FUNDAMENTALS OF BUSINESS ACCOUNTING

Unit – 1

Meaning of Accounting:

Accounting is a process of identifying financial transactions, measuring them in monetary terms, and recording, classifying, summarizing, analyzing, interpreting them and communicating the results to the users.

Definition of Accounting

According to the American Accounting Association [AAA]; "Accounting refers to the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information".

According to the American Institute of Certified Public Accountants [AICPA]; "Accounting is the art of recording, classifying and summarizing in a significant manner and terms of money, transactions and events, which are, in part at least, of a financial character and interpreting the result thereof".

Objective of Accounting

The following are the main objectives of accounting:-

1.To keep Systematic Records

The main objective of accounting is to keep a systematic record of financial transactions which helps the users to understand the day to day transactions in a systematic manner so as to gain knowledge about overall business.

2.To Protect Business Properties

Accounting provides protection to business properties from unjustified and unwarranted use. Information about the above matters helps the proprietor in assuring that the funds of the business are not necessarily kept idle or underutilized.

3.To Ascertain Profit

Another objective of accounting is that it helps in ascertaining the net profit earned or loss suffered on account of carrying the business which is done by keeping a proper record of all books of accounts with respect to revenues and expenses of a particular period.

4.To Ascertain the Financial Position

The accounting also helps the businessman to know about his financial position. This objective is served by the Balance Sheet or Position Statement. The Balance Sheet is a statement of assets and liabilities of the business on a particular date. It serves as a tool for ascertaining the financial health of the business.

5. To Facilitate Decision Making

Accounting also helps in the collection, analysis, and reporting of information at the required points of time to the required levels of authority in order to facilitate rational decision-making.

6. To Test the arithmetical accuracy of accounts

One of the main objects of scientific methods of accounting is to make sure that accounts have been kept in a proper way. The arithmetical accuracy of accounts kept in the ledger can be assured by preparing a trial balance**.**

7. To Determine and evaluation of policy

The object of accounting is to help the management in determining and evaluating the management policies in running the business successfully by supplying necessary, information, interpreting and analyzing the financial statements.

8. To Help the tax fixation

Accounts prepared on the basis of accepted accounting principles in considered reliable to the income tax

9.To satisfy legal condition:

As all kinds of business organizations have to abide by some legal bindings and prohibitions, they are to maintain their accounts accurately.

Functions of accounting:

The basic functions of accounting in a company may include the following:

Historical Functions:

This type of functioning of accounting includes:

1. Recording the financial transactions and maintain a journal to keep them all.
2. It is important to classify and separate the records and the ledger.
3. Preparation of brief summary takes place for quick reviews.
4. This type of accounting gives the net result other than just keeping the records.
5. The preparation of the balance sheet takes place to determine the financial position of the business.
6. The analyzed data and records are then used for other purposes.
7. The last step is to communicate the obtained financial information to the interested sectors, for instance, owners, suppliers, government, researchers, etc.

Managerial Functions

These are managerial functions:

1. Formation of plans in addition to controlling the financial policies.
2. Besides that, a budget is prepared to estimate the total expenditure for future activities.
3. Also, cost control is made possible by comparing the cost with the efficiency of the work.
4. The accounting also provides the necessary information during the evaluation of employee's performance.
5. To check for fraud and errors is what the workability of the whole procedure depends on.

Accounting Cycle:

The **Accounting Cycle** is a sequence of steps or actions with an organization's financial transactions and accounts. Each iteration of the cycle runs across a complete accounting period, usually a fiscal quarter or year.

- The accounting cycle steps include everything from identifying and recording transactions to creating journal and ledger entries and trial balances to rectifying accounting errors before closing the books for the period.

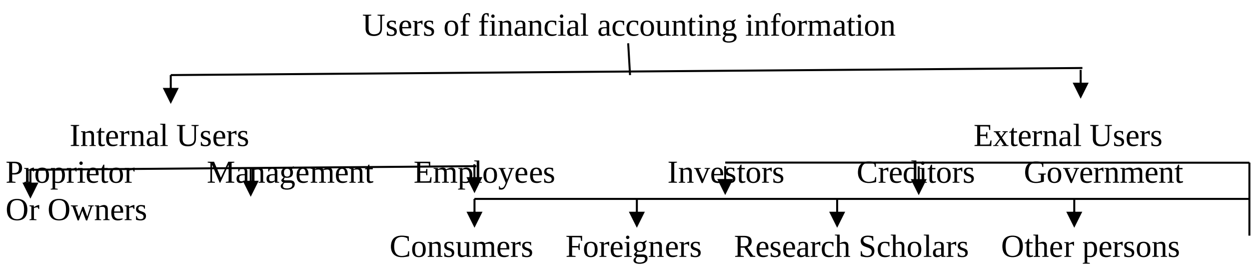
Steps of the Accounting Cycle

There are eight steps to the accounting cycle.

1. **Identify Transactions:** An organization begins its accounting cycle with the identification of those transactions that comprise a bookkeeping event. This could be a sale, refund, payment to a vendor, and so on.
2. **Record Transactions in a Journal:** Next come recording of transactions using journal entries. The entries are based on the receipt of an invoice, recognition of a sale, or completion of other economic events.
3. **Posting**: Once a transaction is recorded as a journal entry, it should post to an account in the general ledger. The general ledger provides a breakdown of all accounting activities by account.
4. **Unadjusted Trial Balance**: After the company posts journal entries to individual general ledger accounts, an unadjusted trial balance is prepared. The trial balance ensures that total debits equal the total credits in the financial records.
5. **Worksheet**: Analyzing a worksheet and identifying adjusting entries make up the fifth step in the cycle. A worksheet is created and used to ensure that debits and credits are equal. If there are discrepancies then adjustments will need to be made.
6. **Adjusting Journal Entries:** At the end of the period, adjusting entries are made. These are the result of corrections made on the worksheet and the results from the passage of time. For example, an adjusting entry may accrue interest revenue that has been earned based on the passage of time.
7. **Financial Statements**: Upon the posting of adjusting entries, a company prepares an adjusted trial balance followed by the actual formalized financial statements.
8. **Closing the Books**: An entity finalizes temporary accounts, revenues, and expenses, at the end of the period using closing entries. These closing entries include transferring net income into retained earnings. Finally, a

company prepares the post-closing trial balance to ensure debits and credits match and the cycle can begin anew.

Users of financial accounting information and their needs



Internal Users:

The owners and persons working in the organisation at managerial levels and employees are considered as internal users of accounting information

a) Proprietors /Owners : Accounting information helps the proprietor to know the earning capacity, financial position, future prospects of the enterprise

b) Management: Management is a group of people who are responsible for using the resources and managing the affairs o fan entity to achieve the goals and objectives. Managers perform many managerial functions such as planning, controlling, directing, measuring, evaluating and taking corrective actions. Accounting information is of great relevance to the management for planning, controlling, co-ordination organising, budgeting, decision-making and for performing many activities. Thus, management can improve the efficiency, increase production and increase profitability by using accounting information in an appropriate manner.

c) Employees: Employees always feel that proprietor makes huge profit while their remunerations are limited, this doubt is removed by accounting information. On the basis of profit and loss account of the current year, they can know current year's profit and can compare it with the profit of the previous year. In case the profitability is higher, they can make a demand for bonus, increase in remuneration and retirement benefit schemes etc.

   Employees are also eager to know about the continuance of the organisation in future for unlimited period because it will result in the continuance of their services, therefore, in the basis of balance sheet they can ascertain their job security and stability.

External Users:

The persons who are neither proprietor nor employees, but they have interest in business activities are called external users. They use accounting information for various purposes according to their requirements.

a) Creditors : Persons who supply goods on credit or provide long-term finance are termed as creditors. They need information to determine whether the concern will be able to pay their principal and interest as and when due.

b) Investors: It is only after knowing the profitability and sound financial position that potential investors take decision about making investment and present investors to continue investment in an enterprise. Accounting information is of great use to them in this connection specially in making judgement for their returns on investments.

c) Consumers : Consumers are interest in the prices of the gods and services rendered by an enterprise. This price decision is based on cost of production plus estimated margin of profit, hence consumers are interested in accounting information with which an idea of price structure can be made.

d) Government: Accounting information is used by the government for the following purposes:
   - Fixation of tax rates and introduction of new taxes
   - To assess whether the unit is going to become sick
   - To compute national income
   - To prepare national accounts
   - To know industrial growth of the country

e) Research Scholars: Accounting information helps research scholars who wants to make a study into the financial operation of a particular firm.

Limitations of Accounting

1. The items expressed in monetary terms are recorded in the accounting where as the items which are nonmonetary nature is not recorded in accounting.
2. Sometimes accounting data are recorded on the basis of estimates and which could be inaccurate.
3. Accounting can be manipulated and biased.
4. Cost concept is adopted in accounting. Changing prices aren't considered. This is very strong limitation f accounting
5. Provision is made for prospective losses, but prospective profits are not taken into account. As a result, the exact state of affairs of the business is not revealed
6. In financial statements, only material items are disclosed in detail. Insignificant items are not disclosed.
7. Accounting methods or systems are static, and not flexible
8. Accounts are influenced by the personal judgements of the accountant. So, accounting records are subjective, and not objective.

ACCOUNTING PRINCIPLES

INTRODUCTION:

A science is an organized body of knowledge, consisting of general principles having universal application. As accounting is a science, it has some general principles having wide application.

DEFINITION AND MEANING:

In the words of A. W. Johnson, "Accounting principles are the assumptions and rules of accounting, the methods and procedures of accounting and the application of these rules, methods and procedures to the actual practice of accounting".

Accounting principles are generally decided rules, derived from the basic accounting concepts, which are followed by accountants universally in writing up the accounts and also in preparing the financial statements of business concerns. In short, accounting principles are rules of action or conduct which are adopted by accountants universally, while recording accounting transactions and preparing financial statements.

Accounting Concepts :

` Accounting concepts are those basic assumptions or conditions upon which the accounting system is based. The important accounting concepts are as follows :

1)**Business Entity Concept**:

Business entity concept is one of the accounting concepts that states that business and the owner are two separate entities and therefore, should be considered separate from each other.

As per this concept, the financial transactions pertaining to the business entity should be recorded separately from the business owners transactions.

This concept is also known as the Economic Entity Concept, which means that the owner of the business and the business itself are considered as two separate entities.

2)Going Concern Concept:

Going concern concept is one of the accounting principles that states that a business entity will continue running its operations in the foreseeable future and will not be liquidated or forced to discontinue operations for any reason.

3)Dual Aspect Concept:

The dual aspect concept states that every business transaction requires recordation in two different accounts. The dual aspect concept indicates that each transaction made by a business impacts the business in two different aspects which are equal and opposite in nature.

4) **Cost Concept:**

The **cost concept of accounting** states that all acquisitions of items (e.g., assets or items needed for expending) should be recorded and retained in books at cost.
For example, if a building is purchased for $500,000, it will continue to appear in the books at that figure, irrespective of its market value.

5)**Money Measurement Concept:**
According to this concept, accounting records only those transactions, which can be expressed in terms of money. Events or transactions, which cannot be expressed in terms of money cannot find place in the books,

6)**Realization Concept** :
According to this concept, the revenue is recognized only when the sale is made. But the sale is a gradual process, which starts with the purchase of raw materials for production and ends with the sale. If no sale is effected, no revenue is recognized. *The realization Principle is a revenue recognition principle that states that the income or revenue is recognized only when earned.*

7)A**ccrual Concept:**
Accrual accounting is a financial accounting method that allows a company to record revenue before receiving payment for goods or services sold and record expenses as they are incurred.

8)**Matching Concept**:
The matching concept is **an accounting practice whereby firms recognize revenues and their related expenses in the same accounting period**. Firms report "revenues," that is, along with the "expenses" that brought them. The purpose of the matching concept is to avoid misstating earnings for a period.

9)**Accounting Period concept**:
Accounting period concept is based on the theory that all accounting transactions of a business should be divided into equal time periods, which are referred to as accounting periods.
Generally an accounting period is of 12 months (1 year). While the time period is fixed, the month can vary from company to company.

10) **Objective Concept**:
The **objective evidence** concept states that no accounting record should be created unless it is supported by independently verifiable evidence. Generally, such

evidence is in writing or should be reduced to writing before an accounting entry is made. All **transactions** must supported with relevant documentary **evidence** .

Accounting Conventions:-

Accounting conventions, are those customs, usage and traditions that are being followed by the accountant for along time while preparing the accounting statements.

1) **Convention of Conservatisms**:

Convention of Conservatism states to anticipate all the future losses and ignore gains. According to this convention, financial statements are usually drawn up on a conservative basis. While preparing accounts and statements, the accountants are expected not to take into account anticipated profits but to provide for all possible anticipated losses.

2) **Convention of Consistency**:

According Convention of consistency means to use the same accounting methods for making financial statement in different years. When we use same accounting methods, it is easy for us to compare the financial statements of different years. For example, if a particular method of charging depreciation on a particular asset is followed, it should be followed consistently. The aim of this convention is to provide for continuity in accounting practices and methods and enable meaningful comparison of accounting statements over a period or between different firms.

3) **Convention of full Disclosure**:

Convention of full Disclosure suggests that a business should report all the necessary information in their financial statements, so that the users who are able to read the financial information are in a better position to make important decisions regarding the company.

4) **Convention of Materiality**:

The materiality convention of accounting states that the business should include only the important or relevant facts in the financial statements. Material facts refer to any information, which if excluded or misreported in the financial statements could influence the decision of the users of such financial statements.

ACCOUNTING STANDARDS

MEANING:

Accounting standards are the policy documents or written statements issued, from time to time, by an apex expert accounting body in relation to various aspects of measurement, treatment and disclosure of accounting transactions or events for ensuring uniformity in accounting practices and reporting. In other words, accounting standards are the guidelines laid down by an apex expert accounting body as to how business transactions or events are to be recorded in books of account, and the manner in which the business transactions are to be exhibited in the financial statements.

Objectives or purposes of accounting standards:

1. The main purpose of accounting standards is to provide information to the users as to the basis on which the accounts have been prepared and the financial statements have been presented.
2. Another objective of accounting standards is to make financial statements more meaningful and comparable and to make people place more reliance on financial statements prepared in conformity with the accounting standards.
3. Yet another objective of accounting standards is to guide the judgment of professional accountants in dealing with those items which are to be followed consistently from year to year.

Benefits of Accounting Standards

Accounting Standards are the ruling authority in the world of accounting. It makes sure that the information provided to potential investors is not misleading in any way. Let us take a look at the benefits of AS.

1] Attains Uniformity in Accounting

Accounting Standards provides rules for standard treatment and recording of transactions. They even have a standard format for financial statements. These are steps in achieving uniformity in accounting methods.

2] Improves Reliability of Financial Statements

There are many stakeholders of a company and they rely on the financial statements for their information. Many of these stakeholders base their decisions on the data provided by these financial statements. Then there are also potential investors who make their investment decisions based on such financial statements.

So it is essential these statements present a true and fair picture of the financial situation of the company. The Accounting Standards (AS) ensure this. They make sure the statements are reliable and trustworthy.

3] Prevents Frauds and Accounting Manipulations

Accounting Standards (AS) lay down the accounting principles and methodologies that all entities must follow. One outcome of this is that the management of an entity cannot manipulate with financial data. Following these standards is not optional, it is compulsory.

So these standards make it difficult for the management to misrepresent any financial information. It even makes it harder for them to commit any frauds.

4] Assists Auditors

Now the accounting standards lay down all the accounting policies, rules, regulations, etc in a written format. These policies have to be followed. So if an auditor checks that the policies have been correctly followed he can be assured that the financial statements are true and fair.

5] Comparability

This is another major objective of accounting standards. Since all entities of the country follow the same set of standards their financial accounts become comparable to some extent. The users of the financial statements can analyze and compare the financial performances of various companies before taking any decisions.

Also, two statements of the same company from different years can be compared. This will show the growth curve of the company to the users.

6] Determining Managerial Accountability

The accounting standards help measure the performance of the management of an entity. It can help measure the management's ability to increase profitability, maintain the solvency of the firm, and other such important financial duties of the management.

Management also must wisely choose their accounting policies. Constant changes in the accounting policies lead to confusion for the user of these financial statements. Also, the principle of consistency and comparability are lost.

Procedure for issuing accounting standards:

The ASB adopts the following procedure for issuing accounting standards:

1. First, the ASB determines the board areas which need formulation of accounting standards, and lists them according to priority.
2. Then, an exposure draft (ED) is prepared with the help of a study group constituted for this purpose. For formulating the exposure draft, the views of professional bodies, the regulating authorities of the government, stock exchange, public sector undertaking, industry, academic bodies and others are obtained.

The exposure draft comprises the following:

a. A statement of concepts and fundamental accounting principles relating to the accounting standards.
b. Definition of the terms used in the accounting standards.
c. The manner in which accounting principles have been applied for formulating the accounting standards.
d. The presentations and disclosure requirements in complying with the standards. The class of enterprises to which the standards are applicable. The data from which the standards will come into force. Thereafter, the exposure draft will be published in the professional journals and circulated otherwise to obtain the views

and comments from professional bodies, academic bodies, the government, industry, etc.

List of accounting standards formulated by the accounting standards board of India:

Till today, the institute of chartered accountant of India has issued 29 accounting standards. Of these, AS-8has been withdrawn and has been merged with AS-26. So, today, there are 28 accounting standards in existence.

The list of accounting standards formulated by the accounting standards board of India is as follows:

AS 1: Disclosure of accounting policies.
AS 2: Valuation of inventories.
AS 3: Cash flow statement.
AS 4: Contingencies and events occurring after the balance sheet date.
AS 5: Net profit or loss for the period, prior period and extraordinary items and changes in accounting policies.
AS 6: Depreciation accounting.
AS 7: Accounting for construction contracts.
AS 9: Revenue recognition.
AS 10: Accounting for fixed assets.
AS 11: Accounting for the effects of changes in foreign rates.
AS 12: Accounting for government grants.
AS 13: Accounting for investments.
AS 14: Accounting for amalgamation.
AS 15: Accounting for retirement benefits in the financial statements of employers.
AS 16: Borrowing costs.
AS 17: Segment reporting.
AS 18: Related party disclosures.
AS 19: Leases.
AS 20: Earnings per share.
AS 21: Consolidated financial statements.
AS 22: Accounting for taxes on income.

AS 23: Accounting for investments in associates in consolidated financial statements.
AS 24: Discontinuing operations.
AS 25: Interim financial reporting.
AS 26: Intangible assets.
AS 27: Financial reporting of interests in joint ventures.
AS 28: Impairment of assets.
AS 29: Provisions, contingent liabilities and contingent assets.