INTERMEDIATE : PAPER - 5

SYLLABUS - 2016

FINANCIAL ACCOUNTING

INTERMEDIATE

STUDY NOTES

The Institute of Cost Accountants of India
CMA Bhawan, 12, Sudder Street, Kolkata - 700 016

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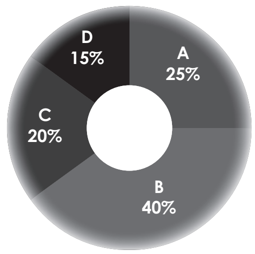
Syllabus - 2016

Paper 5: Financial Accounting (FAC)

Syllabus Structure

The syllabus comprises the following topics and study weightage

A	Accounting - Basics	25%
B	Preparation of Financial Statements	40%
C	Self Balancing Ledgers, Royalties, Hire Purchase & Installment System, Branch & Departmental Accounts	20%
D	Accounting in Computerised Environment and Accounting Standards	15%



ASSESSMENT STRATEGY

There will be examination of three hours.

OBJECTIVES

To gain understanding and to provide working knowledge of accounting concepts, detailed procedures and documentation involved in financial accounting system.

Learning Aims

The syllabus aims to test the student's ability to:

- Understand the framework of accounting systems and the Generally Accepted Accounting Principles
- Prepare necessary financial statements related to different business entities
- Construct financial statements for understandability and relevance of stakeholders

Skill set required

Level B: Requiring the skill levels of knowledge, comprehension, application and analysis.

Sec-A : Accounting – Basics	**25%**
1. Fundamentals of Accounting	
2. Accounting for Special Transactions	
Sec-B : Preparation of Financial Statements	**40%**
3. Preparation of Final Accounts of Profit Oriented organizations, Non-Profit Organizations and from Incomplete Records.	
4. Partnership Accounts	
Sec-C : Self Balancing Ledgers, Royalties, Hire Purchase & Installment System, Branch & Departmental Accounts	**20%**
5. Self-Balancing Ledgers	
6. Royalties, Hire-Purchase and Installment System	
7. Branch and Departmental Accounts	
Sec-D : Accounting in Computerised Environment and Accounting Standards	**15%**
8. Overview of Computerised Accounting	
9. Accounting Standards (Specified only)	

Section A : Accounting – Basics [25 Marks]

1. Fundamentals of Accounting:

Accounting - Meaning, Scope and Significance of Accounting - Accounting Principles, Concepts and Conventions - Capital and Revenue Transactions – Depreciation - Rectification of Errors.

2. Accounting for Special Transactions

Bills of Exchange - Consignment - Joint Venture - Insurance Claims (Loss of Stock and Loss of Profit).

Section B : Preparation of Financial Statements [40 Marks]

3. Preparation of Final Accounts of Profit Oriented organizations, Non-Profit Organizations and from Incomplete Records

(i) Preparation of Financial statements of Profit Oriented organizations: P&L Account, Balance Sheet.

(ii) Preparation of Financial Statements of Non-Profit making organizations: Preparation of Receipts & Payments Account, Income& Expenditure account and Balance Sheet.

(iii) Preparation of Financial Statements from incomplete records (Single entry)

4. Partnership Accounts

Admission, Retirement, Death, Treatment of Joint Life Policy ,Dissolution of partnership firms including piece meal distribution, Amalgamation of partnership firms, Conversion of partnership firm into a company and sale of partnership firm to a company

Section C: Self Balancing Ledgers, Royalties, Hire Purchase & Installment System, Branch & Departmental Accounts [20 Marks]

5. Self-Balancing Ledgers

6. Royalty Accounts, Hire Purchase and Installment System.

7. Branch and Departmental Accounts.

Section D: Accounting in Computerized Environment and Accounting Standards [15 marks]

8. Computerized Accounting System – Features, Significance, Grouping of Accounts, Ledger hierarchy, Accounting Packages and their selection criteria

9. Accounting Standards (AS-1, AS-2, AS-7, AS-9, AS-6 and AS-10 has been replaced by revised AS-10)

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Study Note - 1

FUNDAMENTALS OF ACCOUNTING

This Study Note includes

1.1 Basics
1.2 Generally Accepted Accounting Principles
1.3 Accounting Concepts and Conventions
1.4 Capital & Revenue Transactions
1.5 Accounting for Depreciation
1.6 Rectification of Errors

1.1 BASICS

Business is an economic activity undertaken with the motive of earning profits and to maximize the wealth for the owners. Business cannot run in isolation. Largely, the business activity is carried out by people coming together with a purpose to serve a common cause. This team is often referred to as an organization, which could be in different forms such as sole proprietorship, partnership, body corporate etc. The rules of business are based on general principles of trade, social values, and statutory framework encompassing national or international boundaries. While these variables could be different for different businesses, different countries etc., the basic purpose is to add value to a product or service to satisfy customer demand.

The business activities require resources (which are limited & have multiple uses) primarily in terms of material, labour, machineries, factories and other services. The success of business depends on how efficiently and effectively these resources are managed. Therefore, there is a need to ensure that the businessman tracks the use of these resources. The resources are not free and thus one must be careful to keep an eye on cost of acquiring them as well.

As the basic purpose of business is to make profit, one must keep an ongoing track of the activities undertaken in course of business. Two basic questions would have to be answered:

(a) What is the result of business operations? This will be answered by finding out whether it has made profit or loss.

(b) What is the position of the resources acquired and used for business purpose? How are these resources financed? Where the funds come from?

The answers to these questions are to be found continuously and the best way to find them is to record all the business activities. Recording of business activities has to be done in a scientific manner so that they reveal correct outcome. The science of book-keeping and accounting provides an effective solution. It is a branch of social science. This study material aims at giving a platform to the students to understand basic principles and concepts, which can be applied to accurately measure performance of business. After studying the various chapters included herein, the student should be able to apply the principles, rules, conventions and practices to different business situations like trading, manufacturing or service.

Over years, the art and science of accounting has evolved together with progress of trade and commerce at national and global levels. Professional accounting bodies have been doing intensive research to come up with accounting rules that will be applicable. Modern business is certainly more complex and continuous updating of these rules is required. Every stakeholder of the business is interested in a particular facet of information about the business. The art and science of accounting helps to put together these requirements of information as per universally accepted principles and also to interpret the results. It is interesting to note that each one of us has an accountant hidden in us. We do see our parents keep track of monthly expenses. We make a distinction between payment done for monthly grocery and that for buying a house or a car. We understand that while grocery is a monthly expense and buying a house is like creating a resource that has indefinite future use. The most common accounting record that each one of us knows is our bank passbook or a bank statement, which the bank maintains for us. It tracks each rupee that we deposit or withdraw from our account. When we go to supermarket to buy something, the cashier at the counter will record things we buy and give us a 'bill' or 'cash memo'. These are source documents prepared for the transaction between the supermarket and us. While these are simple examples, there could be more complex business activities. A good working knowledge of keeping records is therefore necessary. Professional accounting bodies all over the world have been functioning with the objective of providing this body of knowledge. These institutions are engaged in imparting training in the field of accounting. Let us start with some basic definitions, concepts, conventions and practices used in development of this art as well as science.

Definitions

In order to understand the subject matter with clarity, let us study some of the definitions which depict the scope, content and purpose of Accounting. The field of accounting is generally sub-divided into:

(a) Book-keeping

(b) Financial Accounting

(c) Cost Accounting and

(d) Management Accounting

Let us understand each of these concepts.

(a) Book-keeping

The most common definition of book-keeping as given by J. R. Batliboi is "Book-keeping is an art of recording business transactions in a set of books."

As can be seen, it is basically a record keeping function. One must understand that not all dealings are, however, recorded. Only transactions expressed in terms of money will find place in books of accounts. These are the transactions which will ultimately result in transfer of economic value from one person to the other. Book-keeping is a continuous activity, the records being maintained as transactions are entered into. This being a routine and repetitive work, in today's world, it is taken over by the computer systems. Many accounting packages are available to suit different business organizations.

It is also referred to as a set of primary records. These records form the basis for accounting. It is an art because, the record is to be kept in such a manner that it will facilitate further processing and reporting of financial information which will be useful to all stakeholders of the business.

(b) Financial Accounting

It is commonly termed as Accounting. The American Institute of Certified Public Accountants defines Accounting as "an art of recoding, 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."

The first step in the cycle of accounting is to identify transactions that will find place in books of accounts. Transactions having financial impact only are to be recorded. E.g. if a businessman negotiates with the customer regarding supply of products, this will not be recorded. The negotiation is a deal which will potentially create a transaction and will have exchange of money or money's worth. But unless this transaction is finally entered into, it will not be recorded in the books of accounts.

Secondly, the recording of the business transactions is done based on the Golden Rules of accounting (which are explained later) in a systematic manner. Transaction of similar nature are grouped together and recorded accordingly. e.g. Sales Transactions, Purchase Transactions, Cash Transactions etc. One has to interpret the transaction and then apply the relevant Golden Rule to make a correct entry thereof.

Thirdly, as the transactions increase in number, it will be difficult to understand the combined effect of the same by referring to individual records. Hence, the art of accounting also involves the step of summarizing them. With the aid of computers, this task is simplified in today's accounting world. The summarization will help users of the business information to understand and interpret business results.

Lastly, the accounting process provides the users with statements which will describe what has happened to the business. Remember the two basic questions we talked about, one to know whether business has made profit or loss and the other to know the position of resources that are used by the business.

It can be noted that although accounting is often referred to as an art, it is a science also. This is because it is based on universally applicable set of rules. However, it is not a pure science as there is a possibility of different interpretation.

(c) Cost Accounting

According to the Chartered Institute of Management Accountants (CIMA), Cost Accountancy is defined as "application of costing and cost accounting principles, methods and techniques to the science, art and practice of cost control and the ascertainment of profitability as well as the presentation of information for the purpose of managerial decision-making."

It is a branch of accounting dealing with the classification, recording, allocation, summarization and reporting of current and prospective costs and analyzing their behaviours. Cost Accounting is frequently used to facilitate internal decision making and provides tools with which management can appraise performance and control costs of doing business. It primarily involves relating the costs to the different products produced and sold or services rendered by the business. While Financial Accounting deals with business transactions at a broader level, Cost Accounting aims at further breaking it up to the last possible level to indentify costs with products and services. It uses the same Financial Accounting documents and records. Modern computerized accounting packages like ERP systems provide for processing Financial as well as Cost Accounting records simultaneously.

This branch of accounting deals with the process of ascertainment of costs. The concept of cost is always applied with reference to a context. Knowledge of cost concepts and their application provide a very sound platform for decision making. Cost Accounting aims at equipping management with information that can be used for control on business activities.

(d) Management Accounting

Management Accounting is concerned with the use of Financial and Cost Accounting information to managers within organizations, to provide them with the basis in making informed business decisions that would allow them to be better equipped in their management and control functions. Unlike Financial Accounting information (which, for public companies, is public information), Management Accounting information is used within an organization (typically for decision-making) and is usually confidential and its access available only to a selected few.

According to the Chartered Institute of Management Accountants (CIMA), Management Accounting is "the process of identification, measurement, accumulation, analysis, preparation, interpretation and communication of information used by management to plan, evaluate and control within an entity and to assure appropriate use of and accountability for its resources. Management Accounting also comprises the preparation of financial reports for non management groups such as shareholders, creditors, regulatory authorities and tax authorities".

Basically, Management Accounting aims to facilitate management in formulating strategies, planning and constructing business activities, making decisions, optimal use of resources, and safeguarding assets of business.

These branches of accounting have evolved over years of research and are basically synchronized with the requirements of business organizations and all entities associated with them. We will now see what are they and how accounting satisfies various needs of different stakeholders.

Difference between Book-keeping and Accountancy:

The Significant difference between Book-keeping and Accountancy are:

Sl No.	Points of difference	Book Keeping	Accountancy
1.	**Meaning**	Book-keeping is considered as end.	Accountancy is considered as beginning.
2.	**Functions**	The primary stage of accounting function is called Book-keeping.	The overall accounting functions are guided by accountancy.
3	**Depends**	Book-keeping can provide the base of Accounting.	Accountancy depends on Book-keeping for its complete functions.
4.	**Data**	The necessary data about financial performances and financial positions are taken from Book-keeping.	Accountancy can take its decisions, prepare reports and statements from the data taken from Book-keeping.
5.	**Recording of Transactions**	Financial transactions are recorded on the basis of accounting principles, concepts and conventions.	Accountancy does not take any principles, concepts and conventions from Book-keeping.

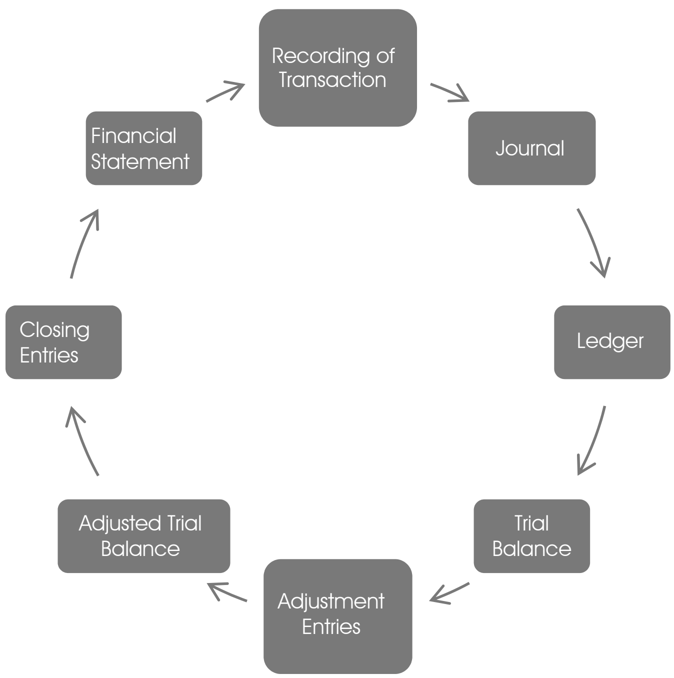
Difference between Management Accounting and Financial Accounting:

The significant difference between Management Accounting and Financial Accounting are:

Management Accounting	Financial Accounting
1. Management Accounting is primarily based on the data available from Financial Accounting.	1. Financial Accounting is based on the monetary transactions of the enterprise.
2. It provides necessary information to the management to assist them in the process of planning, controlling, performance evaluation and decision making.	2. Its main focus is on recording and classifying monetary transactions in the books of accounts and preparation of financial statements at the end of every accounting period.
3. Reports prepared in Management Accounting are meant for management and as per management requirement.	3. Reports as per Financial Accounting are meant for the management as well as for shareholders and creditors of the concern.
4. Reports may contain both subjective and objective figures.	4. Reports should always be supported by relevant figures and it emphasizes on the objectivity of data.
5. Reports are not subject to statutory audit.	5. Reports are always subject to statutory audit.
6. It evaluates the sectional as well as the entire performance of the business.	6. It ascertains, evaluates and exhibits the financial strength of the whole business.

Accounting Cycle

When complete sequence of accounting procedure is done which happens frequently and repeated in same directions during an accounting period, the same is called an accounting cycle.



Accounting Cycle

Steps/Phases of Accounting Cycle

The steps or phases of accounting cycle can be developed as under:

(a) **Recording of Transaction:** As soon as a transaction happens it is at first recorded in subsidiary book.

(b) **Journal:** The transactions are recorded in Journal chronologically.

(c) **Ledger:** All journals are posted into ledger chronologically and in a classified manner.

(d) **Trial Balance:** After taking all the ledger account's closing balances, a Trial Balance is prepared at the end of the period for the preparations of financial statements.

(e) **Adjustment Entries:** All the adjustments entries are to be recorded properly and adjusted accordingly before preparing financial statements.

(f) **Adjusted Trial Balance:** An adjusted Trail Balance may also be prepared.

(g) **Closing Entries:** All the nominal accounts are to be closed by the transferring to Trading Account and Profit and Loss Account.

Financial Statements: Financial statement can now be easily prepared which will exhibit the true financial position and operating results.

Objectives of Accounting

The main objective of Accounting is to provide financial information to stakeholders. This financial information is normally given via financial statements, which are prepared on the basis of Generally Accepted Accounting Principles (GAAP). There are various accounting standards developed by professional accounting bodies all over the world. In India, these are governed by The Institute of Chartered Accountants of India, (ICAI). In the US, the American Institute of Certified Public Accountants (AICPA) is responsible to lay down the standards. The Financial Accounting Standards Board (FASB) is the body that sets up the International Accounting Standards. These standards basically deal with accounting treatment of business transactions and disclosing the same in financial statements.

The following objectives of accounting will explain the width of the application of this knowledge stream:

(a) To ascertain the amount of profit or loss made by the business i.e. to compare the income earned versus the expenses incurred and the net result thereof.

(b) To know the financial position of the business i.e. to assess what the business owns and what it owes.

(c) To provide a record for compliance with statutes and laws applicable.

(d) To enable the readers to assess progress made by the business over a period of time.

(e) To disclose information needed by different stakeholders.

Let us now see which are different stakeholders of the business and what do they seek from the accounting information. This is shown in the following table.

Stakeholder	**Interest in business**	**Accounting Information**
O wners / Inv es tors / existing and potential	Profits or losses	Financial statements, Cost Accounting records, Management Accounting reports
Lenders	Assessment of capability of the business to pay interest and principal of money lent. Basically, they monitor the solvency of business	Financial statement and analysis thereof, reports forming part of accounts, valuation of assets given as security
Customers and suppliers	Stability and growth of the business	Financial and Cash flow statements to assess ability of the business to offer better business terms and ability to supply the products and services
Government	Whether the business is complying with various legal requirements	Accounting documents such as vouchers, extracts of books, information of purchase, sales, employee obligations etc. and financial statements
Employees and trade unions	Growth and profitability	Financial statements for negotiating pay packages
Competitors	Performance and possible tie-ups in the era of mergers and acquisitions	Accounting information to find out possible synergies

Users of Accounting Information

Accounting provides information both to internal users and the external users. The internal users are all the organizational participants at all levels of management (i.e. top, middle and lower). Generally top level management requires information for planning, middle level management which requires information for controlling the operations. For internal use, the information is usually provided in the form of reports, for instance Cash Budget Reports, Production Reports, Idle Time Reports, Feedback Reports, whether to retain or replace an equipment decision reports, project appraisal report, and the like.

There are also the external users (e.g. Banks, Creditors). They do not have direct access to all the records of an enterprise, they have to rely on financial statements as the source of information. External users are basically, interested in the solvency and profitability of an enterprise.

Types of Accounting Information

Accounting information may be categorized in number of ways on the basis of purpose of accounting information, on the basis of measurement criteria and so on. The various types of accounting information are given below:

I. Accounting information relating to financial transactions and events.

(a) Financial Position- Information about financial position is primarily provided in a Balance Sheet. The financial position of an enterprise is affected by different factors, like -

(i) Information about the economic resources controlled by the enterprise and its capacity in the past to alter these resources is useful in predicting the ability of the enterprise to generate cash and cash equivalents in the future.

(ii) Information about financial structure is useful in predicting future borrowing needs and how future profits and cash flows will be distributed among those with an interest in the enterprise; it is also useful in predicting how successful the enterprise is likely to be in raising further finance.

(iii) Information about liquidity and solvency is useful in predicting the ability of the enterprise to meet its financial commitments as they fall due. Liquidity refers to the availability of cash in the near future to meet financial commitments over this period. Solvency refers to the availability of cash over the longer term to meet financial commitments as they fall due.

(b) Financial Performance- Information about financial performance is primarily provided in a Statement of Profit and Loss which is also known as Income Statement.

Information about the performance of an enterprise and its profitability, is required in order to assess potential changes taking place in the economic resources that it is likely to control in the future. Information about variability of performance is also important in this regard. Information about performance is necessary in predicting the capacity to generate cash flows from its available resource. It is an important input in forming judgments about the effectiveness of an enterprise to utilize resources.

(c) Cash Flows—Information about cash flows is provided in the financial statements by means of a cash flow statement.

Information concerning cash flows is useful in providing the users with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash and cash equivalent.

These information may be classified as follows:

(i) on the basis of Historical Cost,

(ii) on the basis of Current Cost,

(iii) on the basis of Realizable Value,

(iv) on the basis of Present Value

II. Accounting information relating to cost of a product, operation or function.

III. Accounting information relating to planning and controlling the activities of an enterprise for internal reporting.

This information may further be classified as follows:

(i) Information relating to Finance Area

(ii) Information relating to Production Area

(iii) Information relating to Marketing Area

(iv) Information relating to Personnel Area

(v) Information relating to Other Areas (such as Research & Development).

IV. Accounting information relating to Social Effects of business decisions.

V. Accounting information relating to Environment and Ecology.

VI. Accounting information relating to Human Resources.

Basic Accounting Terms

In order to understand the subject matter clearly, one must grasp the following common expressions always used in business accounting. The aim here is to enable the student to understand with these often used concepts before we embark on accounting procedures and rules. You may note that these terms can be applied to any business activity with the same connotation.

(i) Transaction: It means an event or a business activity which involves exchange of money or money's worth between parties. The event can be measured in terms of money and changes the financial position of a person e.g. purchase of goods would involve receiving material and making payment or creating an obligation to pay to the supplier at a future date. Transaction could be a cash transaction or credit transaction. When the parties settle the transaction immediately by making payment in cash or by cheque, it is called a cash transaction. In credit transaction, the payment is settled at a future date as per agreement between the parties.

(ii) Goods/Services : These are tangible article or commodity in which a business deals. These articles or commodities are either bought and sold or produced and sold. At times, what may be classified as 'goods' to one business firm may not be 'goods' to the other firm. e.g. for a machine manufacturing company, the machines are 'goods' as they are frequently made and sold. But for the buying firm, it is not 'goods' as the intention is to use it as a long term resource and not sell it. Services are intangible in nature which are rendered with or without the object of earning profits.

(iii) Profit: The excess of Revenue Income over expense is called profit. It could be calculated for each transaction or for business as a whole.

(iv) Loss: The excess of expense over income is called loss. It could be calculated for each transaction or for business as a whole.

(v) Asset: Asset is a resource owned by the business with the purpose of using it for generating future profits. Assets can be Tangible and Intangible. Tangible Assets are the Capital assets which have some physical existence. They can, therefore, be seen, touched and felt, e.g. Plant and Machinery, Furniture and Fittings, Land and Buildings, Books, Computers, Vehicles, etc. The capital assets which have no physical existence and whose value is limited by the rights and anticipated benefits that possession confers upon the owner are known as Intangible Assets. They cannot be seen or felt although they help to generate revenue in future, e.g. Goodwill, Patents, Trade-marks, Copyrights, Brand Equity, Designs, Intellectual Property, etc.

Assets can also be classified into Current Assets and Non-Current Assets.

Current Assets – An asset shall be classified as Current when it satisfies any of the following :

(a) It is expected to be realised in, or is intended for sale or consumption in the Company's normal Operating Cycle,

(b) It is held primarily for the purpose of being traded ,

(c) It is due to be realised within 12 months after the Reporting Date, or

(d) It is Cash or Cash Equivalent unless it is restricted from being exchanged or used to settle a Liability for at least 12 months after the Reporting Date.

Non-Current Assets – All other Assets shall be classified as Non-Current Assets. e.g. Machinery held for long term etc.

(vi) **Liability:** It is an obligation of financial nature to be settled at a future date. It represents amount of money that the business owes to the other parties. E.g. when goods are bought on credit, the firm will create an obligation to pay to the supplier the price of goods on an agreed future date or when a loan is taken from bank, an obligation to pay interest and principal amount is created. Depending upon the period of holding, these obligations could be further classified into Long Term on non-current liabilities and Short Term or current liabilities.

Current Liabilities – A liability shall be classified as Current when it satisfies any of the following :

(a) It is expected to be settled in the Company's normal Operating Cycle,

(b) It is held primarily for the purpose of being traded,

(c) It is due to be settled within 12 months after the Reporting Date, or

(d) The Company does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date (Terms of a Liability that could, at the option of the counterparty, result in its settlement by the issue of Equity Instruments do not affect its classification)

Non-Current Liabilities – All other Liabilities shall be classified as Non-Current Liabilities. E.g. Loan taken for 5 years, Debentures issued etc.

(vii) **Internal Liability :** These represent proprietor's equity, i.e. all those amount which are entitled to the proprietor, e.g., Capital, Reserves, Undistributed Profits, etc.

(viii) **Working Capital :** In order to maintain flows of revenue from operation, every firm needs certain amount of current assets. For example, cash is required either to pay for expenses or to meet obligation for service received or goods purchased, etc. by a firm. On identical reason, inventories are required to provide the link between production and sale. Similarly, Accounts Receivable generate when goods are sold on credit. Cash, Bank, Debtors, Bills Receivable, Closing Stock, Prepayments etc. represent current assets of firm. The whole of these current assets form the working capital of a firm which is termed as Gross Working Capital.

Gross Working Capital = Total Current Assets

= Long term internal liabilities plus long term debts plus the current liabilities minus the amount blocked in the fixed assets.

There is another concept of working capital. Working capital is the excess of current assets over current liabilities. That is the amount of current assets that remain in a firm if all its current liabilities are paid. This concept of working capital is known as Net Working Capital which is a more realistic concept.

Working Capital (Net) = Current Assets – Currents Liabilities.

(ix) **Contingent Liability :** It represents a potential obligation that could be created depending on the outcome of an event. E.g. if supplier of the business files a legal suit, it will not be treated as a liability because no obligation is created immediately. If the verdict of the case is given in favour of the supplier then only the obligation is created. Till that it is treated as a contingent liability. Please note that contingent liability is not recorded in books of account, but disclosed by way of a note to the financial statements.

(x) **Capital :** It is amount invested in the business by its owners. It may be in the form of cash, goods, or any other asset which the proprietor or partners of business invest in the business activity. From business point of view, capital of owners is a liability which is to be settled only in the event of closure or transfer of the business. Hence, it is not classified as a normal liability. For corporate bodies, capital is normally represented as share capital.

(xi) **Drawings :** It represents an amount of cash, goods or any other assets which the owner withdraws from business for his or her personal use. e.g. if the life insurance premium of proprietor or a partner of business is paid from the business cash, it is called drawings. Drawings will result in reduction in the owners' capital. The concept of drawing is not applicable to the corporate bodies like limited companies.

(xii) **Net worth :** It represents excess of total assets over total liabilities of the business. Technically, this amount is available to be distributed to owners in the event of closure of the business after payment of all liabilities.

That is why it is also termed as Owner's Equity. A profit making business will result in increase in the owner's equity whereas losses will reduce it.

(xiii) Non-current Investments : Non-current Investments are investments which are held beyond the current period as to sale or disposal. e. g. Fixed Deposit for 5 years.

(xiv) Current Investments : Current investments are investments that are by their nature readily realizable and are intended to be held for not more than one year from the date on which such investment is made. e. g. 11 months Commercial Paper.

(xv) Debtor : The sum total or aggregate of the amounts which the customer owe to the business for purchasing goods on credit or services rendered or in respect of other contractual obligations, is known as Sundry Debtors or Trade Debtors, or Trade Receivable, or Book-Debts or Debtors. In other words, Debtors are those persons from whom a business has to recover money on account of goods sold or service rendered on credit. These debtors may again be classified as under:

(i) Good debts : The debts which are sure to be realized are called good debts.

(ii) Doubtful Debts : The debts which may or may not be realized are called doubtful debts.

(iii) Bad debts : The debts which cannot be realized at all are called bad debts.

It must be remembered that while ascertaining the debtors balance at the end of the period certain adjustments may have to be made e.g. Bad Debts, Discount Allowed, Returns Inwards, etc.

(xvi) Creditor : A creditor is a person to whom the business owes money or money's worth. e.g. money payable to supplier of goods or provider of service. Creditors are generally classified as Current Liabilities.

(xvii) Capital Expenditure: This represents expenditure incurred for the purpose of acquiring a fixed asset which is intended to be used over long term for earning profits there from. e. g. amount paid to buy a computer for office use is a capital expenditure. At times expenditure may be incurred for enhancing the production capacity of the machine. This also will be a capital expenditure. Capital expenditure forms part of the Balance Sheet.

(xviii) Revenue expenditure: This represents expenditure incurred to earn revenue of the current period. The benefits of revenue expenses get exhausted in the year of the incurrence. e.g. repairs, insurance, salary & wages to employees, travel etc. The revenue expenditure results in reduction in profit or surplus. It forms part of the Income Statement.

(xix) Balance Sheet: It is the statement of financial position of the business entity on a particular date. It lists all assets, liabilities and capital. It is important to note that this statement exhibits the state of affairs of the business as on a particular date only. It describes what the business owns and what the business owes to outsiders (this denotes liabilities) and to the owners (this denotes capital). It is prepared after incorporating the resulting profit/losses of Income Statement.

(xx) Profit and Loss Account or Income Statement: This account shows the revenue earned by the business and the expenses incurred by the business to earn that revenue. This is prepared usually for a particular accounting period, which could be a month, quarter, a half year or a year. The net result of the Profit and Loss Account will show profit earned or loss suffered by the business entity.

(xxi) Trade Discount: It is the discount usually allowed by the wholesaler to the retailer computed on the list price or invoice price. e.g. the list price of a TV set could be ₹ 15000. The wholesaler may allow 20% discount thereof to the retailer. This means the retailer will get it for ₹ 12000 and is expected to sale it to final customer at the list price. Thus the trade discount enables the retailer to make profit by selling at the list price. Trade discount is not recorded in the books of accounts. The transactions are recorded at net values only. In above example, the transaction will be recorded at ₹ 12000 only.

(xxii) Cash Discount: This is allowed to encourage prompt payment by the debtor. This has to be recorded in the books of accounts. This is calculated after deducting the trade discount. e.g. if list price is ₹ 15000 on which a trade discount of 20% and cash discount of 2% apply, then first trade discount of ₹ 3000 (20% of ₹ 15000) will be deducted and the cash discount of 2% will be calculated on ₹ 12000 (₹15000 – ₹ 3000). Hence the cash discount will be ₹ 240/- (2% of ₹ 12000) and net payment will be ₹ 11,760 (₹12,000 - ₹ 240)

Let us see if we can apply these in the following illustrations.

Illustration 1.

Fill in the blanks:

(a) The cash discount is allowed by_______to the_____.

(b) Profit means excess of__________over________.

(c) Debtor is a person who _______ to others.

(d) In a credit transaction, the buyer is given a___facility.

(e) The fixed asset is generally held for_____.

(f) The current liabilities are obligations to be settled in_____ period.

(g) The withdrawal of money by the owner of business is called ________________.

(h) The amount invested by owners into business is called __________.

(i) Transaction means exchange of money or money's worth for __________.

(j) The net result of an income statement is or______________.

(k) The_______shows financial position of the business as on a particular date.

(l) The_______discount is never entered in the books of accounts.

(m) Vehicles represent_________expenditure while repairs to vehicle would mean__________expenditure.

(n) Net worth is excess of_____________ ___________ over _______________ ______________.

Solution:

(a) creditor, debtor

(b) income, expenditure

(c) Owes

(d) Credit

(e) Longer period

(f) Short

(g) Drawings

(h) Capital

(i) Value

(j) Profit, loss

(k) Balance sheet

(l) Trade

(m) Capital, revenue

(n) Total assets, total liabilities

Illustration 2.

Give one word or a term used to describe the following:-

(a) An exchange of benefit for value

(b) A transaction without immediate cash settlement.

(c) Commodities in which a business deals.

(d) Excess of expenditure over income.

(e) Things of value owned by business to earn future profits.

(f) Amount owed by business to others.

(g) An obligation which may or may not materialise.

(h) An allowance by a creditor to debtor for prompt payment.

(i) Assets like brand value, copy rights, goodwill.

Solution:

(a) Transaction, (b) Credit transaction, (c) Goods, (d) Loss, (e) Assets, (f) Liability, (g) Contingent Liability, (h) Cash Discount, (i) Intangible Asset.

1.2 GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

A widely accepted set of rules, conventions, standards, and procedures for reporting financial information, as established by the Financial Accounting Standards Board are called Generally Accepted Accounting Principles (GAAP). These are the common set of accounting principles, standards and procedures that companies use to compile their financial statements. GAAP are a combination of standards (set by policy boards) and simply the commonly accepted ways of recording and reporting accounting information.

GAAP is to be followed by companies so that investors have a optimum level of consistency in the financial statements they use when analyzing companies for investment purposes. GAAP cover such aspects like revenue recognition, balance sheet item classification and outstanding share measurements.

1.3 ACCOUNTING CONCEPTS AND CONVENTIONS

As seen earlier, the accounting information is published in the form of financial statements. The three basic financial statements are

(i) The Profit & Loss Account that shows net business result i.e. profit or loss for a certain periods.

(ii) The Balance Sheet that exhibits the financial strength of the business as on a particular dates.

(iii) The Cash Flow Statement that describes the movement of cash from one date to the other.

As these statements are meant to be used by different stakeholders, it is necessary that the information contained therein is based on definite principles, concrete concepts and well accepted convention.

Accounting principles are basic guidelines that provide standards for scientific accounting practices and procedures. They guide as to how the transactions are to be recorded and reported. They assure uniformity and understandability. Accounting concepts lay down the foundation for accounting principles. They are ideas essentially at mental level and are self-evident. These concepts ensure recording of financial facts on sound bases and logical considerations. Accounting conventions are methods or procedures that are widely accepted. When transactions are recorded or interpreted, they follow the conventions. Many times, however, the terms-principles, concepts and conventions are used interchangeably.

Professional Accounting Bodies have published statements of these concepts. Over years, many of these concepts are being challenged as outlived. Yet, no major deviations have been made as yet. Path breaking ideas have emerged and the accounting standards of modern days do require companies to record and report transactions which may not be necessarily based on concepts that are in vogue for long. It is essential to study accounting from the basic levels and understand these concepts in entirety.

Theory Base of Accounting

Basic Assumptions
- (a) Business Entity Concept
- (b) Going Concern Concept
- (c) Money Measurement Concept
- (d) Accounting Period Concept
- (e) Accrual Concept

Basic Principles
- (a) Revenue Realization Concpet
- (b) Matching Concept
- (c) Full Disclosure Concept
- (d) Dual Aspect Concept
- (e) Verifiable Objective Evidence Concpet
- (f) Historical Cost Concept
- (g) Balance Sheet Equation Concpet

Modifying Principles
- (a) Materiality Concept
- (b) Consistency Concept
- (c) Conservatism Concpet
- (d) Timeliness Concept
- (e) Industry Practice Concept

A. BASIC ASSUMPTIONS

(a) Business Entity Concept

As per this concept, the business is treated as distinct and separate from the individuals who own or manage it. When recording business transactions, the important question is how will it affect the business entity? How they affect the persons who own it or run it or otherwise associated with it is irrelevant. Application of this concept enables recording of transactions of the business entity with its owners or managers or other stakeholders. For example, if the owner pays his personal expenses from business cash, this transaction can be recorded in the books of business entity. This transaction will take the cash out of business and also reduce the obligation of the business towards the owner.

At times it is difficult to separate owners from the business. Consider an individual, who runs a small retail outlet. In the eyes of law, there is no distinction made between financial affairs of the outlet with that of the individual. The creditors of the retail outlet can sue the individual and collect his claim from personal resources of the individual. However, in accounting, the records are kept as distinct for the retail outlet and the individual respectively. For certain forms of business entities, such as limited companies this distinction is easier. The limited companies are separate legal persons in the eyes of law as well.

The entity concept requires that all the transactions are to be viewed, interpreted and recorded from 'business entity' point of view. An accountant steps into the shoes of the business entity and decides to account for the transactions. The owner's capital is the obligation of business and it has to be paid back to the owner in the event of business closure. Also, the profit earned by the business will belong to the owner and hence is treated as owner's equity.

(b) Going Concern Concept

The basic principles of this concept is that business is assumed to exist for an indefinite period and is not established with the objective of closing it down. So unless there is good evidence to the contrary, the accountant assumes that a business entity is a 'going concern' - that it will continue to operate as usual for a longer period of time. It will keep getting money from its customers, pay its creditors, buy and sell goods, use assets to earn profits in future. If this assumption is not considered, one will have to constantly value the worth of the assets and resource. This is not practicable. This concept enables the accountant to carry forward the values of assets and liabilities from one accounting period to the other without asking the question about usefulness and worth of the assets and recoverability of the receivables.

The going concern concept forms a sound basis for preparation of a Balance Sheet.

(c) Money Measurement Concept

A business transaction will always be recoded if it can be expressed in terms of money. The advantage of this concept is that different types of transactions could be recorded as homogenous entries with money as common denominator. A business may own ₹ 3 Lacs cash, 1500 kg of raw material, 10 vehicles, 3 computers etc. Unless each of these is expressed in terms of money, we cannot find out the assets owned by the business. When expressed in the common measure of money, transactions could be added or subtracted to find out the combined effect. In the above example, we could add values of different assets to find the total assets owned.

The application of this concept has a limitation. When transactions are recorded in terms of money, we only consider the absolute value of the money. The real value of the money may fluctuate from time to time due to inflation, exchange rate changes, etc. This fact is not considered when recording the transaction.

(d) The Accounting Period Concept

We have seen that as per the going-concern concept the business entity is assumed to have an indefinite life. Now if we were to assess whether the business has made profit or loss, should we wait until this indefinite period is over? Would it mean that we will not be able to assess the business performance on an ongoing basis? Does it deprive all stakeholders the right to the accounting information? Would it mean that the business will not pay income tax as no income will be computed?

To circumvent this problem, the business entity is supposed to be paused after a certain time interval. This time interval is called an accounting period. This period is usually one year, which could be a calendar year i.e. 1st January to 31st December or it could be a fiscal year in India as 1st April to 31st March. The business organizations have the freedom to choose their own accounting year. For certain organizations, reporting of financial information in public domain are compulsory. In India, listed companies must report their quarterly unaudited financial results and yearly audited financial statements. For internal control purpose, many organizations prepare monthly financial statements. The modern computerized accounting systems enable the companies to prepare real-time online financials at the click of button.

Businesses are living, continuous organisms. The splitting of the continuous stream of business events into time periods is thus somewhat arbitrary. There is no significant change just because one accounting period ends and a new one begins. This results into the most difficult problem of accounting of how to measure the net income for an accounting period. One has to be careful in recognizing revenue and expenses for a particular accounting period. Subsequent section on accounting procedures will explain how one goes about it in practice.

(e) The Accrual Concept

The accrual concept is based on recognition of both cash and credit transactions. In case of a cash transaction, owner's equity is instantly affected as cash either is received or paid. In a credit transaction, however, a mere obligation towards or by the business is created. When credit transactions exist (which is generally the case), revenues are not the same as cash receipts and expenses are not same as cash paid during the period.

When goods are sold on credit as per normally accepted trade practices, the business gets the legal right to claim the money from the customer. Acquiring such right to claim the consideration for sale of goods or services is called accrual of revenue. The actual collection of money from customer could be at a later date.

Similarly, when the business procures goods or services with the agreement that the payment will be made at a future date, it does not mean that the expense effect should not be recognized. Because an obligation to pay for goods or services is created upon the procurement thereof, the expense effect also must be recognized.

Today's accounting systems based on accrual concept are called as Accrual System or Mercantile System of Accounting.

B. BASIC PRINCIPLES

(a) The Revenue Realisation Concept

While the conservatism concept states whether or not revenue should be recognized, the concept of realisation talks about what revenue should be recognized. It says amount should be recognized only to the tune of which it is certainly realizable. Thus, mere getting an order from the customer won't make it eligible to recognize as revenue. The reasonable certainty of realizing the money will come only when the goods ordered are actually supplied to the customer and he is billed. This concept ensures that income unearned or unrealized will not be considered as revenue and the firms will not inflate profits.

Consider that a store sales goods for ₹ 25 lacs during a month on credit. The experience and past data shows that generally 2% of the amount is not realized. The revenue to be recognized will be ₹ 24.50 lacs. Although conceptually the revenue to be recognized at this value, in practice the doubtful amount of ₹ 50 thousand (2% of ₹ 25 lacs) is often considered as expense.

(b) The Matching Concept

As we have seen the sale of goods has two effects: (i) a revenue effect, which results in increase in owner's equity by the sales value of the transaction and (ii) an expense effect, which reduces owner's equity by the cost of goods sold, as the goods go out of the business. The net effect of these two effects will reflect either profit or loss. In order to correctly arrive at the net result, both these aspects must be recognized during the same accounting period. One cannot recognize only the revenue effect thereby inflating the profit or only the expense effect which will deflate the profit. Both the effects must be recognized in the same accounting period. This is the principle of matching concept.

To generalize, when a given event has two effects – one on revenue and the other on expense, both must be recognized in the same accounting period.

(c) Full Disclosure Concept

As per this concept, all significant information must be disclosed. Accounting data should properly be clarified, summarized, aggregated and explained for the purpose of presenting the financial statements which are useful for the users of accounting information. Practically, this principle emphasizes on the materiality, objectivity and consistency of accounting data which should disclose the true and fair view of the state of affairs of a firm. This principle is going to be popular day by day as per Companies Act, 1956 major provisions for disclosure of essential information about accounting data and as such, concealment of material information, at present, is not very easy. Thus, full disclosure must be made for such material information which are useful to the users of accounting information.

(d) Dual Aspect Concept

The assets represent economic resources of the business, whereas the claims of various parties on business are called obligations. The obligations could be towards owners (called as owner's equity) and towards parties other than the owners (called as liabilities).

When a business transaction happens, it will involve use of one or the other resource of the business to create or settle one or more obligations. e.g. consider Mr. Suresh starts a business with the investment of ₹ 25 lacs. Here, the business has got a resource of cash worth ₹ 25 lacs (which is its asset), but at the same time it has created an obligation of business towards Mr. Suresh that in the event of business closure, the money will be paid back to him. This could be shown as:

Assets = **Liabilities** + **Capital**

In other words,

Cash brought in by Mr. Suresh (₹ 25 lacs) = Liability of business towards Mr. Suresh (₹ 25 lacs)

We know that liability of the business could be towards owners and parties other than owners, this equation could be re-written as:

Assets = **Liabilities** + **Owner's equity**

Cash ₹ 25,00,000 = **Liabilities ₹ nil** + **Mr. Suresh's equity ₹ 25,00,000**

This is the fundamental accounting equation shown as formal expression of the dual aspect concept. This powerful concept recognizes that every business transaction has dual impact on the financial position. Accounting systems are set up to simultaneously record both these aspects of every transaction; that is why it is called as Double-entry system of accounting. In its present form the double entry system of accounting owes its existence to an Italian expert Mr. Luca Pacioli in the year 1495.

Continuing with our example of Mr. Suresh, now let us consider he borrows ₹ 15 lacs from bank. The dual aspect of this transaction-on one hand the business cash will increase by ₹ 15 lacs and a liability towards the bank will be created for ₹ 15 lacs.

Assets = Liabilities + **Owner's equity**

Cash ₹ 40,00,000 = **Liabilities ₹ 15,00,000** + **Mr. Suresh's equity ₹ 25,00,000**