Chapter 1 - Introduction to Accounting

Meaning of Accounting:

Accounting is a language of business. It keeps the records of the financial activities so as to know whether business is making profits or losses. By maintaining accounts in a systematic manner, it tries to ascertain its position at the end of its financial year.

Definition of Accounting

Accounting is a discipline, which records, classifies, summarizes and interprets financial information of a business enterprise.

Smith and Ashburne define accountancy as ***"the science of recording and classifying business transactions and events, primarily of financial character and the art of making significant summaries, analysis and interpretations of those transactions and events and communicating the results to persons who must make decisions or form judgments."***

From the above definitions, it is evident that :

(a) Accounting is an art as well as science.

(b) It does the recording, classifying, analyzing and summarizing transactions and events of financial character.

(d) It also interprets and communicates the results thereof to the interested persons.

Thus accounting involves not only recording and classifying the financial data, but also covers its interpretation and reporting (communication) to the parties who are interested in using the information in their decision-making.

Book-keeping and Accountancy Distinguished:

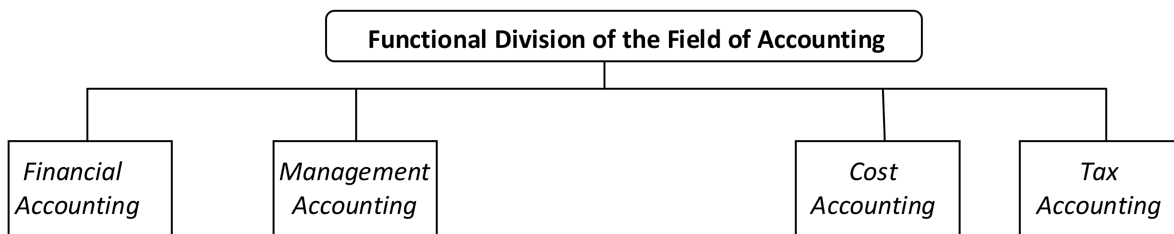
Book-keeping is the first step in the process of accounting money transactions. It is an art and science of classifying and then correctly recording the financial transactions in a set of books in a most systematic manner.

Accounting is a step ahead. It includes book-keeping. It comprises of recording of business dealings as well as a further process of summarizing, analyzing, interpreting and reporting of all those dealings, which have been recorded by a book-keeper.

Thus, book-keeping deals with only recording and classifying of money dealings, *whereas*, accounting is one step ahead where they are further summarized, analyzed, interpreted and ultimately reported to the internal and external users for their decision-making.

Branches of Accounting

The entire accounting work can be broadly classified according to the nature of accounting functions to be performed by the accountants specialized in such functions.



1. **Financial Accounting** includes systematic recording of financial transactions, and events so as to find out its profits earning capacity , financial state of affairs . Financial accounting involves the following stages:
   - **i)** ***Recording*** of day to day financial transactions and events of business on the basis of accounting vouchers and bills in the books of prime entry such as journal, subsidiary books and cash book.
   - **ii)** ***Classifying*** the business transactions under proper ledgers. It is called ledger posting.

iii) ***Summarizing*** involves preparation of Trial Balance, Profit and Loss Account and Balance Sheet from the closing balances of ledgers at the end of accounting period. From the financial statements of business like Profit and Loss account and Balance Sheet the stake holders of business understand the profitability and financial position of business.

iv) ***Interpreting*** is the final function of accounting .It is concerned with making meaningful judgment about the financial conditions and profitability of business on the basis of financial statements of business.

v) ***Communicating*** is concerned with the transmission of summarized, analyzed and interpreted information to the stakeholders of business for making rational decisions. This is done through annual report containing financial reports, auditor's reports, managing director's report, accounting ratios, charts, diagrams and graphs etc.

2. Management Accounting is concerned with reporting the financial and cost data to the management of an enterprise for decision making. It involves preparation of summary, analytical and critical statements of financial working of enterprise and reporting the same to the management for the purpose of making decisions.

3. Cost Accounting is classifying recording and appropriate allocation of expenditure for determination of cost of products or services. It presents suitably arranged data management for purpose of cost control. It helps the business for achieving better results.

4. ***Tax Accounting*** has been developed in order to meet the legal requirements. This helps in calculating the tax liability, filling of returns and other legal matters.

Main Objectives of Accountancy Summarized :

(a) To have ***permanent record*** of all business transactions.

(b) To keep records of *income and expenses* in order ***to ascertain business profitability*** by preparing Profits and Loss Account.

(c) To ascertain ***financial position of business*** by preparing the Balance Sheet.

(d) To provide the ***financial data to the users*** for making rational decision making.

(e) To keep track of all ***changes in the value of assets & liabilities***.

(f) To keep ***control on expenses*** of business.

(h) To know the detailed information about transactions with the customers as well as suppliers and to know the ***owing of business***.

(i) To have important ***information for legal and tax purpose***s.

Meaning of Important Terms :

a) Accounting Concepts :

Accounting concepts or postulates means the necessary conditions or assumptions required to be adopted while recording business transactions.

b) Accounting Conventions :

Accounting conventions on the other hand mean traditions or customs based on which financial statements, namely balance sheet and profit and loss account are to be prepared.

c) Accounting Standards :

Accounting standards are the rules of conduct imposed by professional body for public accountants in order to regulate and control the financial accounting process.

Kinds of Accounting Principles :

Accounting principles are broadly classified into following four categories, namely :

I. Accounting Concepts : (Assumptions or conditions)

II. Accounting Conventions : (Traditions or customs)

III. Accounting Standards : (Codes of conduct).

I. Accounting Concepts : (Conditions or Assumptions)

(a) Business Entity Concept : (Entity Concept)

Under this concept it is assumed that business has separate existence, independent from its owners. Business is treated as an separate entity and all transactions, including those between the business and its owners are analyzed and recorded from the point of view of business.

Therefore when a capital is introduced by owner it is analyzed as a transaction between 'the business and a third party' and recorded in the books of business as per this point of view. Thus the business becomes the borrower and owner becomes the lender.

This concept recognizes and keeps the private transactions of the owner(s) away from the business transactions.

This concept is applicable to the accounting of all the forms of business organizations.

(b) Going concern concept or continuity concept :

Under this concept it is assumed that the business is expected to continue for a long period in future. It is assumed that enterprise is a going concern and it is going to continue its operations for the foreseeable future. It has no intention to stop its operations except under some abnormal circumstances.

As a result of this concept fixed assets of business are valued at cost *less* depreciation and not at the market value. Prepaid expenses are treated as assets on the presumption that the business will continue and these expenses will be utilizes in future.

In view of going concern concept, the business can plan its future prospects, expenditure, can frame policies specially about the valuation and depreciation of long lasting assets and prepare financial statements as required under IAS - 1.

(c) Realization Concept :

This concept assumes that revenue profit or loss comes into existence out of sale of goods and services and that it is considered as earned only when it is realized in money or in money's worth or at least in some legal obligation by the customer. No revenue or income will arise without the realization of sales. Thus revenue is recognized only when sales are effected or services are rendered. Such revenue is realized in money or money's worth or legal obligation.

As such, under this concept only those incomes and profits that have either realized in cash, or resulted in money's worth or turned into legal obligations from the customers are recorded. Other imaginary transactions, or likely sales or anticipated revenues are totally ignored.

(d) Periodic Matching (of Cost and Revenue) Concept :

This concept assumes that all the costs or expenses of a business enterprise pertaining to a particular period of time are *compared or matched* with its revenue of that period in order to ascertain net profit or net loss. However, before matching or comparing the costs with the revenue, it is essential and important to measure the costs as well as the revenue on some sound principles.

Any revenue earned is no revenue unless its cost is considered and no cost is supposed to have been incurred unless it results in some form of revenue. Therefore, all the expenses and revenue related to each other are matched or compared through a financial statement, namely 'Profit and Loss Account' (or Income and Expenditure Account or Revenue Account).

Here it is important to note the *revenue earned*, whether received or receivable and *expenses incurred*, whether paid or payable are considered for matching provided they relate to each other during the same or a particular period.

(e) Money Measurement Concept :

As per this concept, only those transactions, which can be measured in terms of money are recorded in accounts. Transactions and events that cannot be expressed in terms of money are recorded in accounting books even if they are very important from the point of view of business. For example, events such as death, retirement etc; of an executive or managing director or *cordial* or *strained* relations between the management and workers; or entry of a new competitor into market or globalization of economy etc; are no doubt very important and significant events from business point of view but are not recorded because they cannot be expressed or measured in terms of money.

(f) Dual Aspect Concept : (Dualism Concept of Accounting).

This is the basic concept of accounting. According to this concept every business transaction or event has two aspects. Accountant should record both these aspects of a transaction. The two effects of transaction are as under:

1) It increases one Asset and decreases the other Asset of an enterprise, e.g. Cash purchase of an asset.
2) It increases an Asset and at the same time increases Liability, E.g. Credit purchase of an asset.
3) It decreases one Asset, decreases a Liability, E.g. Bank loan or creditors paid in cash.
4) It increases one Liability, decreases other liability, E.g. Loan repaid..

Thus the double or dual or twofold aspects of all the business transactions pertaining to a particular period are recognized and recorded under this concept.

(a) Accrual Concept:

Under accrual concept, the effects of transactions and other events are recognized and recorded in accounting records as and when they occur (and not only when cash or cash equivalent of such transactions is received or paid).

Accrual basis of accounting has been defined by Eric L. Kohler in his dictionary for accountants as "*the method of accounting whereby revenues and expenses are identified with specific periods of time, such as a month or year, and are recorded as incurred, along with acquired assets, without regard to the date of receipt or payment of cash*".

No business results would be true if all revenue earned and expenses incurred during a particular period are not recorded. Revenue earned means revenue received in cash as well as revenue accrued and receivable. Similarly expenses incurred indicates expenses paid in cash as well as those accrued and due (*payable*). Therefore, to arrive at the true results (profits or losses) of a business concern, these accruals of income and expenditure of a particular period should not be ignored.

Thus, under this concept it is assumed that accrued income as well as accrued expenses along with the income received and expenses paid are to be recognised and recorded provided they relate to the same period of time.

(b) Legal Aspect Concept :

Every business transaction has some legal aspect involved in it. Due regard should be given to its legal position and it should be recorded accordingly, as far as and to the extent to which it is possible. If it is not at all possible to do so, then at least an explanatory foot note should be appended. For example, treatment of discount on bills discounted in consignment accounts, or allocation of audit fees over the periods of pre and post incorporation of a company or legal status of a supplier in ordinary credit transaction or in 'sale or approval' transactions etc.

(c) Cost or Objectivity Concept :

Under this concept, it is assumed that the transactions; particularly the balance sheet items should be recorded at their cost price and not at their present worth or market price. The amount of every transaction must be as agreed between the parties, though its real worth may be something different as per market trends or whims of individuals. *In any case, every transaction must be supported by facts and objective material evidence and recorded accordingly.*

Thus if an asset is actually bought at 'X' cost but if its market price is 'Y', then it should be recorded at 'X' cost and not at 'Y' price. If it is depreciable asset then its depreciated or written down value should be recorded. In case nothing has been paid for the acquisition of an asset; then such asset is not to be shown in the statement. For example, self generated goodwill or reputation, knowledge and skill built up over the years and so on.

Under no circumstances, a transaction should be recorded on the whims, fancies, biased opinions, market fluctuations etc. Similarly, sudden, uncertain events that may change the course of business should also be ignored, howsoever important and valuable they may be.

In short, objectivity (facts and material evidence) rather than subjectivity (individualistic whimsical approach) reins supreme in this concept.

(d) Historical Record Concept : (Historical cost)

Under this concept it is assumed that only the transactions that have actually taken place (*historical transactions*) are recorded and any hypothetical, imaginary or likely transactions are not considered. Mere possibility of happening of an event is not a transaction and therefore not to be recorded. For example, intention to sell is not a 'sale' or placing of an order or signing an agreement is not a transaction. Similarly, budgeted income or expenditure, estimated sales or purchases are no transactions at all. Hence not to be recorded.

However, provision for depreciation, reserves, repairs, doubtful debts etc are recorded under special circumstances though they are nothing but the estimates.

Thus under this concept transactions are recorded on the basis of their actual happening and not on their likely future happening and that too only to the extent of their money's worth.

(e) Accounting Period Concept :

In fact the accounts of an undertaking must be prepared and income be measured over its entire life period; *from* the date of its inception (*beginning*) *to* the date of its liquidation (*end*). However, since the life of a business is infinite (indefinite) as assumed under going concern concept, it is not possible to measure the income over a life time at a stretch. Instead it is assumed under this concept that the life span of a concern can be split up into small time units such as a month, quarter, half year or year and income can be measured for such small period.

Accounting period as defined by *Eric L. Kohler* "as *the period of time for which an operating statement is customarily prepared*". Most of the business enterprises choose twelve months period starting from 1st April and ending on 31st March next as their accounting period for which operating results are obtained and financial statements are prepared. This approach is followed by the businesses, which are continuing in nature (of long lasting nature).

II. Accounting Conventions : (Traditions or Customs)

(a) Consistency Convention :

Consistency means 'continued uniformity' during a period or from one period to another in methods of accounting. Such a uniformity is to be maintained mainly on the 'bases of valuation' and 'methods of accrual' as reflected in financial statements.

According to I.A.S-1, 'consistency is a fundamental assumption and it is assumed that accounting policies are consistent from one period to another'. For example valuation of stock should always be done at cost or market price whichever is less, as a matter of policy and there should be no frequent changes in this policy.

Thus consistency implies application or use of uniform rules, regulations, policies from year to year i.e. permanently and consistently, without frequent changes.

This enables the management to make comparisons of accounting results of different periods or within interrelated groups of financial statements. Frequent changes in use of policies will lead to wrong comparisons.

Observation of consistency convention does not mean flexibility or change is not permitted. Particularly while introducing improved methods and techniques this convention is set aside. Consistency does not mean rigidity. It only refers to uniformity of rules, policies etc, to be adopted.

Consistency is of three types, namely '*vertical consistency*' applicable to interrelated group of financial statements bearing the same date; *horizontal consistency*, as between the financial statements from one period to another; and '*third dimensional consistency*' as between one enterprise to another in the same industry.

(b) Conservatism Convention :

It is a general tendency in every field and particularly in business to maintain a fairly stable state of affairs without sudden or abrupt or considerable changes. Such a tradition is known as convention of conservatism. Of course, gradual changes are no doubt permitted or acceptable to a reasonable extent. But if they are great and alarming, one has to be cautious and must play safe, go slow and steady.

Thus conservation is a custom or tendency to '*play safe*' or go '*cautiously*' while preparing and presenting financial statements. Because it is no doubt dangerous and harmful to paint a 'too rosy' picture of the business affairs. Such a rosy picture *i.e. window dressing* may bring the business into serious troubles. Hence caution.

However, it is not advisable even to paint a gloomy or too worst a picture of the affairs. Building secret reserves is also a bad sign and therefore should be avoided.

In fact, what is needed is to show a true and fair position of the business through the statements. It is acceptable if one is conservative in presenting the facts even if they may be sometimes, far from the truth but in no case a false, untrue, bright impression be created. Under this principle, prospective losses may be taken into account but in no case the prospective or unrealised profits. Stock valuation is the best example, where it is valued at cost or market price whichever is less and the unrealised profit hidden therein is avoided. However, this principle goes against the convention of "Full Disclosure" and hence subject to criticism.

The other examples of application of this principle are :

(1) Provision of the prospective loss for bad and doubtful debts and for discount.

(2) Valuation of investments at cost or market price, similar to that of stock or provision for the price fluctuations therein.

(3) Amortization (writing off) of intangible assets having indefinite life.

(4) Valuation of Joint Life Policy at its surrender value.

(c) Full Disclosure Convention :

Except under special circumstances and barring certain cases, a business house is expected to disclose full information to the parties concerned without concealing anything. In fact the Indian Companies Act makes it mandatory to disclose in the financial statements, all information of material importance, with explanatory notes, wherever necessary.

It is a right of those who rely on financial statements to have full and fair information of the business affairs presented with a fair amount of honesty. It is expected that nothing is omitted (full disclosure) and the accounting principles are applied in fair manner. As such, the balance sheet shall not be a mere sheet of ledger balances. Instead it shall be a statement that shall convey all the needed information to the users in an easily understandable manner. However, if a business feels that certain information is not to be disclosed in the

utmost interest of the business, it can hold it back. But, in any case, honestly and as far as possible, all necessary information should be disclosed as per this convention.

(d) Convention of Materiality :

Materiality refers to '*relative importance*' of any item when compared against its standard importance. Eric L. Kohler defines it as "*a statement or fact or an item likely to influence the judgement of a reasonable person*".

As per the American Accounting Association (AAA), "*an item should be regarded as material, if there is a reason to believe that knowledge of it would influence the decision of informed investor*".

Thus materiality means the material or important facts capable of influencing the decision. It is a fact or an item or a statement of considerable importance.

Under this convention, the financial statements are expected to cover only the material or important facts, ignoring all other unimportant items.

The accountant, while preparing the statements, is expected to attach importance to material (important) details and ignore less important or insignificant facts. If such insignificant information cannot be avoided, then either it should be recorded as footnotes or merged with the more important facts. For example contingent liabilities, market value of investments etc, are not the balance sheet items, but still shown therein, either in the inner column (*as memorandum items*) or as footnotes.

However, care should be taken to decide the materiality of an item, because what is of material importance to one may not be important for others. It is a relative term and depends on circumstances and situations.

This convention is quite similar to a convention of full disclosure.

Accounting Standards

Need for Accounting Standards:

Accounting is a language of business. It communicates the financial results of an enterprise to various stakeholders by means of financial statements such as profit and loss A/c and balance sheet. These financial statements should show true and fair view of the business. But due to the wide variety of accounting methods, principles and techniques used in preparing accounts in the various enterprises, financial statements used to be misleading, tendentious and provide distorted picture of the business. In order to ensure transparency, consistency, comparability, adequacy and reliability of financial statements and financial reporting through these statements, it was essential to standardize the principles and policies of accounting used by the various enterprises. Accounting standards provide a framework and standard accounting policies so that financial statements of different enterprises are comparable.

Meaning of Accounting Standards:

Accounting standards are the written policy documents stating the norms of accounting policies and practices to be observed by the various enterprises. They are issued by expert accounting authorities of the nation. They provide broad guidelines regarding principles and methods to be used by the enterprises in the country from among the several alternatives. Accounting standards deal with the following aspects

1) What events and transactions should be recognized and shown in the financial statements?

2) How to measure these events and transactions?

3) How to present these events and transactions in the financial statements?

4) What facts and figures should be disclosed in the financial statements so as to guide the stakeholders in making proper decisions?

Objectives of Accounting Standards

1) To provide a set of standard accounting policies, valuation norms and disclosure requirements to the business houses in a country

2) To facilitate true comparison of the financial statements of various enterprises by minimizing the variations in the accounting policies, principles and methods that distort the comparison

3) To harmonize the diverse accounting policies and practices used by the various enterprises

Significance of Accounting Standards

Accounting standards minimize the wide variations in the accounting methods, techniques, principles, practices and policies applied in preparations and presentations of financial statements. They help in preparation of financial statements that will provide true and fare view of the business. Following benefits are enjoyed by an enterprise through an application of accounting standards

1) ***Reduction in variations:*** Standards reduce the confusing variations in the accounting treatment of various firms in preparing financial statements

2) ***Disclosure beyond the requirement of law:*** Some important information is not disclosed in the financial statements of various firms, as it is not required by the law. Standards may require the firm to disclose such information which is useful for the proper judgment of business through accounts by the stakeholders

3) ***Facilitates comparison:*** Accounting standards facilitate true comparison of the financial position of companies situated in different parts of the world. And also the different companies situated in the same country

Accounting Standards in India (AS)

AS in India are prepared by Accounting Standards Board of India (ASBI) which was formulated on ***21st April, 1977*** by the Institute of Chartered Accountants of India. So far it has issued ***31*** Accounting Standards. ***Section 211(3A)*** of the Indian Companies Act 1956 requires that the financial statements of Indian Companies should comply Indian Accounting Standards.

(1) **Disclosure of Accounting Policies AS-1** : This AS issued in November 1979 is mandatory for all corporate as well as non corporate enterprises. This standard requires that all the significant accounting policies followed in preparing financial statements of an enterprise should be disclosed in a clear and concise manner as an integral part of financial statements. Any change in the accounting policies that has material effect on the current accounting period or may have material effect in the subsequent periods should be disclosed together with the reason. The effect of such change should be disclosed by way of note and if possible should be quantified.

Some of the areas of accounting where diverse accounting policies are applied are:

(a) Method of depreciation

(b) Valuation of stock

(c) Treatment of goodwill

(d) Capitalization of expenses

(e) Deferred revenue expenditure

(f) Treatment of expenditure on Research and Development

(g) Valuation of Investment

The financial position and profitability of an enterprise is significantly influenced by its accounting policies. Hence this standard requires the enterprise to disclose its accounting policies and the changes therein as a part of financial statements. Proper disclosure of accounting policies ensures proper understanding of financial statements by the readers and meaningful comparison of financial statements of different firms by the stakeholders.

According to this standard if any of the fundamental accounting assumptions such as going concern, Consistency, Accrual etc. are not followed the fact should be disclosed with the reason in the financial statements.

(2) Depreciation Accounting AS-6: This standard was issued in 1985 and revised in 1994. It is recommendatory and not mandatory both for corporate and non-corporate enterprises.

This standard requires that the depreciation amount of the depreciable assets should be allocated on systematic basis to each accounting period during the useful life of the assets. The depreciation method selected should be applied consistently from period to period. If there is a change in the method of providing depreciation its effects should be quantified and disclosed in the financial statements. In case any depreciable asset is disposed off, discarded or demolished the net surplus or deficiency, if material, should be disclosed separately. The depreciation method used, and depreciation rates are also to be shown in the financial statements.

The useful life of depreciable asset should be estimated after considering the following factors.

(a) Expected physical wear and tear

(b) Obsolescence

(c) Legal or other limits on use of assets

The useful lives of major depreciable assets or classes of depreciable assets may be reviewed periodically. Where there is a revision of the estimated useful life of an asset, the un-amortized depreciable amount should be charged over the revised remaining useful life.

Where depreciable asset is revalued the provision for depreciation should be based on revalued amount and on the estimate of the remaining useful life of asset. Material effect of such revaluation of deprecation should be disclosed separately in the year of revaluation

3) Revenue recognition concept AS-9

It was issued in 1985. It is mandatory for corporate and non corporate enterprises according to the standard, the revenue is the gross inflow of cash, receivables or other considerations arising in the course of ordinary activities of an enterprise such as from –

1) Sale of goods
2) Rendering of services, and
3) Use of other enterprises resources yield in interest, rent, royalty and dividends.

An enterprise should disclose the circumstances if any, in which revenue recognition has been postponed due to some uncertainties in determination of revenue within reasonable time limit.