Notes [redacted]

FINANCIAL ACCOUNTING

Module - I

Fundamentals of Accounting

Accounting as a business function

Primary functions : Production (or purchasing)
Sales

Support functions : Personnel
Administration
Accounting

Accounting is a support function of business. It provides information for decision making. Through accounting business organisations can assess ~~the~~ & evaluate their performance.

Accounting as the language of business

Accounting is the language of business as it is the means of communication for business. It reports about the performance & health of business enterprise. Languages evolve & change in response to changing needs of the society & so does accounting. Thus one has to learn the language of business to become eligible to work effectively in the accounting department of any business organisation.

Definition and meaning of Accounting

"The art of recording, classifying & summarising in a significant manner and in terms of money transactions & events which are in parts at least of a financial character & interpreting the result thereof."

Given by American Institute of certified Public Accountants (AICPA)

Objectives & Functions of Accounting

1) To maintain systematic records

The first function of accounting is to keep systematic record of business transactions to provide information to the users of accounting.

2) To ascertain profit or loss

Accounting ascertains the net results of business operations during a particular period by preparing profit & loss account.

3) To ascertain the health of the business

Through accounting the financial position of the business can be ascertained by preparing the balance sheet

4) To provide accounting information to users

The function of accounting is to communicate accounting information to the interested parties.

Users of Accounting information

External Users of Accounting

1) Investors

Those who are interested in investing money in an organisation ~~to Know~~ are interested in knowing the financial health of the organisation to know how safe the investment already made is and how safe their proposed investment will be. To know the financial health & financial position of the concern accounting information are essential.

2) Creditors

Creditors like suppliers & bankers are also interested to know the financial position of a concern before giving loans or granting credits. Creditors need accounting information relating to current assets, quick assets & current liabilities to be satisfied with the liquidity position of the concern.

3) Members of Non-profit Organisation

Members of non profit organisations such as schools & colleges, clubs etc need accounting information to know how their contributed funds are being utilised & to ascertain if the organisation deserves continued support or support should be withdrawn depending upon profit & service to the society.

4) Government -

Central & state governments are interested in accounting information because they want to know earnings or sales for a particular period for purposes of taxation.

5) Consumers

Consumers need accounting information for establishing good accounting control so that cost of production may be reduced with the resultant reduction of prices of goods they buy.

6) Research scholar

Accounting information, being a mirror of the financial performance of a business organisation, is of immense value to research scholar who wants to make a study into the financial operations

Internal Users

1. **Owners**

The owners are interested to know the profitability & the financial position of the concern in which they have invested their funds so accounting information are very important for them.

2. **Management**

Accounting information is an aid to the management so as to compare the ~~acq~~ actual performance of the employees with the budgeted performance they are expected to achieve & remedial action can be taken if actual performance is not upto the mark.

3. **Employees**

Employees are interested in the financial position of a concern they serve particularly when payment of bonus depends upon the size of the profits earned.

Limitations of Accounting

1) Records only monetary transactions

Accounting only records events which are of financial nature and completely excludes non financial data. Thus it does not show a complete picture.

2) Historical in nature

The accounting records are based on historical cost & thus do not reflect current values of assets.

3) Permits alternative treatments

Accounting allows the use of different methods & this may lead to different results. For ex depreciation can be calculated by different methods.

4) Effect of price level changed not considered

Accounting transactions are recorded at cost but when the values of assets change due to inflation this is not recorded in accounting books.

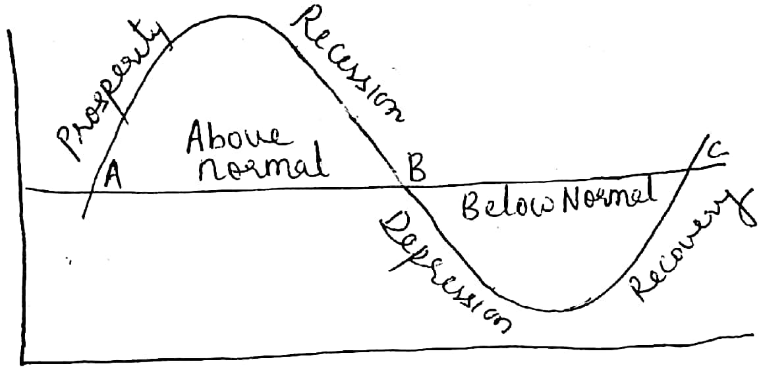
5) Does not provide timely information for decision making

Accounting information are supplied periodically & not at regular intervals ~~for~~ which is required for accounting users. Thus accounting fails to provide timely

Scanned by CamScanner

Cyclical Nature of Business & Accounting Cycle

A business cycle can be defined as wave like fluctuations of business activity characterised by recurring phases of expansions & contractions in periods varying from 3 to 4 years.



Prosperity / Expansion

- → Rising profits
- → Demand for Raw materials
- → Rise in production
- → Increase in demand
- → Rapid Increase in supply
- → Modest Increase in prices

~~Depression / Contraction~~

Recession

- → Forces of expansion weaken
- → Forces of Contraction strengthen
- → Liquidation in the stock market
- → strains in banking system
- → Liquidation of bank loans
- → Fall in prices

→ Sharp reduction in demand for capital equipment
→ Abandoning of relatively new project

Depression / Contraction

→ Relatively low economic activity
→ Fall in productions of goods & services
→ Fall in ~~exp~~ employment
→ Demand for consumer goods decline
→ Substantial Reduction in Income
→ Fall in general price level
→ Liquidation of inventories by wholesalers & producers.
→ Declining profits

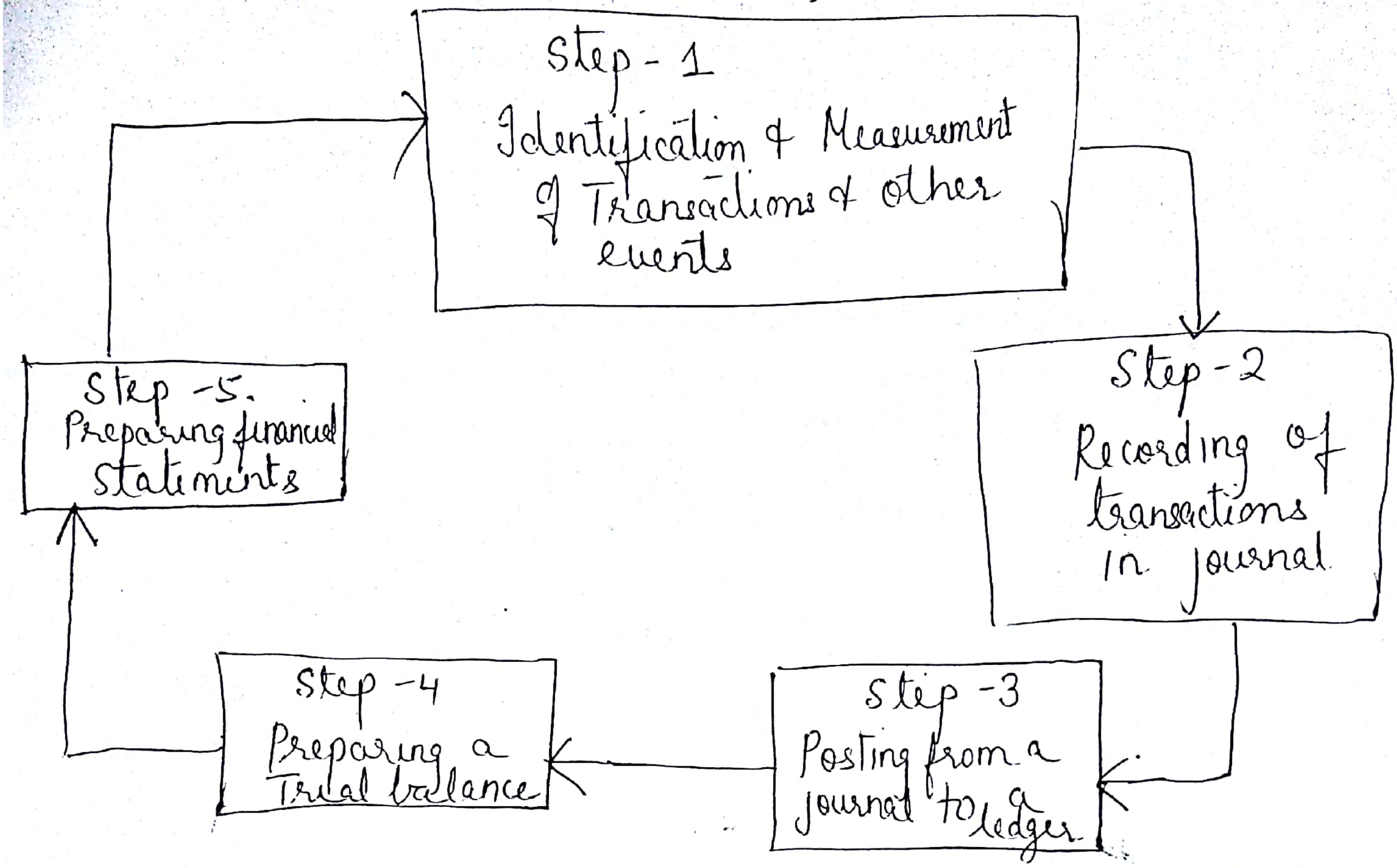
Recovery

→ Scarcity in availability of goods & services
→ Fall in prices gradually stops
→ With increase in business prospects some firms go for larger investment
→ Correction of distortion in cost price relations
→ ~~Restore~~ Forces try to restore normal prices.

Accounting Cycle

The sequence of accounting procedures used to record, classify & summarise ~~ac~~ accounting information is known as accounting cycle.

Sequence of accounting Cycle



1) Identification of Accounting Cycle

Analysis of Transactions & other events to know what shall be recorded.

2) Record transactions in the journal

Journal is a chronological record of transactions & events.

3) Post to ledger accounts

The events recorded in journal are classified into meaningful groups & posted to the ledger.

4) Prepare a trial balance

The purpose of preparing a trial balance is to verify the accuracy of the posting process and the computation of ledger account balances.

5) Prepare financial statements

These are summary statements prepared for specific purposes. For ex balance sheet, P/L a/c

Accounting Concepts as Applicable to Balance Sheet & Income statement / Generally Accepted Accounting principles (GAAP)

Concept is defined as the basic assumptions or conditions upon which the accounting is based.

1) Business Entity Concept

Business ~~ent~~ entity means a unit of organised business activity. In accounting business is treated as separate and distinct from its owners. Business is treated as an artifical person with a separate legal entity. The owner of the business is treated as a creditor of the business & his contribution is called capital.

2) Money measurement concept

The basic unit of measurement in accounting is money. Money is the only factor common to all business transactions. ~~Heteg~~ Heterogenous facts about a business entity can be expressed in monetary terms that can be added & substracted. Another implication is that only those transactions are recorded in the ... expressed in terms of money

3) Going Concern Concept

Going Concern concept assumes that the business will continue to operate for an indefinitely long period in future irrespective of change in its ownership. The major implication is that fixed assets are valued at original cost & are depreciated in a systematic manner. Suppliers will not supply goods on credit & other parties may not do business with the business unless it is pressumed to be a going concern

4) Cost Concept

Cost is defined as the expenditure incurred for acquiring an asset or service. This principle states that the assets & services are recorded at their purchase cost & the accounting record should be based on cost rather than on current market value. But the real worth of assets change with passage of time.

5) Realisation Concept

According to this principle any change in the value of an asset should only be recognised at the time the firm realises or disposes of the asset because there is no certainty of income

6) Accrual Concept

Accrual implies earning an income (whether received or not) & incurring an expenditure (whether paid or not in an accounting period. This concept recognises income when it is earned rather than when it is collected. Similarly this concept recognises expenses when it is incurred rather than when it is paid for.

7) Periodicity Concept / Accounting period concept

This concept assumes a definite accounting period. To know the performance & health of the business the company's long life is divided into definite accounting periods generally one year. In India the financial year is from 1st April to 31st march.

8) Matching Concept

This concept helps to match the expenses with the revenues to find out profits or losses. This is done to determine the result of business operation

9) Dual Aspect Concept

This concept states that every transaction or event in accounting has two aspects one receiving aspect another giving aspect. This principle is the core of double entry book keeping & this gives rise to fundamental accounting equation: Asset = Liabilities + Capital.

10) Consistency Concept / Convention

According to this concept once the method of treatment is decided by the enterprise it will be same for all other subsequent events & transactions till there is a sound reason to change

Scanned by CamScanner

11) Conservatism (Prudence) Concept / Convention

This principle states that anticipate no profits or gains till they are realised but provide for all possible losses. This concept tries to ensure adequate-
ly the risk and uncertainties inherent in the business. Ex Making provision for bad debts & Valuing goods at cost price or market price whichever is less.

12) Objective evidence concept

This principle ensures that accounting transactions should be supported by objective evidences ie business documents which are verified & free from personal bias. Ex bank statements., cash memos, invoices etc. This principle helps to minimise possibility of errors & frauds.

13) Revenue recognition concept

According to this concept revenue is considered as earned on the date when it is realised. Revenue is realised by sale of goods or by rendering of services.

14) Materiality Concept / Convention

Information is material if its non-disclosure could influence the economic decisions of users taken on the basis of financial statements. The transaction having significant effect on the business is material. Events of relatively small importance [illegible] ignored.

15) Full disclosure Concept | Convention

According to this principle all significant information relating to the economic affairs of the business organisation should be reported fully on the financial statiments. These information help the parties to take their decisions.

Scanned by CamScanner

Nature of GAAP

1) Accounting Principles are Man Made

These are the best possible solutions / suggestions based on practical experiences. They are recommended for use by all enterprises to ensure uniformity and understandability.

2) Accounting principles are flexible

These principles change as per the requirement of the situation. Whenever decisions are to be taken it is taken by the accountants which ultimately becomes the generally accepted accounting principle.

3) Accounting principles change with time

Accounting principles are not permanent and change with time as per the law and custom prevailing in a country.

4) Accounting principles are generally Accepted

Accounting principles are the base and guide for accounting and are generally accepted depending on relevance, objectivity and feasibility of the principle.

Relevance means they result in information that is useful to the users of accounting information.
Objective means they are not influenced by the personal bias of the persons preparing the accounting information.
Feasibility means if they can be applied without undue complexity and cost.

Accounting standards

The Accounting standards are a set of guidelines issued by accounting body of a country that are followed for preparation and presentation of financial statements.
Kohler has defined Accounting standards as "a mode of conduct ~~to~~ imposed on an accountant by custom, law and a professional body".

Need for Accounting standards

1) These provide the norms on the basis of which financial statements should be prepared.
2) The application of Accounting standards make financial statements for meaningful & comparable as they ensure uniformity in their preparation & presentation.
3) Accounting standards create confidence among the users of accounting as they consider the information as more reliable
4) These help auditors in auditing the accounts. They help accountants to follow uniform policies and practices.

Ethical Issues in Accounting

1) Provide fair and accurate reporting of the financial position of a business

2) Ethical Issues

Reporting income, falsifying documents, allowing or taking questionable deductions, illegally evading income taxes, engaging in frauds etc.

Fraud in financial statement can be committed in 5 ways

-> Fictitious Revenues - Revenues not actually earned
-> Fradulent timing differences
-> Concealed liabilities and expenses
-> Fradulent disclosures or omissions
-> Fradulent asset valuation - false statement of the inventory available

Types of Accounts

Financial accounts - Company uses to report to their shareholders

Internal Management Accounts - Shows the internal operations of the business and its financial activities

Role of Accountants

-> To provide information to the new investors
-> To types of Accounts ,

Accountants employed by organisation

Takes care of internal management accounts of various

Management Accountant

-) formulation of Policies
-) Planning and controlling the activities of employee
-) decision making
-) Disclosure to shareholders etc

Financial Accountant

-) Economic information to investors, employers suppliers, outside people involved in the business etc.

Accountants in professional Practices

Provides 2 types of accounting services

!) The auditor

Appointed by shareholders to audit a particu Company

Duties include

-) To give an accurate statement about the state of affairs
-) To meet the objective of the Companies Act
-) To be reasonably skillful and careful in identifying the true nature of accounts

Accounts in related services

—) Tax services
—) Management consultancies
—) Insolvency services
—) Environmental audit

The Ethical Audit

Main purpose check the actions of the firm objectives.
—) Assess the business – structure, procedures systems & policies
—) Whether business activities comply with the standards
—) To identify the way in which it does business
—) Evaluate that wether management has relevant information in running the business
—) To help management undergo major alterations like restructuring
—) To identify the training necessary for the employee
—) Establishing ethical conduct of the business to attract valuable investments
—) Establish code of conduct
—) Help the shareholders to evaluate the performance of the directors & vice-versa.

Ethical issues in finance

steps by Management account

-> Determining the key elements of the business like the objectives and see how they are defined & measured

-> Making sure that the funds are allocated to different activities on the basis of their importance

-> Frame rules that have a positive effect on business activities.