FINANCIAL ACCOUNTING – I

UNIT – I

INTRODUCTION TO ACCOUNTING

DEFINITION OF ACCOUNTING

1. According to American Institute of Certified Public Accountants (AICPA), “Accounting is the art of recording, classifying & summarizing in a significant manner & in terms of money transaction & events which are in part atleast, of a financial character & interpreting the results thereof”.

2. American Accounting Association (AAA) defined accounting as “the process of identifying, measuring & communicating economic information to permit informed judgements & decisions by the users of information”.

The process of accounting contains the following steps:

- IDENTIFYING: it means identifying business transactions to be recorded in books of accounts.

- MEASURING: it means expressing the value of business transactions in terms of money.

- RECORDING: recording means entering in terms of money, business transactions, as and when they occur, either in journal or in subsidiary books.

- CLASSIFYING: it is the process of classifying or grouping the similar items under one head. In accounts, this type of work is technically known as posting.

- SUMMARISING: it involves preparation of financial statements which include profit & loss account & balance sheet. P&L account shows the result made by the business(profit or loss) for a particular business & balance sheet shows the financial position of business.

- ANALYSIS & INTERPRETATION: the financial data recorded is analysed & interpreted in such a manner that end users can make a meaningful judgement about the financial condition of the business.

- COMMUNICATING: having done all above steps, the net result should be communicated to the proper person for decision making.

OBJECTIVES OR NEED FOR ACCOUNTING

SYSTEMATIC RECORDING OF TRANSACTIONS: basic objective of accounting is to systematically record the financial aspects of business transactions. These recorded transactions are later on classified & summarised logically for the preparation of financial statements & for their analysis & interpretation.

ASCERTAINMENT OF RESULTS OF ABOVE RECORDED TRANSACTIONS: accounting prepares profit & loss account to know the result of business operations for a particular period of time. if revenues exceed expenses then it is said that business is running profitably but if expenses exceed revenue then it can be said business is running under loss.

ASCERTAINMENT OF FINANCIAL POSITION OF THE BUSINESS: business is not only interested in knowing the results of the business in terms of profit or loss for a particular period but also anxious to know that what he owes(liability) to the outsiders & what it owns(assets) on a certain date, to know this, accountant prepares a financial statement popularly known as Balance Sheet.

PROVIDING INFORMATION TO THE USERS FOR RATIONAL DECISION MAKING: 'accounting as a language of business' communicates the financial result of an enterprise to various stakeholders by means of financial statements. accounting aims to meet the information needs of the decision-making & helps them in rational decision making.

TO KNOW THE SOLVENCY POSITION: by preparing the balance sheet, management not only reveals what is owned & owed by the enterprise, but also it gives the information regarding concern's ability to meet its liability in the short run(liquidity position) & in also in the long run(solvency position) as and when they fall due.

FUNCTIONS OF ACCOUNTING

- **MEASUREMENT**: accounting measures past performance of the business entity & its current financial position.

- **FORECASTING:** accounting helps in forecasting future performance & financial position of the enterprise using past data.

- **DECISION-MAKING:** accounting provides relevant information to the users of accountants to aid rational decision-making

- **COMPARISON & EVALUATION:** accounting assesses performance achieved in relation to targets & discloses information regarding accounting policies & contingent liabilities which play an important role in predicting, comparing & evaluating the financial results.

• **CONTROL:** accounting also identifies weaknesses of the operational system & provides feedbacks regarding effectiveness of measures adopted to check such weaknesses.

• **GOVERNMENT REGULATION & TAXATION:** accounting provides necessary information to the government to exercise control on the entity as well in collection of tax revenues.

USERS OF ACCOUNTING INFORMATION SYSTEM

Persons in various walks of life require accounting information relating to a business concern for various purposes. Some of the groups who use the accounting information are:

A. INTERNAL USERS OF ACCOUNTING

I. OWNERS: the owners provide funds for the operation of a business & they want to know whether their funds are being properly utilized or not. They are also interested in knowing the profitability & financial position of their business.

II. MANAGEMENT: the information available in the books of accounts is much helpful to the management to plan the future activities of the business. It also helps the management to evaluate the performances & to take corrective actions wherever necessary.

III. EMPLOYEES: employees are interested in knowing the earning capacity of the firm. They make use of the accounting information available from the financial statements to support their claims for better emoluments, bonus, working conditions etc.

B. EXTERNAL USERS OF ACCOUNTING

1) INVESTORS: the prospective investors are in need of accounting information to judge the profitability & solvency of the concern in which they are going to invest their savings.

2) CREDITORS, BANKERS etc: they want to know the financial position of a concern before giving loans or granting credit. The financial statements helps in judging such position.

3) GOVERNMENT: government is also interested in the accountants of various business concerns in order to impose income tax, sales tax & excise duty. Moreover, such information is much helpful to the government to frame the economic policies of our nation.

4) CUSTOMERS: customers would like to have accounting information relating to profit made by the business.

5) RESEARCHER SCHOLORS: at present, research scholars also use the accounting information extensively for the purpose of their research work.

ACCOUNTING PRINCIPLES

According to the Terminology Committee of AICPA, “the word principle is used to mean a general law or rule adopted or preferred as a guide to action & a settled ground or basis of conduct or practice.”

Generally Accepted Accounting Principles (GAAP) may be defined as rules of action or conduct which are derived from experience & practice & when they prove useful, they become accepted as principles of accounting

ACCOUNTING PRINCIPLES

CONCEPTS

1. Business entity concept
2. Money measurement concept
3. Accounting period concept
4. Going concern concept
5. Dual aspect concept
6. Historical record concept
7. Revenue recognition concept
8. Matching concept
9. Realization concept
10. Objectivity concept
11. Cost concept
12. Accrual concept
13. Legal aspect concept

CONVENTIONS

1) Convention of consistency
2) Convention of disclosure
3) Convention of conservatism
4) Convention of materiality

ACCCOUNTING CONCEPTS:
Accounting is the language of business. To make the language to convey the same meaning to all people, accountants have agreed a number of concepts or assumptions which they try to follow. The following are the important concepts.

1. BUSINESS ENTITY CONCEPT: this concept implies that a business unit is separate & distinct from the person who supply funds to it. According to this concept business is kept separate from the proprietor so that the transaction of the business is recorded seperately, when such a distinction is not made properly. The affairs of the business get mixed up with the personal affairs of the proprietor & the true position of the business will not be available.

2. MONEY MEASUREMENT CONCEPT: under this concept only those transactions which can be expressed in terms of money are recorded in books of accounts. Non-monetary transactions such as efficiency, honesty etc., cannot be recorded in the books of accounts since they cannot be converted into real money value.

3. ACCOUNTING PERIOD CONCEPT: this is also known as concept of definite accounting period. According to this concept, the life of the business is divided into suitable accounting period. This division is made to ascertain the profit or loss of the business for a particular period(i.e., 31st March) & to know the financial position of the business on a particular date with help of balance sheet.

4. GOING CONCERN CONCEPT: this concept refers to the continuous existence of the business concern. The life of the business does not come to an end within a year. It is carried on for a number of years in future. Based on this concept, the suppliers are ready to supply the goods on credit basis & the firm sells goods to its customers on credit basis.

5. DUAL ASPECT CONCEPT: every transaction involves two fold aspects:

- Receiving aspect &
- Giving aspect

These must be a double entry to have a complete record of each business transaction. An entry being made for the receiving amount & a similar entry is made for the giving account. Thus every debit must have a corresponding credit & vice versa & upon this dual aspect concept can be raised the whole super structure of double entry system, simple equation in this regard is

Asset = Capital + Liabilities
Capital= Assets – Liabilities
Liabilities = Assets – Capital

6. HISTORICAL RECORD CONCEPT: according to this concept, only those transactions which have actually taken place must be recorded. Based on anticipation, possibility etc., the transactions should not be recorded. However, certain amounts are based on estimates, like, depreciation, provision for bad debts etc.

7. REVENUE RECOGNITION CONCEPT: this concept is mainly concerned with the revenue being recognised in the profit & loss account of an enterprise. Revenue is the gross inflow of cash, receivables or other considerations arising in the course of ordinary activities of an enterprise from the sale of goods or services. Revenue is recognised in the period in which it is earned irrespective of the fact whether it is received or not during that period.

8. MATCHING CONCEPT: according to this principle, the expenses incurred in an accounting period should be matched with the revenues recognized in that period, that is if revenue is recognized on all goods sold during the period, cost of those goods sold should also be charged to that period.

9. REALIZATION CONCEPT: as per this concept, a business has to record revenue or income, only after it has been legitimately realized. For instance, if a business sells goods or services, the value is realized only when cash is received or when the debtor or customer agrees to pay cash in future, without either of the two, there is no realization of revenue & therefore no profit or income can be said to have arisen.

10. OBJECTIVITY CONCEPT: all accounting transactions should be evidenced & supported by documents such as invoices, receipts, cash memos, vouchers etc. These supporting documents form basis for making entries in the books of accounts & for their verifications by auditors.

11. COST CONCEPT: according to this concept, an asset is recorded in the books at the price paid to acquire it & this cost is basis for all the subsequent accounting for the asset. Assets are not recorded at their realizable value because these values keep on changing with change in price level from time to time.

12. ACCRUAL CONCEPT: financial position & profitability of a concern are assessed at a regular interval called accounting period. While preparing profit & loss account of a concern, all revenue items relating to that period are taken into consideration irrespective of the fact that whether these items are paid or payable(outstanding). For example outstanding salaries, prepaid insurance etc.

13. LEGAL ASPECT CONCEPT: the accounting record should reflect the legal validity of the transactions entered in the books, where it is not possible, appropriate qualifying note should be made. For example, a firm should not say anybody as its debtor unless he is legally liable to pay to the firm.

ACCCOUNTING CONVENTIONS:

Conventions denote customs or traditions & these conventions are used as a guide to the preparation of financial statements. The following are the important accounting conventions:

1) CONVENTION OF CONSISTENCY: accounting rules, practices & conventions should be continuously observed & applied i.e., they should not change from one year to another. The results of different years will be comparable only when accounting rules are continuously observed from year to year.

2) CONVENTION OF FULL DISCLOSURE: according to this concept, the financial statements (trading & profit and loss account & balance sheet) should act as a means of conveying & not concealing.

The financial statements must disclose all the relevant & reliable information, so that the information may be useful to the users.

3) CONVENTION OF CONSERVATISM: it is also known as concept of prudence, is often stated as "anticipate no profits, provide for all possible losses". This means an accountant should follow a cautious approach. He should record lowest possible value for assets & revenues, and the highest possible value for liabilities & expenses. For example making provision for doubtful debts.

4) CONVENTION OF MATERIALITY: it reveals that only important items should be recorded in the books. It is done to make a clear understandable accounting statement rather than preparing

ADVANTAGES & LIMITATIONS OF ACCOUNTING

ADVANTAGES:

I. REPLACEMENT OF MEMORY: in a large business it is very difficult for a businessman to remember all the transactions. Accounting provides records which will furnish information as & when desired & thus it replaces human memory.

II. EVIDENCE IN COURT: properly maintained accounts are often treated as a good evidence in the court to settle a dispute.

III. SETTLEMENT OF TAXATION LIABILITY: if accounts are properly maintained, it will be of a great assistance to the businessman in settling the income tax & sales tax liability.

IV. COMPARATIVE STUDY: it provides the facility of comparative study of the various aspects of the business such as profits, sales, expenses etc, with that of previous year & helps the businessman to locate significant factor leading to the change, if any.

V. SALE OF BUSINESS: if accounts are properly maintained, it helps to ascertain the roper purchase price in case the businessman is interested to sell his business.

VI. ASSISTANCE TO THE INSOLVENT PERSON: if a person is maintaining proper accounts & unfortunately becomes insolvent, he can explain many things about past with the help of accounts & can start a fresh life.

VII. ASSISTANCE TO VARIOUS PARTIES: it provides information to various parties i.e., owners, creditors, invertors, government, managers, research scholars, public & employees & financial position of a business enterprise from their own view point.

VIII. FACILITATE IN RAISING LOANS: accounting facilitates raising loans from lenders by providing them the required financial information.

IX. ASSISTANCE TO MANAGEMENT: accounting assists the management in taking managerial decisions.

X. FACILITATES CONTROL OVER ASSETS: accounting facilitates control over assets by providing information regarding cash balance, bank balance, debtors, fixed assets etc.

LIMITATIONS:

1) RECORDS ONLY MONETARY TRANSACTIONS: accounting records only those transactions which can be measured in monetary terms. Those transactions which cannot be measured in monetary terms as conflict between production manager & marketing manager, efficient management etc., may be very important for a concern but not recorded in the business books.

2) EFFECT OF PRICE LEVEL CHANGES NOT CONSIDERED: accounting records are recorded at cost in the books. The effect of price level changes is not brought into the books with the result that comparison of the various years becomes difficult.

3) NO REALISTIC INFORMATION: accounting information may not be realistic as accounting statements are prepared by following basic concepts & conventions. The financial statements will not reflect the true position of the business.

4) PERMITS ALTERNATIVE TREATMENTS: accounting permits alternative treatments within generally accepted accounting concepts & conventions. For example, method of charging depreciation may be straight line method or diminishing balance method. Application of different methods may give different results may not be comparable. Hence accounts can be manipulated.

5**) PROFIT NO REAL TEST OF MANAGERIAL PERFORMANCE:** profit earned during an accounting period is the test of managerial performance. Profit may be shown in excess by manipulation of accounts. Real idea of managerial performance may not be available by manipulated profit.

6) HISTORICAL IN NATURE: usually accounting supplies information in the form of profit and loss account and balance sheet at the end of the year. So, the information provided is of historical interests and only gives post mortem analysis of the past accounting information. For control and planning purposes management is interested in quick and timely information which is not provided by accounting.

7) WINDOW DRESSING IN BALANCE SHEET: when an accountant resorts to window dressing in the balance sheet, then balance sheet cannot exhibit the true and fair view of state of affairs of the business.

Branches of Accounting

Financial Accounting: Finalization of accounts, preparation of financial statement, communication of accounting information to the users and interpretation thereof are the subject matter of financial accounting. Main aim is to ascertain the operational efficiency by preparing P/L a/c and B/S.

Cost Accounting: This system deals with classification, recording, allocation and summarisation of cost of products or operations.

Management Accounting: A system of accounting which provides information to the management to discharge its managerial function is known as management accounting. Information provided by such account is helpful to the management in formulating major policies and managing the day-to-day affairs of the business.

Accounting Cycle: It refers to complete sequence of accounting procedure which is frequently repeated in same direction during accounting period. The sequence is : Recording of transaction in journal or subsidiary books posting them to various ledger accounts Preparation of trial balance from ledger accounts

Preparation of final accounts.

ACCOUNTING STANDARDS

Meaning

Accounting standard are written policy documents issued by Government or other regulatory body or expert institute covering various aspects or recognition, measurement, treatment, presentation and disclosure of accounting transactions and events in the financial statements. In short AS may be regarded as a practice of accounting of As refer to uniform accounting rules and guidelines or uniform accounting practices to be adopted for preparing uniform and consistent financial statements.

DEFINITION:

According to ICAI (Institute of Chartered Accountants of India), accounting standards are "written documents, policies, procedures issued by expert accounting body or government or other regulatory body covering the aspects of recognition, measurement, treatment, presentation and disclosure of accounting transactions in the financial statement".

Accounting standards are issued by the "Institute of Chartered Accountants of India" (ICAI).

According to 'Jawaharlal', a written statement issued from time to time by institutions of accounting profession, in which it has sufficient involvement which are established expressly for this purpose.

According to 'Kohler', accounting standards are codes of conduct imposed by customs, law or

professional bodies for the benefit of public accountants and accountants generally.

OBJECTIVES OF ACCOUNTING STANDARDS:

1. Standardize the diverse accounting policies.

2. To eliminate to the extent possible the non-comparability of financial statements.

3. It adds the reliability to the financial statements.

4. It increases the arithmetic accuracy of financial statements.

5. Accounting standards helps to understand accounting treatment in financial statement.