BACHELOR OF COMPUTER APPLICATIONS

SEMESTER 4

DCA2204

PRINCIPLES OF FINANCIAL ACCOUNTING AND MANAGEMENT

Unit 1

Financial Accounting an Introduction

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1. INTRODUCTION

Accounting is an important endeavour: it helps the management of an organization to have control over its performance. The success of a business entity depends on the combined effects of four factors – land, labour, capital and management. The contribution of each factor has to be properly measured and then only the resultant performance of the entity can be properly evaluated. An outsider does not consider how many engineers, chartered accountants, and MBAs an organization possesses, to judge its performance. He may be interested only in the bottom line (i.e., profits) of the organization. The efforts of each person in that organization are to be translated into some accounting numbers to find out the financial performance of that entity. Thus, without accounting, a business entity cannot communicate with the outside world. Accounting is the language of business. Accounting is not only necessary for business activities; it is equally important for all types of non-business economic activities. For example, accounting is necessary to run a school, a charitable institution, and even a family.

The accounting system is a major quantitative information system in every organization. It provides information for four broad purposes.

Internal routine reporting to managers for cost planning and cost control of operations, and performance evaluation of people and activities.

1. Internal routine reporting to managers on the profitability of products, brand categories, customers, etc.
2. Internal non-routine reporting to managers for strategic and tactical decisions.
3. External reporting through financial statements to investors, government authorities and other interested parties.

The first three functions are the domain of management accounting; and, the fourth function, i.e., external reporting, is truly called financial accounting. Financial accounting operates under a lot of constraints – constraints of accounting principles, accounting standards etc. whereas management accounting enjoys greater freedom.

Thus, it can be said that the basic purpose of accounting is to provide decision-makers with information that is useful in making economic decisions.

1.1 Objectives:

After studying this unit, you will able to:

- *Explain the concept of accounting*
- *Explain the meaning of accounting trail*
- *Explain accounting equation.*

2. BASIC ACCOUNTING CONCEPTS

A renowned ccountant once observed that 'Accounting was born without notice and reared in neglect.' Accounting was first practiced and then theorized. Certain ground rules were initially set for financial accounting: these rules arose out of conventions. Therefore, these are called accounting conventions or concepts. We shall discuss here only the basic accounting concepts or conventions that are very vital to understand the process of accounting.

The Entity Concept

A business is an artificial entity distinct from its proprietor(s). A business entity is an economic unit which owns its assets and has its own obligations. The owner(s) may have personal bank accounts, real estate, and other assets, but these will not be considered as assets of the business. A business entity may be in the form of a sole proprietorship concern, partnership, or a corporate entity. In case of a sole proprietary form of business, the sole proprietor is considered fully responsible for the welfare of the entity and, in the eyes of law, the sole proprietor and the business is not considered to have a separate existence. For accounting purposes, however, they are separate entities. A partnership form of business has more than one owner who have "agreed to share profits of a business carried on by all or any of them acting for all". A corporate entity is a separate legal entity, entirely divorced separated from its owners (called equity shareholders). A sole proprietorship business normally comes to an end with the expiry death of the owner, a partnership firm may cease to operate or, at least, there will be reconstruction of the agreement on the expiry death of an owner (called partner) but a corporate entity is not disturbed at all on the expiry death of any equity shareholder.

Money Measurement Concept

Each transaction and event must be expressible in monetary terms. If an event cannot be expressed in monetary terms, it cannot be considered for accounting purposes. For example, if you successfully pass a Distance Learning Programme of a university, it will give you a great deal of satisfaction. But that satisfaction cannot be expressed in monetary terms. Hence such an event is not fit for accounting. On the other hand, if you are robbed of Rs. 1,000 in a train journey, the loss suffered can definitely be expressed in monetary terms. This concept implies that the legal currency of a country should be used for such measurement.

The Cost Concept

Assets such as land, buildings, plant and machinery etc. and obligations, such as loans, public deposits, should be recorded at historical cost (i.e., cost as on acquisition). For example, the land purchased by a business entity two years back at a cost of Rs. 10 lakhs should be shown, as per the cost concept, at the same amount even today when the current price of the land may have increased five-fold. Thus, the greatest limitation of this concept is that it distorts the true worth of an asset by sticking to its original cost.

The Going Concern Concept

One common argument put forward by the proponents of cost concept is that the assets are shown at its original cost (net depreciation) because these are meant for use for a long period of time and not for immediate resale. Therefore, the cost concept rests on the assumption that an entity would continue its operation for a long time. An entity is said to be a going concern if it has `neither the intention nor the necessity of the liquidation or of curtailing materially the scale of the operations'. This concept is considered as one of the fundamental accounting assumptions. The valuation principle of assets and liabilities depend on this concept. If an entity is not a going concern, its assets and liabilities are to be valued in an altogether different manner.ie. at realisable value.

The Periodicity Concept

The activities of a going concern are continuous flows. In order to judge the performance of a business entity, one cannot wait for eternity to see the business coming to a halt. Therefore, the best way to judge a business is to have a periodic performance appraisal. Such a period to measure business performance is called an accounting period. The results of operations of an entity are measured periodically, i.e.; in each accounting period. Different business units may follow different accounting periods depending on convenience. For example, one entity may follow calendar year as the accounting period, while the other one may follow the financialyear (April to March) as the accounting period. However, in India, the Income Tax Act, 1961 prescribes that each business unit should follow a uniform accounting period, i.e., the fiscal financial year. The Companies Act, 1956 has no such prescription but as per

Companies Act 2013 every company have to follow the financial year starting from 1st April to 31st March .

The Accrual Concept

It suggests that incomes and expenses should be recognized as and when they are earned and incurred, irrespective of whether the money is received or paid in connection thereof. This concept is used by all businesses that disclose their financial statements to various interested parties. In fact, the Companies Act, 1956 2013 provides that accrual concept has to be maintained for practically all purposes. The alternative to the accrual basis of accounting is called ash basis of accounting. The law in India provides that in cases where accrual concept cannot be followed under any circumstances, cash basis may be followed.

Examples of accrual concept:

1. Rent paid for fifteen months in advance on 1st January 2007. The business follows calendar year as the accounting year. In this case, rent for only the first twelve months should be recognized as expenses for the year 2007.
2. Credit sales for the year 2007 were Rs. 20,00,000. Cash collected from customs during 2007 was Rs. 15,00,000. In this case, credit sales for 2007 should be considered as Rs. 20,00,000 and not as Rs. 15,00,000.

The Matching Concept

The inherent concept involved in accrual accounting is called matching concept. Revenue earned in an accounting year is offset (matched) with all the expenses incurred during the same period to generate that revenue, thus providing a measure of the overall profitability of the economic activity. Thus, matching concept is very vital to measure the financial results of a business. The timing of incurring expenses and earning revenues does not always match. For example, in case of a seasonal business, majority of sales may take place only in four months of a year whereas fixed expenses like salaries, rent etc. are incurred throughout the year. Matching concept suggests that the expenses incurred to generate revenue are to be matched against that revenue to find out the profitability.

Concept of Prudence

It says 'anticipate no profits but provide for all possible losses'. It is also called as " Principle of conservatism". Prudence is the 'inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not, overstated and liabilities or expenses are not understated'. Expected losses should be accounted for but not anticipated gains.

The Realization Concept

The realization concept tells that to recognize revenue it has to be 'realised'. Realization principle does not demand that the revenue has to be received in cash. Revenue from sales transactions should be recognized when the seller of goods has transferred to the buyer the property in the goods for a price and no uncertainty exists regarding the consideration that will be derived from the sale of goods. Revenue arises from the consideration that will be derived from the sale of goods. Revenue arising from the use of resources by /

SELF-ASSESSMENT QUESTIONS – 1

1. ____________________has more than one owner who have "agreed to share profits of a business carried on by all or any of them acting for all".
2. ______________ is a separate legal entity, entirely separated from its owners.
3. _________________ suggests that incomes and expenses should be recognized as and when they are earned and incurred, irrespective of whether the money is received or paid in connection thereof.
4. The valuation principle of assets and liabilities depend on ___________________ concept.

3. DOUBLE ENTRY ACCOUNTING

The term 'accounting' has been defined by the American Institute of Accountants (now known as American Institute of Certified Public Accountants) as "the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof". Thus, accounting starts with recording and ends in presenting financial information in a manner which facilitates informed judgments and decisions by users'. The recording of transactions and events follows a definite rule. Each transaction and/or event has two aspects or sides – debit and credit. Every debit has an equal and opposite credit. This is the crux of double entry concept. Each transaction should be recorded in such a way that it affects two sides – debit and credit – equally.

In simpler terms we can understand it as Double entry is an accounting term stating that every financial transaction has equal and opposite effects in at least two different accounts.

It may not be out of place to mention here that the principles of the double entry accounting were first explained in print by Luca Fra Pacioli, an Italian Mathematician. His book 'Summa de Arithmetica, Geometria Proportioniet Proportionalita' was published in 1494. Three hundred years later, Johann Von Goethe, perhaps the most influential writer of the late 18th century, described Pacioli's system as something of timeless beauty and simplicity. It may sound strange that even in today's advanced age of computers, Pacioli's simple principles still apply.

4. THE ACCOUNTING TRAIL

We have seen in section 1.3 that the accounting function initiates with the recording of transactions and events and ends with the presentation of financial statements. Thus, the sequence of activities in an accounting process can be shown in figure 1.1.

Transaction/Event

↓

Preparation of Vouchers

↓

Recording in the Primary Books

↓

Posting in the Secondary Books

↓

Preparation of Trial Balance

↓

Preparation and Presentation of Financial Statements

Fig 1.1: The Accounting Trail

Transactions and Events

The Statement of Financial Accounting Concepts (No. 6), issued by the Financial Accounting Standard Board (FASB) of U.S.A. defines an event as 'a happening of consequence to an entity'. An event may be an internal happening or an external incident. For example, when the management of a business entity negotiates a wage settlement with its Labour Union, it is an internal event. On the other hand, when the same management recruits a fresh MBA, it is an external event. However, this does not involve transfer or exchange of any value instantly. Again, if the same business purchases raw materials from its supplier, it is an external event and it also involves exchange of value instantly. Thus, all external events do not involve immediate exchange of value. Preparation of Vouchers

In the present age of information technology, majority of the business entities use software packages for accounting purposes. The computer takes care of most of the operations like recording in primary books, postings in secondary books, preparation of trial balance and finally even preparation of financial statements. The human intervention normally ends with the preparation of necessary documents. These documents (popularly called vouchers) can be of three types – *Receipt Voucher, Payment Voucher and Journal Voucher*. The receipt voucher is prepared to record all cash and bank receipts. The payment voucher is prepared to record all cash and bank payments. The journal voucher is drawn to record all non-cash transactions and events. The voucher should be filled with all the necessary information minutely so that the computer takes the details correctly. Each account will have a unique code number and if the concerned person commits any mistake in writing the proper code number, the recording by the computer will be wrong. For example, if salary paid for a particular month is to be recorded in primary books, codification should be properly done. Suppose salary account has a code of 101, if the accountant writes 110 as the account code in the payment voucher erroneously, the computer will sincerely read 110 as the accounts code and the amount will be recorded in a wrong account. Therefore preparation of vouchers is a vital step in the accounting process.

The remaining steps of accounting trial will be discussed in subsequent units.

SELF-ASSESSMENT QUESTIONS – 2

5. A/An ____________________ is described as 'a happening of consequence to an entity' by The Financial Accounting Standard Board (FASB) of U.S.A.
6. The external events that involve transfer of value between two entities are called ____________________.

5. FINANCIAL STATEMENTS AND THEIR NATURE

Financial statements are the end products of the accounting process. Financial statements are prepared and presented for external users. The scope of financial statements is different in different countries. In India, the term 'Financial Statements' consists of Balance Sheet, Profit and Loss Account and the Schedules and Notes forming part thereof. The Conceptual Framework developed by the International Accounting Standards Committee (IASC) defines the objective of financial statements as 'to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions'.

There are three elements of Balance Sheet – Assets, Liability and Equity. An asset is a resource legally owned by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise. A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits. Equity is the excess of assets over liabilities. Equity is nothing but the funds belongs to owners of the concern

There are two elements of Profit and Loss Account – Income and Expense. Income is an inflow of economic benefits or enhancement of assets or decrease of liabilities resulting in increases in equity. Expenses are outflow of economic benefits or depreciation of assets or increase/creation of liabilities resulting in decrease in equity. For example, sale of goods on credit is an income because it leads to enhancement of assets. Also, a cash sale is an income as it leads to inflow of economic benefits. Similarly, purchase of raw materials on credit is an expense (provided the raw material is consumed during the period) because it results in increase in liabilities and cash purchases is also an expense as it leads to outflow of economic benefits.

Recognition Criteria of Elements in Financial Statements

An asset is recognized in a financial statement if it satisfies the following two conditions:

1. The asset has a cost or value that can be reliably measured; and
2. It is expected that future economic benefits will flow to the enterprise out of the use of that asset.

For example, the investments made by an enterprise in acquiring a building for official purposes is an 'asset' because future economic benefits will be derived from the use of that building and the building has a definite cost.

A liability is recognized if the following conditions are satisfied:

1. It is expected that an outflow of resources embodying economic benefits will result from the settlement of a present obligation, and
2. The amount of settlement can be reliably measured.
3. The amount at which equity is shown in the balance sheet is dependent on the measurement of assets and liabilities.

Income is recognized in the financial statement when 'an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably'.

Expenses, on the other hand, are recognized when there has arisen a decrease in future economic benefits that can be reliably measured and that relate to a decrease in an asset or an increase of a liability. Expenses are recognized by following the matching principles (discussed in sub section 1.2). However, when economic benefits out of an expenditure are expected to arise over several accounting periods, expenses are to be recognized on a reasonable basis over the same period. For example, the amount paid to an advertising agency to carry out advertisements on behalf of a business entity for the next two years, should be recognised as expense over two accounting periods either equally or on some other suitable basis (e.g. turnover). On the other hand, an expenditure is immediately recognized in the financial statement as 'expenses' if such expenditure is not expected to produce any future economic benefits. For example, one common expenditure of any oil extraction business is exploration expenditure. Oil companies spend huge amount every year on exploration exercises. The benefits of such exploration exercise normally spread over several accounting periods. However, if an exploration experiment on a particular oil field proves abortive, the entire expenditure should be recognized as expenses immediately.

6. THE ACCOUNTING EQUATION

In section 1.5, we have stated that a balance sheet has three elements – Assets, Liabilities, and Equity. We have also stated that equity is the residual interest of owners in assets over liabilities. Thus, the relationship among these three elements of the balance sheet can be expressed with the help of an equation, known as the Fundamental Accounting Equation:

(1) .....

$$\boxed{\text{Assets (A)} = \text{Liabilities (L)} + \text{Equity (E)}}$$

The above equation has a unique feature in the sense that all business transactions will affect the equation in such a way that either the equality will be maintained or a new equality be achieved. This is possible because of the operation of the double entry concept. Every business transaction can be explained in terms of its effect on the accounting equation.

The increase in owner's equity (E) can normally occur in the following situations:

(a) There has been a fresh addition of funds by the owners (e.g. in terms of equity capital in case of a corporate entity).

(b) There has arisen a surplus (excess of income over expenses).

Addition of funds by owners is an occasional feature and not a recurring phenomenon. Thus, if, for the sake of simplicity, we consider only situation

(b) to be the cause of a change in owners' equity, the equation (1) can be written as:

(2) .....

$$\boxed{A = L + E_O + (Y - X)}$$

Where, EO is the equity at the beginning of an accounting period, Y is the income recognized in the same accounting period and X is the expenses recognized during that period.

SELF-ASSESSMENT QUESTIONS – 3

7. A balance sheet has three elements – Assets, _______________, and Equity.
8. ________________is the residual interest of owners in assets over liabilities.
9. Complete the following Fundamental Accounting Equation. Assets (A) =________________ ___________________+ Equity (E)

7. SUMMARY

- **Accounting** involves recording, classifying and summarizing, in a meaningful way, transactions and events which are of a financial character, and interpreting the results thereof.
- **Basic accounting concepts** are ground rules for financial accounting. These concepts are very vital for understanding the process of accounting.
- **Double entry accounting** demands that each debit should have an equal and opposite credit. The transactions and events are recorded in books of accounts by following double entry accounting.
- **The Accounting trail** shows the process of accounting. Accounting function initiates with the recording of transactions and events and ends with the presentation of financial statements.
- **Financial statements** consist of the Balance Sheet, Profit and Loss Account, and the schedules and notes forming part thereof.
- **The Accounting equation** shows the relationship of different elements of a balance sheet.
- **Fundamental Accounting Assumptions:** Going concern, consistency, and accrual are the three fundamental accounting assumptions. These underlien the preparation and presentation of financial statements.

GLOSSARY

- **Debit:** It is derived from the Latin word 'debere' meaning 'owned to owe" me, the proprietor'
- **Credit**: It is derived from the Latin word `credo' meaning 'trust or believe'

- **Asset:** An asset is a resource legally owned by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.
- **Liability:** A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits from the enterprise.
- **Income:** It is an inflow of economic benefits or enhancement of assets or decrease of liabilities resulting in increase in equity.
- **Expenses:** Expenses are an outflow of economic benefits or depreciation of assets or increase/creation of liabilities resulting in decrease in equity.
- **Equity:** It is the residual interest of owners in assets over liabilities.

8. TERMINAL QUESTIONS

SHORT ANSWER TYPE QUESTIONS

1. What is the recognition criteria for assets in financial statements?
2. Briefly explain the Accrual concept of accounting.
3. What are the elements of financial statements?

LONG ANSWER TYPES QUESTIONS

4. What is double entry accounting?
5. Briefly explain the 'Entity Concept' and 'Money Measurement Concept' of accounting with example
6. Explain, in brief, the recognition criteria of elements of financial statements.

9. ANSWERS

Self –Assessment Questions

1. Partnership
2. A corporate entity
3. The Accrual Concept
4. The Going Concern Concept
5. Event
6. Transactions
7. Liabilities
8. Equity
9. Liabilities (L)

Terminal Questions:

SHORT ANSWER TYPE QUESTIONS:

1. An asset is recognized in a financial statement if it satisfies the following two conditions:
   - The asset has a cost or value that can be reliably measured; and
2. It is expected that future economic benefits will flow to the enterprise out of the use of that asset.
3. It suggests that incomes and expenses should be recognized as and when they are earned and incurred, irrespective of whether the money is received or paid in connection thereof.
4. In India, the term 'Financial Statements' consists of Balance Sheet, Profit and Loss Account and the Schedules and Notes forming part thereof.

LONG ANSWER TYPE QUESTIONS:

5. Each transaction and/or event has two aspects or sides – debit and credit. Every debit has an equal and opposite credit. This is the crux of double entry concept. Each transaction should be recorded in such a way that it affects two sides – debit and credit – equally.

In simpler terms we can understand it as Double entry is an accounting term stating that every financial transaction has equal and opposite effects in at least two different accounts.

6. **Business entity concept:** A business is an artificial entity distinct from its proprietor(s). A business entity is an economic unit which owns its assets and has its own obligations. The owner(s) may have personal bank accounts, real estate, and other assets, but these will not be considered as assets of the business.
    - **Money measurement concept:** Each transaction and event must be expressible in monetary terms. If an event cannot be expressed in monetary terms, it cannot be considered for accounting purposes. For example, if you successfully pass a Distance Learning Programme of a university, it will give you a great deal of satisfaction. But that satisfaction cannot be expressed in monetary terms. Hence such an event is not fit for accounting. On the other hand, if you are robbed of Rs. 1,000 in a train journey, the loss suffered can definitely be expressed in monetary terms. This concept implies that the legal currency of a country should be used for such measurement.
7. An **asset** is recognized in a financial statement if it satisfies the following two conditions:
    - The asset has a cost or value that can be reliably measured; and
    - It is expected that future economic benefits will flow to the enterprise out of the use of that asset.

A **liability** is recognized if the following conditions are satisfied:

- It is expected that an outflow of resources embodying economic benefits will result from the settlement of a present obligation, and
- The amount of settlement can be reliably measured.
- The amount at which equity is shown in the balance sheet is dependent on the measurement of assets and liabilities.

Income is recognized in the financial statement when 'an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably'.

Expenses, on the other hand, are recognized when there has arisen a decrease in future economic benefits that can be reliably measured and that relate to a decrease in an asset or an increase of a liability. Expenses are recognized by following the matching principles.

However, when economic benefits out of an expenditure are expected to arise over several accounting periods, expenses are to be recognized on a reasonable basis over the same period. On the other hand, an expenditure is immediately recognized in the financial statement as 'expenses' if such expenditure is not expected to produce any future economic benefits.

10. CASE STUDY

Assume yourself as an owner of a mobile shop. List out all the revenues you earn, the expenses you incur for a month. Also record the assets you own and liabilities you owe to others to run the business. Refer format of Profit and Loss account and Balance Sheet from any Financial Accounting books.

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