UNIT 1:

Introduction to Accounting

Definition of Accounting

Accounting can be defined as a process of reporting, recording, interpreting and summarising economic data. The introduction of accounting helps the decision-makers of a company to make effective choices, by providing information on the financial status of the business.

The American Institute of Certified Public Accountants (AICPA) had defined accounting as the "art of recording, classifying, and summarising in a significant manner and in terms of money, transactions and events which are, in part at least, of financial character, and interpreting the results thereof".

Today, accounting is used by everyone and a good understanding of it is beneficial to all. Accountancy act as a language of finance. To understand accounting efficiently, it is important to understand the aspects of accounting.

- **Economic Events-** It is a consequence of a company has to undergo when the number of monetary transactions is involved. Such as purchasing new machinery, transportation, machine installation on-site, etc.
- **Identification, Measurement, Recording, and Communication-** The accounting system should be outlined in such a way that the right data is identified, measured, recorded and communicated to the right individual and at the right time.
- **Organization-**In refers to the size of activities and level of a business operation.
- **Interested Users of Information-** It is about communicating important financial information to the customers, according to which they will make the correct decision.

Fundamentals of Accounting

- **Assets-** The economic value of an item which is possessed by the enterprise is referred to as Assets. To put it in other words, assets are those items that can be transformed into cash or that generates income for the enterprise shortly. It is useful in paying any expenses of the business entity or debt.

- **Liabilities-** The economic value of an obligation or debt that is payable by the enterprise to other establishment or individual is referred to as liability. To put it in other words, liabilities are the obligations that are rising out of previous transactions, which is payable by the enterprise, through the assets possessed by the enterprise.
- **Owner's Equity-** Owner's equity is one of the 3 vital segments of a sole proprietorship's balance sheet and one of the main aspects of the accounting equation: Assets = Liabilities + Owner's Equity. It depicts the owner's investment in the trade minus the owner's withdrawal from the trade + the net income since the business concern commenced.

Objectives of Accounting

The main objectives of accounting are:

To maintain a systematic record of business transactions

- Accounting is used to maintain a systematic record of all the financial transactions in a book of accounts.
- For this, all the transactions are recorded in chronological order in Journal and then posted to principle book i.e. Ledger.

To ascertain profit and loss

- Every businessman is keen to know the net results of business operations periodically.
- To check whether the business has earned profits or incurred losses, we prepare a "Profit & Loss Account".

To determine the financial position

- Another important objective is to determine the financial position of the business to check the value of assets and liabilities.
- For this purpose, we prepare a "Balance Sheet".

To provide information to various users

- Providing information to the various interested parties or stakeholders is one of the most important objectives of accounting.
- It helps them in making good financial decisions.

To assist the management

- By analysing financial data and providing interpretations in the form of reports, accounting assists management in handling business operations effectively.

Characteristics of Accounting:

The following attributes or characteristics can be drawn from the definition of Accounting:

(1) Identifying financial transactions and events

- Accounting records only those transactions and events which are of financial nature.
- So, first of all, such transactions and events are identified.

(2) Measuring the transactions

- Accounting measures the transactions and events in terms of money which are considered as a common unit.

(3) Recording of transactions

- Accounting involves recording the financial transactions inappropriate book of accounts such as Journal or Subsidiary Books.

(4) Classifying the transactions

- Transactions recorded in the books of original entry – Journal or Subsidiary books are classified and grouped according to nature and posted in separate accounts known as 'Ledger Accounts'.

(5) Summarising the transactions

- It involves presenting the classified data in a manner and in the form of statements, which are understandable by the users.
- It includes Trial balance, Trading Account, Profit and Loss Account and Balance Sheet.

(6) Analysing and interpreting financial data

- Results of the business are analyzed and interpreted so that users of financial statements can make a meaningful and sound judgment.

(7) Communicating the financial data or reports to the users

- Communicating the financial data to the users on time is the final step of Accounting so that they can make appropriate decisions.

What are the Advantages of Accounting?

The following are the main advantages of accounting:

1. Provide information about financial performance

- Accounting provides factual information about financial performance during a given period of time
- Like, profit earned or loss incurred over a period and financial position at a particular point of time.

2. Provide assistance to management

- Accounting helps management in business planning, decision making and in exercising control.

- For this, it provides financial information in the form of reports.

3. Facilitates comparative study

- By keeping systematic records and preparation of reports at regular intervals, accounting helps in making a comparison.

4. Helps in settlement of tax liability

- Systematic accounting records help in settlement of various tax liabilities. Such as – Income Tax, GST, etc.

5. Helpful in raising loan

- Banks and Financial Institutions grant a loan to the firm on the basis of appraisal of the financial statement of the firm.

6. Helpful in decision making

- Accounting provides useful information to the management for taking decisions.

What Are the Limitations of Accounting?

Following are the limitations of accounting:

- **Accounting is not precise**: Accounting is not completely free from personal bias or judgment.
- **Accounting is done on historic values of assets:** Accounting records assets at their historical cost less depreciation. It does not reflect their current market value.
- **Ignore the effect of price level changes:** Accounting statements are prepared at historical cost. So changes in the value of money are ignored.
- **Ignore the qualitative information:** Accounting records only monetary transactions. It ignores the qualitative aspects.
- **Affected by window dressing:** Window dressing means manipulation in accounting to present a more favourable position of the business than the actual position.

What Is an Accounting Convention?

Accounting conventions are guidelines used to help companies determine how to record certain business transactions that have not yet been fully addressed by accounting standards. These procedures and principles are not legally binding but are generally accepted by accounting bodies. Basically, they are designed to promote consistency and help accountants overcome practical problems that can arise when preparing financial statements.

Accounting conventions are important because they ensure that multiple different companies record transactions in the same way. Providing a standardized methodology makes it easier for investors to compare the financial results of different firms, such as competing ones operating in the same sector.

That said, accounting conventions are by no means flawless. They are sometimes loosely explained, presenting companies and their accountants with the opportunity to potentially bend or manipulate them to their advantage.

Accounting Convention Methods

There are four main accounting conventions designed to assist accountants:

- **Conservatism:** Playing it safe is both an accounting principle and convention. It tells accountants to err on the side of caution when providing estimates for assets and liabilities. That means that when two values of a transaction are available, the lower one should be favored. The general concept is to factor in the worst-case scenario of a firm's financial future.
- **Consistency**: A company should apply the same accounting principles across different accounting cycles. Once it chooses a method it is urged to stick with it in the future, unless it has a good reason to do otherwise. Without this convention, investors' ability to compare and assess how the company performs from one period to the next is made much more challenging.
- **Full disclosure**: Information considered potentially important and relevant must be revealed, regardless of whether it is detrimental to the company.
- **Materiality:** Like full disclosure, this convention urges companies to lay all their cards on the table. If an item or event is material, in other words important, it should be disclosed. The idea here is that any information that could influence the decision of a person looking at the financial statement must be included.

What Are the Generally Accepted Accounting Principles (GAAP)?

Generally accepted accounting principles (GAAP) refer to a common set of accounting rules, standards, and procedures issued by the Financial Accounting Standards Board (FASB). Public companies in the U.S. must follow GAAP when their accountants compile their financial statements.

GAAP is guided by ten key tenets and is a rules-based set of standards. It is often compared with the International Financial Reporting Standards (IFRS), which is considered more of a principles-based standard. IFRS is a more international standard, and there have been recent efforts to transition GAAP reporting to IFRS.

The ultimate goal of GAAP is to ensure a company's financial statements are complete, consistent, and comparable. This makes it easier for investors to analyze and extract useful information from the company's financial statements, including trend data over a period of time. It also facilitates the comparison of financial information across different companies.

The 10 Key Principles of GAAP

There are 10 general concepts that lay out the main mission of GAAP.[2]

1. Principle of Regularity
The accountant has adhered to GAAP rules and regulations as a standard.

2. Principle of Consistency
Accountants commit to applying the same standards throughout the reporting process, from one period to the next, to ensure financial comparability between periods. Accountants are expected to fully disclose and explain the reasons behind any changed or updated standards in the footnotes to the financial statements.

3. Principle of Sincerity
The accountant strives to provide an accurate and impartial depiction of a company's financial situation.

4. Principle of Permanence of Methods
The procedures used in financial reporting should be consistent, allowing a comparison of the company's financial information.

5. Principle of Non-Compensation
Both negatives and positives should be reported with full transparency and without the expectation of debt compensation.

6. Principle of Prudence
This refers to emphasizing fact-based financial data representation that is not clouded by speculation.

7. Principle of Continuity

While valuing assets, it should be assumed the business will continue to operate.

8. Principle of Periodicity

Entries should be distributed across the appropriate periods of time. For example, revenue should be reported in its relevant accounting period.

9. Principle of Materiality

Accountants must strive to fully disclose all financial data and accounting information in financial reports.

10. Principle of Utmost Good Faith

Derived from the Latin phrase *uberrimae fidei* used within the insurance industry. It presupposes that parties remain honest in all transactions.