Introduction to Accounting 1

1.1 MEANING OF ACCOUNTING

- **Accounting** may be defined as the process of recording, classifying, summarizing, analysing, and interpreting financial transactions and communicating the results thereof to the users interested in such communication. In other words, accounting can be defined as an information system that provides information to users about the economic activities and condition of an entity for the purpose of decision-making.
- A very comprehensive definition was put forward by the **American Institute of Certified Public Accountants (AICPA)**, according to which 'Accounting is the art of recording, classifying, and summarising in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.'
- **American Accounting Association (AAA)** defines accounting as 'the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by the user of accounts.'

From the aforementioned definitions, the following attributes of accounting can be observed:

- **Identification** of monetary transactions and events
- **Measurement** of the identified transactions and events
- **Recording** of such transactions
- **Classifying** and **summarizing** of the recorded transactions
- Obtaining the results of operations
- **Analysing** and **interpreting** the results to help in decision-making
- **Communicating** such information to the users (both internal and external)

To conclude, accounting is regarded as the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of information. It is a service activity to provide qualitative financial information and it is useful in making economic decision.

Student Note

- Luca Pacioli (1447–1517), an Italian mathematician, in his book *Summa de Arithmetica, Geometrica, Proportioni et Proportionalite* discussed in detail about the accounting and recording system.
- He is considered to be the 'Father of Accounting'.

1.2 RELATIONSHIP OF ACCOUNTING WITH BOOK-KEEPING AND ACCOUNTANCY

Book-keeping is a part of accounting that is concerned with the recording of transactions and maintenance of books of accounts. Its primary objective is to maintain systematic recording of transactions on a regular basis. It is a concept narrower than accounting.

Accountancy is a discipline that incorporates certain principles or rules of accounting. It refers to the entire body of the theory and practice of accounting. It is a concept wider than accounting.

Relationship: Thus, Book-keeping is a subset of accounting, whereas Accounting, in turn, is a part of Accountancy (see Fig. 1.1).

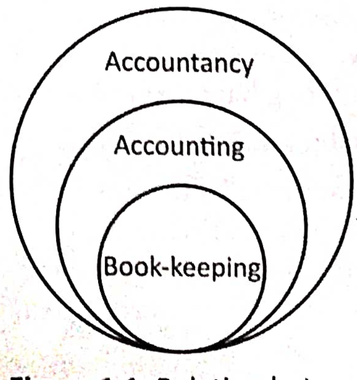

Figure 1.1 Relation between Book-keeping, Accounting, and Accountancy

1.3 NATURE OF ACCOUNTING

- **It is a process** as it performs the task of collecting, recording, classifying, summarizing, and analysing financial information in a sequential order.
- **It is considered as an art** because it has certain definite techniques of performing the various functions.
- **It is an information system** as it receives transactions as inputs, processes them applying necessary principles and techniques, and generates needful information required by different users.
- **It is a 'means to an end' and not an 'end in itself'**. Accounting generates and communicates the financial information to the users for the purpose of taking decisions. It does not end with merely reporting the results of an entity to the users but also paves the way for their decision-making.
- **It deals with only monetary events,**' that is, only those transactions which can be measured and expressed objectively in terms of money.

1.4 ACCOUNTING—'THE LANGUAGE OF AN ENTITY'

Languages are used to communicate certain facts and feelings by one person to another. Every organization has to communicate its developments and happenings to its stakeholders. Accounting prepares different statements and reports to communicate the financial results and position of the organization to its users. Hence, accounting is considered to be the language of an entity.

1.5 FUNCTIONS OF ACCOUNTING

The primary functions of accounting are as follows:

1. **Keeping systematic records:** By maintaining proper books of accounts and regular recording of transactions therein in a chronological and systematic manner.
2. **Ascertaining the operating results:** By preparing the Income Statement through matching of expenses against revenues.
3. **Ascertaining the financial position of the business:** By drafting the Balance Sheet at the end of each accounting period.
4. **Facilitating rational decision-making by the users:** By providing necessary information in an organized and systematic manner.

1.6 BRANCHES OF ACCOUNTING

The primary function of the discipline of accounting is to record the happenings of different events for the purpose of meeting different objectives of the various users or stakeholders. Depending upon the type of information dealt with, the time of usage of information, and the target audience, different branches of accounting have evolved over the time period.

Classification

- Traditionally, the important branches of accounting are as follows:
  - Financial Accounting,
  - Cost Accounting, and
  - Management Accounting
- However, in recent years the scope of accounting has expanded to include the following:
  - Human Resource Accounting
  - Environmental Accounting
  - Social Accounting
  - Forensic Accounting, etc

Financial Accounting: Financial Accounting is that branch of accounting that is concerned with the recording of transactions in the books of accounts. The primary objective of this is to determine the operating results (i.e., profit or loss) of an organization during each accounting period and to disclose its financial position as at the end of such accounting period. It records the transactions that have already occurred. For this reason, financial accounting is also called historical accounting or post-mortem accounting.

Cost Accounting: Cost Accounting is that branch of accounting that is concerned with the collection, classification, recording, summarization, and presentation of costing information that is used for cost ascertainment, cost control and cost reduction. Cost Accounting deals with the determination of costs of manufacturing a product or rendering a service. The objectives of cost accounting are ascertainment of cost, cost control, and cost reduction.

Management Accounting: It is the branch of accounting that deals with the presentation of accounting information in such a way so as to assist the management in day-to-day operations of the concern, in planning, in policy formulation, in controlling, and in decision-making. Management accounting utilizes data and information from both financial accounting and cost accounting.

Comparison between Financial and Cost Accounting

The following is the comparison between Financial Accounting and Cost Accounting:

Points of Difference	Financial Accounting	Cost Accounting
1. Applicability	It is applicable to all types of entities (namely, trading, manufacturing, service-rendering, etc.)	It is applicable only for manufacturing and service-rendering entities and not for trading concerns.
2. Concern	It is concerned with classifying, recording, and analysing the transactions of an entity.	It is concerned with classifying, recording, allocation, reporting, and control of costs.
3. Objective	Its objective is to determine the true financial performance of the organization and disclose its financial position.	Its objective is ascertainment of cost, cost control, and cost reduction.
4. Function	Its function is to classify, record, analyse, and interpret the financial transactions of an entity.	Its function is to classify, record, analyse, and interpret the cost-related transactions of an entity.
5. Cost focus	It is concerned only with historical costs.	It is concerned with both historical costs as well as future or estimated costs.
6. Nature of data	It uses only actual financial data.	It uses actual data as well as abstract data such as, opportunity costs, relevant costs, etc.
7. Focus	It focuses on the entire organization.	It focuses on specific parts of the organization, namely, individual products, services, departments, etc.

1.7 ACCOUNTING INFORMATION

Accounting Information refers to the information generated by the accounting system of an entity relating to a particular accounting period. They disclose the operating results and financial position of the entity. It acts as a mirror of the financial performance of a concern.

Users of Accounting Information

Users of accounting information refer to those people or organizations who refer to the information generated by the accounting system of an entity for their respective purposes. The users of accounting information can be broadly classified into two categories—External and Internal, which are discussed as follows.

A) *External Users*

a) **Investors:** Investors may include 'existing investors' as well as 'prospective investors'. Accounting information is accessed by both these parties for different purposes.
Existing investors are interested to know the performance of the organization for measuring their return from the investments already made.
Prospective investors require information about the past performance of the concern in which they would like to park their funds so as ensure that their investments are rationally made.

b) **Loan providers:** These entities conduct detailed study of the past accounting information of its prospective borrowers. It is done for ascertaining the financial credibility and credit worthiness of the borrower to get a measure of its repaying capacity.

c) **Stock Exchange:** They require accounting information of the entities whose securities are traded in the stock exchange for protecting the interest of the parties associated with the exchange.

d) **Suppliers or Creditors:** They supply goods and services on credit basis to an entity. The financial information is studied by the creditors for deciding upon the extent of credit to be granted and also the party's capability of meeting the commitment, that is, their credit worthiness.

e) **Customers:** They are dependent on an organization for the goods or services. As such, to have some interest about the long-term existence and continuation of the entity, they study the relevant accounting information of such entity.

f) **Government:** The government needs accounting information for ensuring proper allocation of resources, price control, and regulating the activities of the enterprise. Moreover, they gather financial information for preparing the statistics for national income computation.

g) **Regulatory Agencies:** Certain governmental or quasi-governmental organizations are responsible for overall regulation of specific sectors of the economy. They need to study the accounts prepared by the different concerns operating in the respective sector for the purpose of regulation and control.

Examples of Regulatory Agencies in India	
Name of Regulatory Body	**Regulated Sector**
Reserve Bank of India (RBI)	Banking
Securities and Exchange Board of India (SEBI)	Capital Markets
Telecom Regulatory Authority of India (TRAI)	Telecom
Insurance Regulatory and Development Authority (IRDA)	Insurance
Directorate General of Civil Aviation (DGCA)	Aviation

h) **Tax Authorities:** The taxation authorities are interested to study the financial information of different entities for the purpose of levy, collection, and regulation of different types of taxes and duties (both for Direct taxes and Indirect taxes).

i) **Security Analysts:** They are interested to study and analyse the accounting information of different organizations so as to enable them to advise their clients about the buying, selling, or holding decisions.

j) **Academicians and Research Scholars:** This user group is interested in the information provided by the accounting systems of various organizations and agencies for their research work and analysis. The accounting information acts as 'secondary data' for testing of hypothesis and model development.

k) **General public:** Public is generally interested in an organization as every organization (whether profit-oriented or not) is a 'social entity'. It exists in the society and for the society. It adds value to the society in a variety of ways such as creating employment opportunities, producing goods, or rendering services for the public but at the same time may pollute the surrounding environment. As such, for communicating its overall performance and social responsibilities discharged to the public at large, the organization presents the 'Annual Reports' and other social commentaries.

B) *Internal Users*

a) **Owners or Promoters:** These are the people who invest their hard-earned money to start and promote an organization. So, they make regular and detailed study of the accounting information to know the results of operation of the entity and its financial position.

b) **Management:** The management is responsible for regular running and operations of the organization. As such, to measure the results of their operations, they prepare financial statements and analyse them for making proper decisions to ensure further improvements and overcoming deficiencies, if any.

c) **Employees:** Employees and their representative groups (i.e., trade unions, associations, etc.) refer to the accounting information for studying the stability and profitability of the employer organization, primarily for ensuring their job security. It also helps them to assess their performance-related remuneration, retirement benefits, and other employment opportunities.

Qualitative Characteristics of Accounting Information

IASC Framework[1] has identified four qualitative characteristics of accounting information:

1. **Reliability:** Reliability is the quality of accounting information that allows the users to depend on it with confidence. Reliable accounting information acts as the foundation on which the users can build up

[1]IASC refers to 'International Accounting Standards Committee'.

their sound and rational decisions. To make accounting information reliable, it should have the following secondary qualities:

- Verifiability,
- Representational Faithfulness, and
- Neutrality or Unambiguity

2. **Relevance:** Relevance refers to that quality that ensures that the information is meaningful and useful to the user of accounting information for the purpose of decision-making. In order to be relevant, accounting information must be capable of making a difference in the decision-making process of the user. To make accounting information relevant, it should have the following secondary qualities:
   - Timeliness
   - Predictive Value
   - Feedback Value
3. **Understandability:** Understandability refers to that quality that makes the information comprehensible to the users of accounting information. For this purpose, information should be presented in a lucid and systematic way to the users. However, at the same time, the users are expected to have reasonable knowledge of business and accounting.
4. **Comparability:** Comparability is a quality of the relationship between two or more pieces of information. It refers to that quality of the accounting information that enables users to identify similarities in and differences between two sets of financial information.

   Comparability with regard to accounting information may be of two types, which are as follows:
   - **Horizontal Comparability**, i.e., comparison of the financial information of two or more entities pertaining to the same accounting period.
   - **Vertical Comparability**, i.e, comparison of the financial information of a single entity over different accounting periods.

Presently, with the objectives of financial reporting focused on decision-making, comparability is one of the most essential and desirable qualities of accounting information.

2.3 ACCOUNTING EQUATION

Accounting involves recording of transactions in the books of accounts. Every transaction involves two parties, resulting in receiving a benefit in exchange of giving something in return. The value of this 'give and take' must be equal to satisfy both the parties involved in the transaction. This equality when represented in the form of an equation is called Accounting Equation.

Accounting Equation reflects equality between the resources and sources which finance the resources.

Statement: Accounting Equation states the relationship among Assets, Liabilities and Equity.

It is expressed as: **Assets = Liabilities + Equity**.

Features:

Basic Concepts and Conventions

4

4.1 INTRODUCTION

Accounting is the language of an organisation. The primary function of the discipline of accounting is to provide financial information to its users. For this purpose, it is required to record the transactions entered into by a concern in different books of accounts. However, different organizations may practise it in different ways. So, for ensuring uniformity among different entities and to ensure consistency over a period of time, a framework has been developed over the time period. This framework is referred to as 'Generally Accepted Accounting Principles' (GAAP).

Student Note Accounting is applicable for all types of organization, whether profit-oriented or non-profit-oriented. As such, while writing theoretical answers, the word 'business' should be appropriately replaced by the terms like 'concern' or 'organization'.

4.2 GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

GAAP is the common set of accounting principles, standards, and procedures that are used by accountants to prepare the financial statements. They are derived from practice and on being useful get accepted into the accounting system. These principles are developed by the professional accounting bodies of different countries/economies of the world with the aim of attaining uniformity in accounting practised by the entities of the respective countries. As such, different GAAP have been developed in different countries of the world.

The GAAP must aim to satisfy the following three basic criteria:

- *Usefulness*, that is, making the information relevant and meaningful to the users of financial statements
- *Objectivity*, that is, ensuring that the information is reliable, verifiable, trustworthy, and unbiased
- *Feasibility*, that is, making it applicable without much complexity and cost

Objectives of GAAP These principles were developed for attaining the following basic objectives:

- To ensure consistency of the different accounting practices followed by a particular entity over a period of time
- To ensure uniformity among the accounting practices followed by different entities

Features of GAAP The GAAP must have the following essential features:

- They are based on real world accounting problems.
- They should be consistent.
- They should be capable of reflecting future predictions.
- They should generate reliable and comparable information.
- They should be understandable for their easy applicability.
- They should be flexible in nature.
- They should be informative for the users.

4.6 DIFFERENT ACCOUNTING CONCEPTS

The following are the different accounting concepts:

4.6.1 Entity Concept

As per this concept, a concern is considered to have separate entity that is distinct from its owner(s) and all other entities. Thus, even though the owner or promoter is intimately connected with the operations of the organization, he is considered to be a distinct person from the viewpoint of the organization.

Features

- Accounting is done from the viewpoint of the entity as distinguished from the persons associated with the entity.
- It is applicable to all types of organizations, whether profit-oriented or non-profit-oriented.
- All forms of organizations (i.e., proprietary, partnership, or company) should follow this concept.

Implications

- The transactions are recorded in the books of accounts from the viewpoint of the organization only.
- It ensures that transactions of the owners or promoters and those of other entities are not recorded in the books of accounts of the concern.
- Transactions between the owner and the entity are recorded in the books of accounts.
- Accounts representing the owner (namely, Capital A/c and Drawings A/c) are reflected in the Balance Sheet.
- It helps in the reflection of true financial performance and financial position of the concern.

Example

- **Cash was introduced by X, the proprietor, to start a new business.**

The business has a separate entity from its owner, that is, X. So, transaction between X and his business will be recorded in the books of accounts. Cash introduced as capital is considered to be a liability of the business. It is recorded as under:

Cash A/c Dr.
To Capital A/c

4.6.2 Going-concern Concept

As per this concept, an organization will continue to exist in the foreseeable future. It means that an organization has neither the intention nor the need to curtail its operations in the immediate future.

Features

- An organization is deemed to continue to operate into the future for infinite number of accounting periods, that is, it has a perpetual life.
- As per India AS 1, *Presentation of Financial Statements*, it happens to be one of the general features in the preparation and presentation of financial statement.

Implications

- This concept has led to the classification of assets into Current and Non-current Assets and the classification of liabilities into Current and Non-current liabilities.

- This concept is basic to the valuation of fixed assets and the provision for depreciation thereon.
- It gives more importance to the determination of operating results (i.e., profit or loss), rather than to valuation of assets.

Example

- On acquisition of any Fixed Assets, the total cost of the Fixed Asset is not charged to the Income Statement of any one accounting period; rather only the depreciation on such Fixed Asset is charged against profit of every accounting period during the life of the asset. As the organization is viewed as a 'going concern', Fixed Assets are valued on the basis of their cost (as adjusted) and not on the basis of their market values.

4.6.3 Money Measurement Concept

As per this concept, the collection, measurement, and presentation of accounting information are done through money. In other words, only those events that are measureable in terms of money are recorded in the books of accounts.

Features

- Money is considered to be the basic unit of accounting and standard of economic value.
- Every transaction or happening is recorded only in terms of money.
- It accepts money as the common yardstick for collecting, measuring, and presenting the heterogeneous accounting information. Thus, it helps in understanding the state of affairs of the business in a better way.

Implications

- Only those transactions that are measureable in terms of money are recorded in the books of accounts.
- Non-monetary events, however important they might be, are kept out of the periphery of the accounting activities. Thus, accounting fails to provide a complete picture of all the happenings of an organization.
- It does not take care of the effects of inflation because it assumes a stability of money measurement unit.

Example

- Events such as resignation of an experienced manager, conducting meetings within the organization, etc., are not recorded in the books of accounts as they are not measurable in terms of money.
- A business owns a 10,000 sq. ft. office, 10 cars, 8,000 tonnes stock, and ₹80 lakhs bank balance. These different assets are expressed using different units of measurement, but for recording them in the books of accounts they are all expressed on the basis of a common yardstick—money, that is all the above mentioned assets will be reflected in rupee terms.

4.6.4 Dual Aspect Concept

As per this concept, every transaction involves a twofold aspect—a receiving aspect and a giving aspect. Thus, in every transaction, there is the yielding of a benefit (represented by Debit) and the giving of another benefit (represented by Credit). So, for recording every transaction, an amount of debit is to be matched by an equal and corresponding amount of credit. Hence, this concept forms the backbone of the Double Entry system of book-keeping.

Features

- It is the basis of double entry system of book-keeping.
- The entry made for each transaction is composed of two parts—one for 'Debit' and another for 'Credit'.

- Every debit has an equivalent and corresponding credit.
- For a particular accounting period, the total of all debits must be equal to the total of all credits.

Implications

- The fundamental 'Accounting Equation' is based on this concept.
- Passing of journal entries and their posting in the ledger is dependent on this concept.
- The preparation of Trial Balance ensures the arithmetical accuracy of the application of this concept.

Example

Purchase of goods by A from B for cash ₹40,000 was done.

This transaction involves two parties—A and B. The 'Dual Aspect' can be explained as follows:

- A is the receiver of goods, whereas B is the giver of goods; and in exchange
- A is the giver of cash, whereas B is the receiver of cash.

Dual Aspect for A	Dual Aspect for B
1. Receiving goods worth ₹40,000	1. Delivering goods worth ₹40,000
2. Payment of cash ₹40,000	2. Receipt of cash ₹40,000

Books of A			Books of B		
1. Purchases A/c (representing the goods)—to be Debited			1. Sales A/c (representing the goods)—to be Credited		
2. Cash A/c—to be Credited			2. Cash A/c—to be Debited		
Journal entry:			**Journal entry:**		
Purchases A/c	Dr.	40,000	Cash A/c	Dr.	40,000
To Cash A/c		40,000	To Sales A/c		40,000

4.6.5 Periodicity or Accounting Period Concept

One of the fundamental accounting assumptions is that every organization is considered to have an infinite life, that is, it is viewed as a going concern. As per periodicity concept, the total expected lifespan of an organization is artificially segregated into smaller time periods, each of which is identified as a separate accounting period. This ensures the determination of operating results (i.e., profit or loss) and disclosure of financial position at the end of every accounting period. It is also known as 'Accounting Period' or 'Periodic' concept.

Features

- The operating results and financial position of an entity are to be measured and disclosed at regular intervals.
- Each accounting period is of similar duration. Most entities follow a period of 12 months, that is, a year, as their accounting period. However, accounting periods of different durations (namely, quarter or half-year) may be adopted.

Implications

- An outflow, that is, cost, is categorized into 'expense' or 'asset' on the basis of periodicity.
- It paves the way for segregation of transactions between 'capital' and 'revenue'.
- In the absence of this concept, the operating result of an entity should be determined only on its liquidation.
- This has lead to the development of the 'Matching Concept', which ensures correct determination of operating results of an accounting period.
- This concept ensures regular appraisal of the organizational activities and any chance of recovery required for the survival and growth of the entity.

Example

Satyam Computer Services Ltd was a leading software organization that was established in the year 1987. It was in existence for over two decades and was liquidated in the year 2009.

Due to the application of Periodicity Concept, it determined its operating results (i.e., profit or loss) and presented its financial position at the end of every accounting period, rather than waiting to do the same after its liquidation in 2009.

4.6.6 Matching Concept

As per this concept, the expenses incurred during an accounting period are to be matched with the revenues recognized in that particular accounting period. In other words, appropriate costs are to be matched against the appropriate revenues of the accounting period. It is to be noted that only those expenses are to be matched that satisfy the following two conditions:

- Such expenses have been incurred to earn the recognized revenue.
- They relate to the same accounting period to which the same recognized revenue relates.

Features

- It has been derived on the basis of 'Periodicity concept'.
- It is based on 'accrual concept' as it considers the earning of income and incurrence of expenses as against actual inflow and outflow of cash.

Implications

- It calls for adjustments to be made with regard to outstanding expenses, prepaid expenses, accrued incomes, and pre-received incomes in the financial statements.
- It results in the recognition of inventories in the financial statement.

Example

Determination of Gross Profit: Gross Profit of a concern is determined by comparing 'Sales revenue' earned during an accounting period with the 'Cost of Goods Sold' of the corresponding period.

4.6.7 Accrual (or Revenue Recognition) Concept

As per this concept, all transactions entered into by an entity are recorded on 'due' basis. In other words, incomes are recognized and recorded when they are earned, whereas expenses are recorded when they are incurred. It is also known as the 'Revenue Recognition Concept'.

Features

- Transactions not yet settled in cash are taken into account.
- As per the Companies Act, it is mandatory for companies to keep accounts under accrual basis.
- It is one of the general features for preparation and presentation of financial statement as per Ind AS 1, *Presentation of Financial Statements*.

Implications

- Outstanding expenses, prepaid expenses, accrued incomes, and pre-received incomes get reflected in the financial statements.
- It ensures correct determination of operating results (through Matching Concept), and proper reflection of the financial position of the organization through the Balance Sheet.

Example

- Wages ₹10,000 not yet paid will be recorded and presented as 'Outstanding expense' at the time of finalization of accounts.

Student Note

The concepts of accrual, periodicity, and matching work together for income determination and recognition of assets and liabilities.

4.6.8 Realization Concept

As per this concept, revenue is considered as being earned at the following points of time:

- **In case of sale of goods** When the property of goods passes to the buying entity and the buying entity becomes legally liable to pay; and
- **In case of rendering of services** When the services are rendered by the service provider and the service recipient becomes legally liable to pay

In other words, the earning of revenue is not dependent on the actual realization of cash; rather it depends on the transfer of ownership of the goods from the selling entity to the buying entity or on the rendering of service.

Features The following are the features of realization concept:

- The most important aspect of this concept is to determine the point of time at which the revenue is recognized.
- Revenue is recognized when actual 'performance of the sale' is made or 'services are rendered'.
- This concept relates to two types of gains 'Holding Gain' (gain that arises as a result of increase in value from holding an asset) and 'Operating Gain' (gain that arises as a result of sale of an asset).

Implications The following are the implications of realization concept:

- Income may be earned during an accounting period even though cash is yet to be realized.
- This concept distinguishes between holding gain and operating gain.
- It recognizes revenues that are in the nature of Operating Gain only.
- Operating results are determined on realization concept.
- It prevents the practice of inflating profits by recognizing those incomes that are only likely to accrue.

Example

Todi Automobiles places an order with Maruti Ltd, a manufacturer of automobiles, on Jan. 1, 2017. Maruti Ltd manufactures the cars and delivers them to the customer Todi Automobiles on Jan. 10 2017. However, Todi Automobiles makes the payment on Mar. 10, 2017 after enjoying 2-month credit.

In this case, revenue will be realized by Maruti Ltd on Jan. 10, that is, on the date of delivery of the cars to Todi Automobiles and neither on Jan. 1 (when the order was received) nor on Mar. 10 (when the cash was realized).

4.6.9 Cost Concept

As per this concept, an asset is recorded on the basis of original acquisition cost or purchase price. This cost forms the basis for all subsequent accounting of the asset.

Features

- This concept relates to the transactions with respect to the fixed assets and inventories of the organization.
- Value of an asset is to be determined on the basis of its cost of acquisition, that is, its historical cost.
- It brings more objectivity and reliability in the preparation and presentation of financial statement.
- It is free from biasness as no subjective judgement is required for valuation of assets.

Implications

- Since it provides more objective and reliable information, it is helpful in decision-making.
- Self-generated assets (e.g., goodwill of a professional) may not be recorded as no costs are incurred for their acquisition.

- Fair values of the assets may not get reflected in the financial statement, which poses a major threat under inflationary situations.

Example

S, a reputed and experienced Chartered Accountant, purchases a laptop computer for ₹40,000.

The laptop purchased for ₹40,000 will be recorded in the books at its cost of acquisition. However, his goodwill and reputation, being self-generated assets, will not get reflected in the books of accounts.

Student Note

Recent Accounting Standards give more emphasis to 'Fair Value Concept' than 'Cost Concept' in certain situations.

4.7 DIFFERENT ACCOUNTING CONVENTIONS

4.7.1 Consistency Convention

According to this convention, the principles and methods of accounting, valuation, or recording once decided, accepted, and adopted by an entity should be followed from one accounting period to another in dealing with similar class of events. In other words, the principles and methods once put to practice should not be changed. However, it may be altered if it is necessitated by any of the following factors:

- Change in statute
- Change in ASs
- For better disclosure in financial statements

Features

- As per Ind AS 1, *Presentation of Financial Statements*, it happens to be one of the general features in the preparation and presentation of financial statement.
- This convention is applicable when alternative methods of accounting or valuation are equally applicable and acceptable.
- It does not imply non-flexibility, that is, it does not completely prohibit changes.

Implications

- Uniformity in recognizing, valuation, and recording of transactions is maintained.
- It ensures the comparison of the financial information of a particular entity over different accounting periods.
- Ensuring external consistency (i.e., consistency among different organizations) led to the development of national and international ASs.

Example

- Stock pricing should be done consistently under any one method (namely, First-in, First-out (FIFO), Weighted Average, etc.).
- Methods of calculating the depreciation (namely, Straight line or reducing balance method) should not be regularly altered.

4.7.2 Full Disclosure Convention

As per this convention, financial statements should disclose all the relevant and material information which shall be useful to the users of financial statements. This convention has gained acceptance as, at present, most organizations are formed as joint stock companies where there is 'separation of ownership from management'.

Features

- The information disclosed should be full, fair, and adequate so as to enable the users to take proper informed decisions.
- It has been given a statutory status in the field of accounting. For example, the Indian Companies Act, requires that P/L A/c and Balance Sheet must give a true and fair view of the state of affairs of the company and also provide the prescribed formats in which these financial statements are to be prepared.

Implications

- It provides a holistic view of the organization to the outside world.
- It enables the users of financial statements to take proper informed decisions.
- It has led to the practice of providing Notes to Financial Statements, reporting of events occurring after the Balance Sheet date, etc.

Example

- Contingent liabilities, which may not even materialize, are disclosed in the footnote as 'Notes to Balance Sheet.'
- Significant events occurring after the reporting period are to be disclosed (as per Ind AS 10, *Events after the Reporting Period*).

4.7.3 Materiality Convention

As per this convention, only those relevant information, the knowledge of which might influence the decision of the users of accounting information, should be disclosed in the financial statements. In other words, those information that may have an insignificant economic event or may be irrelevant for the users need not be disclosed.

Information is considered to be 'material', the mis-statement of which might influence the economic decisions of the users of financial statements. It is to be noted that the concept of 'materiality' not only depends on the amount of a particular transaction but also on some other factors, namely, the size of the business, the nature of information, etc. Even a transaction involving insignificant amount may be recorded if it affects the decision of the users.

Features

- It is an exception to the 'Full disclosure' convention.
- There is no line separating 'material items' from 'non-material items'. It depends on the judgement of the accountant to decide upon materiality.
- It is one of the general features for preparation and presentation of financial statement as per Ind AS 1. *Presentation of Financial Statements.*

Implications

- It enables the users of financial statements to take proper informed decisions.
- It does away with excess information in the financial statements, thus enabling prompt decision-making by the users.
- It conflicts with the conventions of full disclosure by not disclosing all information.

Example

- The different equipments used in an office, namely, calculators, telephone sets, fax machines, etc. are not accounted for in different accounts, rather they are reflected as Office Equipment A/c.
- Figures are recorded in the books of account (except Petty Cash Book) after rounding them off to the nearest rupee.

4.7.4 Conservatism (or Prudence) Convention

As per this convention, in situations of uncertainty about the future, accountants should not record anticipated unrealized incomes and gains but should provide for all possible expenses and losses. Transactions should be recognized and recorded into the books of accounts after providing for all anticipated expenses or losses but not for anticipated incomes or gains. This convention stresses on the fact that it is better to portray a gloomy picture of the organization than to provide a window-dressed picture. Hence, it is also known as the **Prudence Convention.**

Features

- It is a policy of caution or playing safe.
- Profits or assets are never overstated.
- Losses and liabilities are never understated.

Implications

- It may lead to understatement of assets.
- It conflicts with the conventions of consistency. For example, by following different basis of stock valuation (i.e., either at Cost or Net Realizable Value, whichever is lower) in different accounting periods.
- This convention being subjective in nature conflicts with the objectivity principle. For example, it is almost impossible to predict with pinpoint accuracy the actual amount of bad debts that will occur in the future accounting period(s) out of credit sales of the current accounting period.

Example

- Valuation of inventories on the principle of cost or net realizable value, whichever is lower (as per Ind AS-2 *inventories*)
- Providing for doubtful debts and provision for discount on debtors

4.8 FUNDAMENTAL ACCOUNTING ASSUMPTIONS

- Transactions are recorded in the books of accounts on the basis of certain assumptions.
- There are **three fundamental accounting assumptions**:
  (i) Going Concern
  (ii) Consistency
  (iii) Accrual
- Every entity is mandatorily required to follow these three fundamental accounting assumptions. In other words, the entity does not have any choice with regard to the fact whether these assumptions should be followed or not.
- Disclosure is not required in the financial statements if all these fundamental accounting assumptions are followed.
- However, if any of these fundamental accounting assumptions are not followed, then it has to be disclosed in the financial statements with proper reasoning.