests to proprietor, creditors and investors.

- In short, full disclosure of all relevant facts in accounts is a necessity in order to make accounting record useful. Therefore, full disclosure is a very healthy convention, and is important.

Convention of Materiality:

- American Accounting Association defines the term materiality as "An item should be regarded as material if there is reason to believe that knowledge of it would influence the decision of informed investor." It refers to the relative importance of an item or event. Materiality of an item depends on its amount and its nature.
- Theoretically, all items, large or small, should be treated alike. Materiality convention implies that the economic significance of an item will to some extent affect its accounting treatment.
- For instance, acquisition of items like fountain pen, stapler, pin cushion, punching machine etc., can be treated as part of assets, when considering their durability and span of life. But, it is not necessary to maintain separate ledgers. Such low cost items can be treated as expense for the period.
- Therefore, unimportant items are either left out or merged with other items.

Convention of Conservatism:

- "Anticipate no profit and provide for all possible losses" is the essence of this convention. Future is uncertain. Fluctuations and uncertainties are not uncommon. Conservatism refers to the policy of choosing the procedure that leads to understatement as against overstatement of resources and income.

- The consequences of an error of understatement are likely to be less serious than that of an error of overstatement. For example, closing stock is valued at cost or market price whichever is lower. This is a convention of caution or playing safe and is adhered to while preparing financial statements. Showing a position better than what it is, is not permitted. Moreover, it is not proper to show a position substantially worse than what it is.

Convention of Conservatism:

Following are the examples:

(a) The value of an asset should not be overestimated.
(b) The value of a liability should not be underestimated.
(c) The profit should not be overestimated.
(d) The loss should not be underestimated.

Such conservatism is generally accepted to present a true and fair value of business in the financial statements.

DOUBLE ENTRY SYSTEM OF ACCOUNTING

According to this system of Accounting every transaction has two fold aspect.

i.e., One party receiving benefit &

Other party giving benefit

- Every transaction is divided in to two aspects Debit & Credit.

- The basic principle of Double entry system is ***for every debit there is corresponding credit of equal value.***

BASIC BOOKS OF ACCOUNTS

- An account is a summary of the record of all the transactions relating to particular Person, Asset, expense or gain.

An account has two sides

- Left side of the account is called Debit side
- Right side of the account is called Credit side

CLASSIFICATION OF BUSINESS TRANSACTIONS

- ***All business transactions are classified into three categories:***

1. Those relating to persons
2. Those relating to property & Assets
3. Those relating to income & expenses

- ***Thus, three classes of accounts are maintained for recording all business transactions. They are:***

1. Personal accounts
2. Real accounts
3. Nominal accounts

1. ***Personal Accounts***: Accounts relating to persons & artificial persons are called "Personal Accounts"

- A separate account is kept on the name of each person for recording the benefits received from ,or given to the person in the course of dealings with him.

Ex:

- Krishna's a/c
- Gopal's a/c
- Nagarjuna Finances Ltd. a/c

2. ***Real Accounts***: The accounts relating to properties or assets are known as "Real Accounts".

- Every business needs assets such as machinery , furniture etc, for running its activities .A separate account is maintained for each asset owned by the business.

Ex:

- Cash A/C
- Furniture A/C
- Building A/C
- Machinery A/C etc.

3. ***Nominal Accounts*:** Accounts relating to expenses, losses, incomes and gains are known as "Nominal Accounts". A separate account is maintained for each item of expenses, losses, income or gain.

Ex: Salaries a/c, Stationery a/c, Wages a/c, Postage a/c, Commission a/c, Interest a/c, Purchases a/c, Rent a/c, Discount a/c, Commission received a/c, Interest received a/c, Rent received a/c, Discount received a/c.

BASIC ACCOUNTING RULES

- Before recording a transaction, it is necessary to find out which of the accounts is to be debited and which is to be credited. The following three different rules have been laid down for the three classes of accounts.

1. ***Personal Accounts*****:** The account of the person receiving benefit (receiver) is to be debited and the account of the person giving the benefit (given) is to be credited.

2. ***Real Accounts*:** When an asset is coming into the business, account of that asset is to be debited. When an asset is going out of the business, the account of that asset is to be credited.

3. ***Nominal Accounts*:** When an expense is incurred or loss encountered, the account representing the expense or loss is to be debited. When any income is earned or gain made, the account representing the income of gain is to be credited.

SUMMARY OF ACCOUNTING RULES

***Personal account Rule*:**

"Debit----The Receiver

Credit---The Giver"

***Real account Rule*:**

"Debit----What comes in

Credit---What goes out"

***Nominal account Rule*:**

"Debit----All expenses and losses

Credit---All incomes and gains"

ACCOUNTING PROCESS OR CYCLE

- Journal
- Ledger
- Trial balance
- Trading account
- Profit and loss account
- Balance sheet

JOURNAL

- The book in which the business transactions are recorded in a chronological order, after analyzing them and classifying the benefits according to the principles of debit & credit is called JOURNAL.

- As all the day to day transactions are recorded in journal, this book is also called as "**Day book**" or "Daily record"

- All the transactions related to business like Purchases, Purchase returns, sales, sales returns, cash receipts, cash payments, loans & advances taken (given), assets acquired, salaries paid are first recorded in the book of JOURNAL.

- Hence Journal is called as "Book of Prime Entry".

JOURNAL ENTRY

- The process of recording the business transactions in a chronological order in the journal after analyzing, classifying & identifying them as Dr and Cr is called entry.

- All the transactions are recorded in the book of Journal are in the form of Entry.

- For easy identification of the transaction a brief description is given under each entry with in brackets. (Narration)

Journalize the following transactions

1. Ram commenced business with Rs 50,000
2. Purchase furniture for cash Rs 3,000
3. Purchase machinery from Manoj on credit Rs 40,000
4. Received cash from pavan Rs 8,000 on account
5. Paid rent to land lord Rs 5,000

Journalize the following transactions

- Jan 1 Raja commenced business with Rs 50,000
- Jan 2 Deposited in bank Rs 40,000
- Jan 5 Purchased goods from Krishna on credit Rs 10000
- Jan 7 Sold goods to ram on credit 8,000
- Jan 9 Purchased goods from Mahesh for cash 5000
- Jan 12 Sold goods for cash to Sailesh 8500
- Jan15 Purchased machinery from Ajay engineering company, payment made by cheque 20,000

- Jan 18 Issued cheque to Krishna 7500
- Jan 20 Received interest from raja 700
- Jan 22 Cash withdrawn from bank for office use 2000
- Jan 24 Amount with drawn from bank for personal use 800
- Jan 27 Loan taken from Rajiv Varma 15000
- Jan 29 Cash with drawn from office for personal use 1000
- Jan 30 Goods withdrawn for personal use 2000
- Jan 31 Paid rent to landlord by cheque 600

LEDGER

- Journal cannot give net results of various transactions related to any account, at a given date the full information is not made available, with regard to value of assets, incomes & expenses.

- This limitation can be overcome by opening a LEDGER, which shows the net results of different accounts on given date.

- LEDGER is also called the "**Book of final entry**"

- From the Journal it is not possible to know the total purchases, sales, rent, salaries paid etc, this limitation can be over come by LEDGER.

- It is a book, where the various accounts pertaining to particular person, asset, expense are grouped together in one place in the form of an account.

- The process of transferring the transactions from Journal to Ledger is called "**Posting**"

- LEDGER is the principal book of business & hence called "king of books of accounts"

1. Journalize the following transactions, post them into ledger and balance the accounts.

Jan 1 Kittu commenced business 1,00,000

Jan 2 Purchased goods from Ravi 10,000

Jan 4 Sold goods to Gopi 20,000

Jan 5 Cash purchases 20,000

Jan 7 Paid salaries 5,000

Jan 8 Sold for cash 15,000

Jan 9 Purchased furniture paid by cheque 2,000

Jan 9 Bought goods from Sobhan 10,000

Jan 14 Cash paid to Ravi 9800, discount received 200

Jan 17 Received cash from Gopi 19,500, discount allowed 500

Jan 18 Deposited with bank 10,000

Jan 20 Paid for advertisement by cheque 700

Jan 22 Stationary expenses 800

Jan 24 Sold old furniture 1,700

Jan 28 Paid cash to shoban 4,000

Jan 26 Received interest through cheque (sent to bank on the same day) 500

Jan 31 Proprietors’ personal use 1,000

TRIAL BALANCE

- The Trial Balance contains the debit and credit balances of all LEDGER accounts, it is very much useful in preparation of FINAL ACCOUNTS.
- It is a connecting link between the Ledger & Final Accounts.
- Trial Balance can be prepared at any time & not necessarily at the end of a calendar or accounting year.
- It is the only base for preparation of Final Accounts

A ***Trial Balance*** may be simply defined as a statement prepared by putting all DEBITS on one side and all CREDITS on the other side to check the ***Arithmetical accuracy*** of the ***ledger balances***.

PREPARATION OF TRIAL BALANCE

The following accounts will appear on DEBIT side of ***Trial Balance, Asset accounts & accounts relating to expenses & losses***

The following accounts will appear on **CREDIT side** of **Trial Balance**, ***Liabilities accounts & accounts relating to incomes & gains***

Asset accounts: land, buildings, plant & machinery, debtors, stock, cash, bills receivables (B/R) prepaid expenses, etc .

Liabilities accounts: creditors, bills payable, bank over draft, loans taken, mortgage, all types of reserves and funds etc.

Accounts relating to expenses and losses: wages, salaries, rent, discount allowed (discount), bad debts, depreciation, purchases, sales return (return inwards)

Accounts relating to incomes and gains: interest received, rent amount collected, discount received (discount), sales, purchase returns (return inwards)

Prepare the Trial Balance from the Ledger account balances

Capital 65,500

Creditors 18,200

Debtors 21,350

Cash 6,750

Sales 1,20,000

Purchases 69,100

Cash at bank 7,800

Machinery 35,000

Discount allowed 5,000

Discount received 3,200

Furniture 4,000

Bills payable 4,500

Reserve for bad debts 3,250

Tax outstanding 1,110

Interest on investment 2,150

Drawings 1510

Fixed deposits 45,000

Rent 950

Insurance prepaid 4,200

Wages 3,150

Salaries outstanding 7,200

Bills receivables 21,300.

TRIAL BALANCE

Particulars	Amount	Particulars	Amount
Debtors	**21,350**	Capital	**65,500**
Cash	**6,750**	Creditors	**18,200**
Purchases	**69, 100**	Sales	**1,20,000**
Cash at Bank	**7,800**	Discount Received	**3,200**
Machinery	**35, 000**	Bills Payable	**4,500**
Discount Allowed	**5,000**	Reserve for Bad Debts	**3,250**
Furniture	**4,000**	Tax Outstanding	**1, 110**
Drawings	**1,510**	Interest on Investment	**2,150**
Fixed Deposit	**45, 000**	Salaries Outstanding	**7,200**
Rent	**950**		
Wages	**3,150**		
Bills Receivable	**21300**		
Insurance Prepaid	**4,200**		
	------------		--------------
	2,25,110		**2,25,110**
	-----------		--------------

END