BCOC-131
Financial Accounting

Indira Gandhi
National Open University
School of Management Studies

Block

1

THEORETICAL FRAMEWORK

PROGRAMME DESIGN COMMITTEE B.COM (CBCS)

COURSE DESIGN COMMITTEE

COURSE PREPARATION TEAM

Dr. Sunil Kumar (Unit-4)

Prof. M.S.S. Raju (Course Coordinator & Editor)
Dr. Sunil Kumar (Course Coordinator & Editor)

Preparatory Course in Commerce: PCO-01 (Unit-1, 2 and 3 Revised by Dr. Sunil Kumar)

Prof. J. Satyanarayan, Osmania University, Hyderabad

Prof. V. Vishwanadham, Osmania University, Hyderabad

Dr. D. Obul Reddy, Osmania University, Hyderabad

Shri M. Satyanarayana, Badruka College, Hyderabad

Print Production

Sh. Y. N. Sharma
Assistant Registrar (Pub.)
MPDD, IGNOU

Sh. Sudhir Kumar
Section Officer (Pub.)
MPDD, IGNOU

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BLOCK 1 THEORETICAL FRAMEWORK

This block will introduce you to the core area in Commerce. In order to appreciate the need for accounting, You have to practice accounting and require a clear understanding of the nature and scope of accounting, the language used in accounting and the principles that guide the accountant. This block also deals with basic rules of double entry system and accounting standards which provides the basis for accounting policies in order to prepare the financial statements. This block is structured to cover these and other related aspects. It is hoped that this block will provide you the necessary theoretical background to understand and appreciate accounting in the right perspective. It covers four units.

Unit 1 explains the nature and scope of accounting and the importance of accounting information to various parties.

Unit 2 analyse the basic rules of double entry system and their application.

Unit 3 presents some of the terms commonly used in accounting and the basic concepts underlying accounting.

Unit 4 deals with Accounting Standards which provides the basis for accounting policies and for preparation of financial statements.

UNIT 1 NATURE AND SCOPE OF ACCOUNTING

Structure

1.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the need for accounting;
- identify the objectives of accounting;
- describe accounting as an information system;
- outline the scope and bases of accounting;
- distinguish between book-keeping, accounting and accountancy;
- identify the parties interested in accounting information;
- describe the functions and important branches of accounting;
- describe the advantages and limitations of accounting; and
- state the qualitative characteristics of accounting.

1.1 INTRODUCTION

In this unit, we shall discuss the functions, branches, advantages, limitations, and bases for accounting. In this unit, we also intend to elaborate on the need for accounting and then discuss the nature, scope and importance of accounting.

1.2 NEED FOR ACCOUNTING

Let us elaborate on need for accounting. Suppose you are given ten rupees to purchase vegetables and asked to account for the amount. You have purchased the vegetables— 1 kg of tomatoes for Rs. 4, 1 kg of potatoes for Rs. 3, and 1 kg of brinjalsfor Rs. 2. The total amount spent is Rs. 9 and the balance of amount with you is Re 1. Thus, you have rendered the account for Rs. 10. This is one time affair. Therefore, you could remember what you have spent.

Suppose, you are given Rs. 2,000 and asked to manage the home for a month and render the account for the money at the end of the month. You will be purchasing groceries, milk, vegetables, paying for electricity, school/college fees, etc. You will be spending almost everyday. In that case, is it possible to remember all the payments you are making everyday and render account at the end of the month? No, it is not possible to remember, especially when the number of payments is more. Not only that, it is not even advisable to depend on memory. Therefore, it is better to write down (or record) whatever payments you have made. Further, it is advisable to obtain receipts or bills for the payments you have made, so that you can render the account, beyond doubt.

The above example is a simple one, where you have one receipt of money i.e., Rs. 2,000 and a number of payments. But the case of business is different. In business, you may have to purchase and sell hundreds and thousands of times over a period of time. You will have a number of receipts and a number of payments (known as transactions). Will it be possible for you to remember hundreds and thousands of transactions which have taken place in your business, that too over a period of time, say a year? It is not humanly possible to remember all transactions which have taken place in business over a period of time. Even if you remember all the transactions, you will find it impossible to calculate the net effect of all such transactions i.e., profit. It, therefore, becomes necessary to record all the transactions that have taken place in business.

Further, it is not possible for the businessman to sit at the cash counter throughout the day. Sometimes his family members may be asked to sit at the cash counter. As the size of the business grows, it becomes necessary to employ people to assist the businessman. In such cases, theft of goods or cash is possible or all the sale proceeds may not be put into the cash box. Hence, it becomes necessary to maintain accounting records for the purpose of control, especially when outsiders are employed. It can, thus, be seen that there is need for proper accounting records even in case of a sole proprietorship concern. It is all the more important in the case of other forms of business organisation.

In case of a partnership firm, all the partners may or may not be actively participating in the day-to-day management of the business. It is, therefore, necessary to record all the transactions in order to satisfy all the partners. In case of a company, it is not possible for the owners (shareholders) who are too large in number to take part in the day-to-day management of the company. Generally, the management of the company is entrusted to paid managers. Hence, there is a need for recording all transactions.

Information about the business is required for both internal and external use. For example, the management needs a lot of information (for their internal use) for planning, controlling and evaluating the operations of the business. Information is also needed by some outsiders, banks, creditors, etc. For example, it is required for filing sales tax, income tax, and other tax returns with appropriate tax authorities. When a firm approaches the bank for loan or the creditors for supply of goods on credit, the bank or creditors like to know the firm's financial position (whether it is financially sound or not) and its profit earning capacity. The question is how to obtain all such information. A systematic accounting record is the only answer.

Accounting is necessary in not only business organisations, but also 'non-business' organisations like schools, colleges, hospitals, libraries, etc.

1.3 OBJECTIVES OF ACCOUNTING

From the above discussion, the objectives of accounting can be stated as follows:

i) **To keep systematic records:** Accounting is done tokeep a systematic record of financial transactions, like purchase of goods, sale of goods, cash receipts and cash payments. Systematic record of various assets and liabilities of the business is also to be maintained.

ii) **To ascertain the net effect of the business operations i.e., profit or loss of business:** Weknow that the primary objective of business is to make profit and the businessman is very much interested in knowing the same. A proper record of income and expenses facilitates the preparation of the profit and loss account (income statement). The profit and loss account reveals the profit earned or loss incurred by the business firm during a particular period.

iii) **To ascertain the financial position of the business:** The businessman is not only interested in knowing the operating results, but also interested in knowing the financial position of his business i.e., where it stands. In other words, he wants to know when the business owes to others and what it owns and what happened to his capital – whether the capital increased or decreased or remained constant. A systematic record of various assets and liabilities facilitates the preparation of a statement known as 'balance sheet' (position statement) which answers these questions.

iv) **To provide accounting information to interested parties:** Apart from the owners, there are various other parties who are interested in knowing about the business firm, such as the management, the bank, the creditors, the tax authorities, etc. For this purpose, the accounting system has to furnish the required information.

Check Your Progress A

1. Give five points in support of the need for accounting.

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2. State the main objectives of accounting.

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3. What is profit?

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4. What do you understand by 'Financial Position?

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1.4 DEFINITION AND SCOPE OF ACCOUNTING

Accounting has been defined in different ways by different authorities on the subject. Accounting is a comprehensive discipline and it is difficult to explain satisfactorily through any single definition. However, two definitions are given below. This should help you to understand the nature and scope of accounting.

The American Accounting Association defines Accounting as the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information. This definition stresses three aspects viz., identifying, measuring and communicating economic information.

In the words of the Committee on Terminology appointed by the American Institute of Certified Public Accountants, ''Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least of financial character and interpreting the results thereof ''. This is a popular definition of accounting and it outlines the nature and scope of accounting activity.

A business is generally started with proprietor's funds i.e., capital. The proprietor may also acquire additional funds from outsiders like banks and creditors. These funds are utilised to acquire the assets needed for business and also to carry out other business activities. In the process many transactions and events take place. The accountant has to identify all such transactions and events, measure them in terms of money, and record them in appropriate books of account. Then, he has to classify them under separate heads of accounts, summarise periodically in the form of Profit and Loss Account and Balance Sheet; and analyse, interpret and communicate the results thereof to the interested parties. Accounting can thus be broadly defined as follows;

Accounting is the process of identifying, measuring, recording, classifying, summarising, analysing. interpreting, and communicating the financial transactions and events in monetary terms.

The above definitions clearly bring out the scope of accounting. This can now be outlined as follows:

1. Accounting is concerned with financial transactions and events which bringabout a change in the resources (or wealth) position of the business firm. Such transactions have to be **identified** first, as and when they occur. It is not difficult because, there will be proof in the form of a bill or receipt (called vouchers). With the help of these bills and receipts, identification of a transaction is easy. For example, when you purchase something you get a bill, when you make payment, you get a receipt.

2. These transactions are to be **measured** or expressed in terms of money, if not done already. Generally, this problem will not arise, because the statement of proof expresses the transaction in terms of money. For example, if ten books are purchased at the rate of Rs. 20 each, then the bill is prepared for Rs. 200. But, if an event cannot be expressed in monetary terms, it will not come under the scope of accounting.

3. The transactions which are identified and measured are to be recorded in a book called journal or in one of its sub-divisions.

4. The recorded transactions are to be **classified** with a view to group transactions of similar nature at one place. The work of classification is done in a separate book called ledger. In the ledger, a separate account is opened for each item so that all transactions relating to it can be brought to one place. For example, all payments of salaries are brought to salaries account.

5. The recording and classification of many transactions will result in a mass of financial data. It is, therefore, necessary to **summarise** such data periodically (at least once a year), in a significant and meaningful form. The summarisation is done in the form of profit and loss account which reveals the profit made or loss incurred, and the balance sheet which reveals the financial position.

6. The summary results will have to be **analysed,** interpreted (critically explained) and communicated to interested parties. Accounting information is generally communicated in the form of a 'report'. Big organisations generally present printed reports, called published accounts.

1.5 BOOK-KEEPING, ACCOUNTING AND ACCOUNTANCY

Very often you will come across terms like bookkeeping, accounting, and accountancy in the literature on accounting. We propose to explain them in the following paragraphs:

You know Accounting involves a series of activities, as listed out in the scope of accounting. These activities are; (1) identifying, (2) measuring. (3) recording, (4) classifying, (5) summarising, (6) analysing, (7) interpreting, and (8) communicating, the financial transactions and events. –

Book-keeping is a narrow term, which means record keeping or maintaining books of account. It only covers the first four activities (1 to 4 above) of accounting.

The term 'Accountancy' refers to a systemiatised knowledge of accounting and is regarded as an academic subject like economics; statistics, chemistry, etc. It explains 'why to do' of various aspects of accounting. In other words, when accounting refers to the actual process of preparing and presenting the accounts, Accountancy tells us why and how to prepare the books of account and how to summarise the accounting information and communicate it to the interested parties. Thus Accountancy is a science, a body of systematised knowledge, whereas Accounting is the art of putting such knowledge intopractice.

In general usage, however, Accountancy and Accounting are used as synonyms (meaning the same thing). But, of late, the term accounting is becoming more and more popular.

Cheek Your Progress B

1. Define accounting.

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2. What do you mean by book-keeping?

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3. What is accountancy?

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4. Accounting involves a series of activities. List them.

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1.6 USERS OF FINANCIAL ACCOUNTING INFORMATION

You have learnt that many groups of people are interested in accounting information which may help them:

i) to understand the present position of the enterprise

ii) to compare its present performance with that of its past years

iii) to compare its present performance with that of similar enterprises.

Now, let us see who such parties are and how accounting information is useful to various parties.

Owners: Ownerscontribute capital and assume the risk of business. Naturally, they are interested to know the amount of profit earned by the business and so also its financial position. If however, the management of the business is entrusted to paid managers, the owners also use the accounting information to evaluate the performance of the managers.

Managers: Accounting information, supplemented by other information, is of immense use to managers. It helps them to plan, control and evaluate the operations of the business. They also need such information for various decision-making.

Lenders : The funds are provided by the owners initially, but if the business requires more funds they are provided by banks and other lenders of money. Before they lend money, they would like to know the solvency (i.e.., capacity to repay debts) of the enterprise, so as to satisfy themselves that their money will be safe and that they can expect repayment on time.

Creditors: Those who supply goods and services on credit are called creditors. Like lenders, they too want to know about solvency of the enterprise, so as to decide whether credit can be granted or not.

Prospective investors: A person who wants to become a partner in a partnership concern or a person who wants to become a shareholder of a company, would like to know how safe and rewarding the proposed investment would be.

Tax authorities: Tax authorities of the Government are interested in the financial statements so as to assess the tax liability of the enterprise.

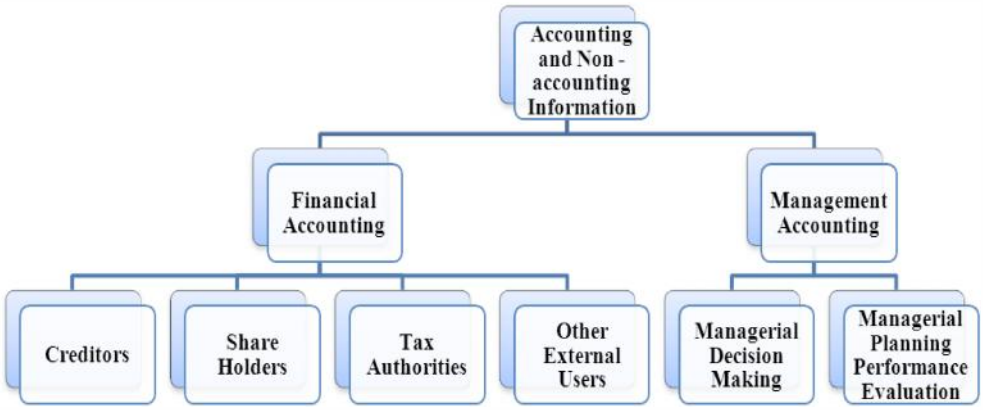
Employees: The employees of the enterprise are also interested in knowing the state of affairs of the organisation in which they are working, so as to know how safe their interests are in that organisation.

1.7 ACCOUNTING AS AN INFORMATION SYSTEM

Accounting is part of an organization's information system, which includes both financial and non-financial data. Accounting is the process of identifying, measuring and communicating economic information to permit judgment and decisions by users of the information. The main objective of accounting is to provide information to the users. Accounting is also required to serve some broad social obligations since the accounting information is used by a large body of people such as customers, employees, investors, creditors and government.

Accounting is commonly divided into (1) Financial Accounting, and (2) Managerial Accounting. Financial accounting refers to the preparation of general purpose reports for use by persons outside an organization. Such users include shareholders, creditors, financial analysts, labour unions, government regulations etc. External users are interested primarily in reviewing and evaluating the operations and financial status of the business as a whole.

Managerial accounting, on the other hand, refers to providing of information to managers inside the organization. For example a production manager may want a report on the number of units of product manufactured by various workers in order to evaluate their performance. A sales manager might want a report showing the relative profitability of two products in order to pinpoint selling efforts. The financial reports are available from the libraries or company themselves whereas managerial accounting reports are not widely distributed outside because they often contain confidential information. The following figure shows that accounting is part of an organization system which includes both financial and non financial data:



Accounting as an information system

Uses of Accounting Information

Accounting provides information for the following three general uses:-

1) **Managerial decision making:** Management is continuously confronted with the need to make decisions. Some of these decisions may have immediate effect while the others have in the long run. Decisions regarding the price of the product like make or buy the product or to drop it, to expand its area of operations etc., are some of the examples of decisions making. Management Accounting provides necessary information to arrive at right conclusions.

2) **Managerial planning, control and internal performance evaluation:** Managerial accounting plays an important role in the planning and control. By assisting management in the decision making process, information is provided for establishing the standard. Accounting also provides actual results to compare with projections.

For example, where a marketing manager is given a target of sales revenues of Rs. 10 crores, the amount of Rs. 10 crores will serve as a standard for evaluating the performance of the marketing manager. If annual sales revenues vary significantly from Rs. 10 crores, steps will be taken to ascertain the causes for the difference. When the factors leading to the variance are not under the control of the marketing manager, then the marketing manager would not be held responsible for it. On the other hand the cause for variance is under the control of marketing manager then he will be held responsible in evaluating the performance of marketing manager. Accounting provides necessary information to measure the variance in the actual performance.

3) **External financial reporting:** Accounting has always been used to supply information to those who are interested in the affairs of the company. Various laws have been passed under which financial statements should be prepared in such way that required information is supplied to shareholders, creditors, government etc. For example, the investors may be interested in

the financial strength of the business, creditors may require information about the liquidity position, government may be interested to collect details about sales, profit, investment, liquidity, dividend policy, prices etc. in deciding social and economic policies. Information is required in accordance with generally accepted accounting principles so that it is useful in taking important decisions.

1.8 BRANCHES OF ACCOUNTING

Accounting, as we know it today, has evolved over many centuries in response to the changing economic, social and political conditions. The development of modern accounting was influenced by a number of factors such as industrial revolution, growth of large enterprises like companies, introduction of compulsory audit of companies, legal regulations, establishment of professional organisations like the Institute of Chartered Accountants of India, the Institute of Cost and Works Accountants of India, American Institute of Certified Public Accountants, etc Economic development and technological improvements have resulted in an increase in the scale of business operations and the advent of company form of organisation. This has made management function more and more complex. These factors have increased the importance of accounting and have given rise to special branches of accounting. The important branches of accounting are briefly explained below:

Financial Accounting: The purpose of this branch of accounting is to keep a record of financial transactions and events so that:

a) the net result of the operations of the business (profit or loss) during an accounting period can be ascertained;

b) the financial position (assets, liabilities and capital position) of the business as at the end of the period can be ascertained; and

c) relevant financial information can be provided to management and other interested parties.

Cost Accounting: The purpose of cost accounting is to analyse the expenditure so as to ascertain the cost of each product, operation, service, etc. The price of an article is nothing but the cost plus a certain amount of profit. Unless cost is known, price cannot be fixed rationally. Cost accounting helps not only in ascertaining the costs but also assists the management in controlling the costs.

Management Accounting: The purpose of management accounting is to assist the management in taking rational policy decisionsand to evaluate the impact of its decisions and actions. Examples of such decisions are: pricing decisions, capital expenditure decisions, etc. This branch of accounting is primarily concerned with presenting information that may be needed by management in such decision-making.

In this course, we are concerned with financial accounting only.

Check Your Progress C

1. Mr. Agarwala started Agarwala Electricals shop with a capital of Rs. 1,00,000. As this amount is insufficient, he has borrowed Rs. 50,000 from Syndicate Bank. As he is not keeping good health, he appointed Mr. Ram Naresh to look after the business on a salary of Rs. 1,000 per month. Pavan Electrical Works supplies electrical goods to Agarwala Electricals

on credit. Mr. Mirchand, Mr. Sabir and Mr. Wilson are the other persons working in Agarwals Electricals, as salesmen. Mr. Agarwals wants to expand the business. He is not in a position to invest more money. Mr. Shyamlal wants to join as a partner. From this, identify the names of the following parties and write the answer in theblank space provided.

		Name
i)	Business firm	....
ii)	Owner	....
iii)	Manager	....
iv)	Lender	....
v)	Creditor	....
vi)	Prospective Investor	....
vii)	Employees	....

2. Complete the following sentences:

   i) Accounting is the process of identifying, measuring and ……………… economic information to permit informed judgements.

   ii) Accounting designed to serve external parties to provide information relating to the operating activities of the business is termed as ………………………

   iii) Accounting designed for operational needs of business is termed as ……………………………………..

   iv) ……………………….. Accounting is more or less compulsory for every business.

1.9 ADVANTAGES OF ACCOUNTING

The following are the advantages of a properly maintained accounting system:

1) **Replaces memory:** Since all the financial events are recorded in the books, there is no need to rely on memory. The books of account will serve as historical records. Any information required at any time can be had from these records.

2) **Provides control over assets:** Accounting provides information regarding balance of cash in hand and at bank, the stock of goods in hand, the amount receivable from various parties, the amount invested in various other assets, etc. Information about these matters help owner(s) and management to make use of the assets in the best possible way.

3) **Facilitates the preparation of financial statements:** With the help of information contained in the accounting records, financial statements viz., Profit and Loss Account and Balance Sheet can be easily prepared. These statements enable the businessman to know the net result of the business during an accounting period and its financial position.

4) **Meets the information requirements:** Various interested parties such as owners, management, lenders, creditors, etc. get the necessary information at frequent intervals which help them in their decision-making.

5) **Facilitates a comparative study:** The financial Statements prepared will enable the enterprise to compare its present position with that of its past, and with that of similar organisations. This helps them to draw useful conclusions and improve its performance.

6) **Assists the management in many ways:** It is possible to identify reasons for the profit earned or loss suffered. The identification of reasons helps in taking necessary steps to increase profits further, or to avoid losses. Accounting information will also help in planning and controlling the activities of the business.

7) **Difficult to conceal fraud or theft:** It is difficult to conceal fraud, theft, etc..as there is an automatic check in the form of periodic balancing of books of account. Further, in big organisations, the record keeping work is divided among many persons. so that chances of committing fraud are minimised.

8) **Tax matters :** The Government levies various taxes such as customs duty, excise duty, sales tax, and income tax. Properly maintained accounting records will help in the settlement of tax matters with the tax authorities.

9) **Ascertaining value of business:** In the event of sale of a business firm, the accounting records will help in ascertaining the value of business.

1.10 LIMITATIONS OF ACCOUNTING

The accounting information is used by various parties who form judgments about the profitability and the financial soundness of a business on the basis of such information. It is, therefore, necessary to know about the limitations of accounting. These are as follows:

1. They do not record transactions and events which are not of a financial character. Hence. They do not reveal a complete picture because facts like quality of human resources, licences possessed, locational advantage, business contacts, etc. do not find any place in books of account.
2. The data is historical in nature. The accountants adopt historical cost as the basis in valuing and reporting all assets and liabilities. They do not reflect current values, it is quite possible that items like land and buildings may have much more value than what is stated in the balance sheet.
3. Facts recorded in financial statements are greatly influenced by accounting conventions and personal judgements. Hence, they do not reveal the true picture. In many cases, estimates may be used to determine the value of various items. For example, debtors are estimated in terms of collectability, inventories are based on marketability, and fixed assets are based on useful working life. All these estimates are materially affected by personal judgements.
4. Data provided in the financial statements is insufficient for proper analysis and decision making. It only provides information about the overall profitability of the business. No information is given about the cost and profitability of different activities.

1.11 BASES OF ACCOUNTING

There are two bases of accounting: (i) cash basis, and (ii) accrual basis. These are explained below:

1.11.1 Cash Basis of Accounting

In this system, the accounting entries are made on the basis of cash received or cash paid. In other words, transactions are recorded only when cash is received or paid. The incomes earned but not yet received (accrued income) or the expenses incurred but not yet paid (expenses outstanding) are completely ignored while preparing the final accounts. For example, rent for the month of December, 2017 is paid in January, 2018. This is taken into the Profit and Loss Account of 2018 even though the benefit of that payment (accommodation) is enjoyed in 2017 itself.

1.11.2 Accrual Basis of Accounting

This system of accounting attempts to record the financial effects of transactions in the period in which they occur and not in the period in which the amount is received or paid to the enterprise.

Accrual accounting is also called 'Mercantile System of Accounting'. It recognises that buying, selling and all other operations of an enterprise during a period may not coincide with the period during which the related cash receipts and cash payments take place. In other words, all revenues earned in a year may or may not have been received in cash in that year. Similarly, all expenses incurred in a year may or may not have been paid in the same year. Accrual accounting attempts to relate the revenues and expenses to year in which they are actually earned or incurred. For example, rent for the month of December, 2017 is paid in January, 2018. As per the accrual principle, it would be taken to the Profit and Loss Account of the year 2017 and not 2018. This is more logical because the benefit of payment is enjoyed in the year 2017 and not in 2018.

The main difference between accrual accounting and cash basis of accounting is the recognition of revenues, gains, expenses and losses. The objective of accrual accounting is to account for the effects of transactions and events to the extent that their financial effects are recognisable and measurable in the periods in which they occur. The adjustments made in the final accounts in respect of prepaid expenses (prepaid insurance, salaries paid in advance, etc.), income received in advance (rent received in advance, interest received in advance, etc.), income earned but not yet received (interest receivable, commission receivable, etc.) are based on accrual accounting.

Sometimes, a business adopts a combination of both the above systems. In that case it is called 'Mixed or Hybrid System'. For example, the business may consider income in cash receipt basis and expenses on accrual basis. This is considered most conservative. In practice, most enterprise adapt the accrual basis of accounting.

1.12 QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION

Business owners can use accounting information to conduct a financial analysis of business operations. Accounting information often has quantitative and qualitative characteristics. Quantitative characteristics refer to the calculation of financial transactions. Qualitative characteristics include the business owner's perceived importance of financial information. Business owners often require financial information when making business decisions. Incorrect or inappropriate information can hamper decision-making or cause business owners to make incorrect assessments about their companies. Some of the qualitative characteristics of accounting information are as follows:

(i) Understandable

Accounting information must be understandable. This is an important qualitative characteristic for small business owners. Many small business owners do not have a strong accounting background. Financial information that is too technical or cannot be understood by a layperson can be ineffective for business owners. Small business owners often use professional accountants to complete various accounting functions. Business owners should choose an accountant who can prepare information in an easily understandable manner.

(ii) Usefulness

Business owners need accounting information that is applicable to the business decision at hand. They can request financial statements, accounting schedules, reconciliations or cost-benefit analysis. For example, cost allocation reports may not provide sufficient information for business owners who must make a decision on hiring employees. Cost allocation usually refers to applying business costs to goods or services produced by the company, which has very little to do with human resources. Business owners should carefully request and review accounting information to ensure that it provides the most useful information for the decision-making process.

(iii) Relevance

Accounting information should relate to a specific time period or contain information regarding individual business functions. Business owners often conduct a trend analysis when reviewing financial information. The trend analysis compares historical financial information to the company's current accounting period information. Irrelevant historical information can severely distort the trend analysis process. For example, reviewing the production process for budgets requires relevant information on the cost of materials for budgets. Cost information on the materials to produce COGS would be irrelevant.

(iv) Reliability

Accounting information must be reliable, so that business owners can be reasonably assured that accounting information presents an accurate picture of the company's financial health. Business owners often use accounting information to secure external financing for their business. Information that is not reliable or accurate may cause lenders and investors to question the business's management ability. Business owners may also struggle to secure external financing with poor accounting information.

(v) **Comparable**

Comparability allows business owners to review their company's accounting information against that of a competitor. Business owners use comparison to gauge how well their companies operate under certain market conditions. Owners often use the leading company of an industry for the comparison process. These companies usually have the most efficient and effective business operations. Non-comparable accounting information can make this a difficult process. For example, business owners should consider preparing financial statements according to standard accounting principles. The statements can then be compared to other company's financial standard prepared in a similar manner.

(vi) **Consistent**

Consistency refers to how business owners and accountants record financial information in a company's general ledger. Business owners need to ensure that financial transactions are handled the same way. Inventory purchases should be recorded the same way as yesterday, today and tomorrow. This helps companies create accurate historical records and limit the amount of financial accounts or journal entries included in their general ledgers.

1.13 FUNCTIONS OF ACCOUNTING

Functions of Accounting involves the creation of financial records of business transactions, flows of finance, the process of creating wealth in an organization, and the financial position of a business at a particular moment in time. The progress and reputation of any business big or small is build up on sound financial footing. There are number of parties who are interested in accounting information relating to a business. Financial Accounting communicates financial information of the business concern to various parties. Financial accounting provides information regarding the status of a business and results of its operation. Here are the functions of accounting:

(i) Recording

This is the basic function of accounting. It is essentially concerned with not only ensuring that all business transactions of financial character are in fact recorded but also that they are recorded in an orderly manner. Recording is done in the book "Journal".

(ii) Classifying

Classification is concerned with the systematic analysis of the recorded data, with a view to group transactions or entries of one nature at one place. The work of classification is done in the book termed as "Ledger".

(iii) Summarizing

This involves presenting the classified data in a manner which is understandable and useful to the internal as well as external end-users of accounting statements. This process leads to the preparation of the following statements: (1) Trial Balance, (2) Income statement (3) Balance Sheet.

(iv) Analysis and Interprets

This is the final function of accounting. The recorded financial data is analyzed and interpreted in a manner that the end-users can make a meaningful judgment about the financial condition and profitability of the business operations. The data is also used for preparing the future plan and framing of policies for executing such plans.

(v) Communicate

The accounting information after being meaningfully analyzed and interpreted has to be communicated in a proper form and manner to the proper person. This is done through preparation and distribution of accounting reports, which include besides the usual income statement and the balance sheet, additional information in the form of accounting ratios, graphs, diagrams, funds flow statements etc.

1.14 LET US SUM UP

1. Business has a series of transactions. It is not possible to remember all the transactions which have taken place over a period of time, and calculate the net effect of all such transactions i.e., profit or loss. Hence, the need for accounting takes place.

2. Information about the business enterprise is required for both internal and external use. To get the required information, a systematic record is necessary.

3. The objectives of accounting are: to keep systematic records; to ascertain the profit or loss and also the financial position; and to provide accounting information to interested parties for rational decision-making.

4. Accounting is the process of identifying, measuring, recording, classifying, summarising, analysing, interpreting and communicating the financial transactions and events.

5. The series of activities mentioned above, explain the nature and outline the scope of accounting.

6. Book-keeping is a part of accounting. It is the record keeping function of accounting and is limited upto the classifying stage.

7. Accountancy is the systematic knowledge, while accounting is the practice of the knowledge i.e., the actual maintenance of books of account and provide accounting information.

8. Many groups of people like owners, management, lenders, creditors, investors, tax authorities, employees, etc., are interested in the accounting information of the enterprise.

9. Changes in economic environment and the increasing complexity of management function have given rise to specialised fields of accounting such as financial accounting, cost accounting and management accounting.

10. There are many advantages of a properly maintained accounting system.

1.15 KEY WORDS

Accountancy: The science of measurement of wealth. It is the systematic knowledge of accounting.

Accounting: Process of identifying, measuring, recording, classifying, summarising and communicating business transactions and events in terms of money.

Accounting Year : A period of 12 months at the end of which the financial results of the enterprise are generally ascertained.

Accrual Basis of Accounting: A basis of accounting which takes into account all incomes, gains, expenses and losses in the year in which they are earned or incurred, and not when they are received or paid.

Book-keeping: Systematic recording of business transactions in the books of account.

Balance Sheet: A statement prepared for ascertaining the financial position of the business as at the end of the accounting period.

Cash Basis of Accounting: A basis of accounting in which accounts are prepared on the basis of cash received or cash paid. No accruals -are considered.

Cost Accounting: A branch of accounting concerned with measurement and control of costs.

Financial Accounting: It is primarily concerned with record keeping directed towards preparation of financial statements and other accounting reports.

Financial Position: Position of assets and liabilities of a business at a given point of time.

Financial Statements: Summary of accounting information such as Profit and Loss Account and Balance Sheet.

Final Accounts : Financial statements prepared at the end of the accounting period for ascertaining the profit or loss and the financial position of the business. They include Profit and Loss Account and the Balance Sheet.

Management: It is used in two senses:

i) to mean the process of management or managing the business, for example, the day-to-day management is entrusted to paid managers; and

ii) to mean the persons who are incharge of carrying out the business activity i.e., managers, for example, management wants this information. Report has to be submitted to the management.

Management Accounting: It is concerned with the supply of information which is useful to the management in planning, controlling and decision-making.

Profit: Excess of income over expenses.

Profit and Loss Account: A statement showing all incomes and expenses for the accounting period. It is prepared for ascertaining the operational result of the enterprise.

1.16 SOME USEFUL BOOKS

Bièrman, Harold & Drebin, *Allan R., Financial Accounting: An Introduction* (Philadelphia: W.B. Saunders Company, 1998).

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Matulich, S. & Heitger, *L.E., Financial Accounting* (New York: McGraw Hill Book Company, 1990).

Patil, V.A. & Korlahalli, Principles and Practice of Book-Keeping (New Delhi: R. Chand & Co., 2018).

1.17 ANSWERS TO CHECK YOUR PROGRESS

C 1. i) Agarwala Electricals Shop

ii) Mr. Agarwala

iii) Mr. Ram Naresh

iv) Syndicate Bank

v) Pawan Electrical Works

vi) Mr. Shyamlal

vii) Mr. Mirchand, Mr. Sabir and Mr. Wilson.

2. i) Communicating

ii) Financial Accounting

iii) Management Accounting

iv) Financial

1.18 TERMINAL QUESTIONS

1. Outline the need for accounting and briefly describe the objectives of accounting.
2. Define accounting and explain its scope.
3. Name the different parties interested in accounting information, and explain why do they want it.
4. What are the qualitative characteristics of accounting information? Briefly Explain.
5. Describe the advantages and limitations of accounting.
6. Briefly discuss the functions of accounting.
7. Define accounting. Explain the need for accounting.

8. Write short notes on the following:

   a) Book-keeping

   b) Accountancy

   c) Accounting

9. Distinguish between cash basis and accrual basis of accounting with examples.

> **Note** : These questions will help you to understand the unit better. Try to write answers for them. But, do not submit your answers to the University for assessment. These are for your own practice only.

UNIT 2 ACCOUNTING PROCESS AND RULES

Structure

2.0 OBJECTIVES

After studying this unit, you should be able to:

- identify the different stages of accounting;
- classify accounts;
- analyze the dual effect of each transaction; and
- apply the rules of accounting, and determine the account to be debited and the account to be credited.

2.1 INTRODUCTION

So far you have learnt the definition of accounting, its objects, advantages, the terms commonly used in accounting, and the basic accounting concepts relevant to record keeping. You know accounting is the art of recording, classifying and summarising the business transactions, and interpreting the results thereof. So, the accounting process starts with recording of transactions and ends with the preparation of financial statements and their analysis. In this unit, we shall first identify the different stages involved in the accounting process and then discuss different classes of accounts, the principle of double entry, and the rules of debit and credit which you are expected to master.

2.2 ACCOUNTING PROCESS

The accounting process consists of the following four steps:

i) Recording the Transactions

ii) Classifying the Transactions

iii) Summarising the Transactions

iv) Interpreting the Results

Recording the Transactions

The accounting process begins with recording of transactions in the books of original entry. The book used for the original entries is called 'Journal'. Business transactions are recorded in the journal as and when they occur in the order of dates. You will learn the method of recording a transaction in the journal in Unit 5. Entries in the journal are made on the basis of various vouchers such as cash memos, invoices, receipts, etc.

Classifying the Transactions

The second step is to group the transactions of similar nature and post them in different accounts in another book called the 'Ledger'. For example, all transactions relating to cash are brought together and are recorded at one place in Cash Account in the ledger. Similarly, dealings with different persons are recorded separately in the account of each person. The accounts so prepared are totaled and balanced periodically to know the net effect of related transactions. We shall discuss the process of posting into ledger and balancing of accounts in detail in Unit 5.

Summarising the Transactions

The next step is to prepare a year-end summary known as 'Final Accounts. But before final accounts are prepared, we prepare a statement called 'Trial Balance' to test the arithmetical accuracy of the work done. In other words, the trial balance is prepared to find out whether the Principle of Double Entry has been strictly followed or not, while recording the transaction. Then, with the help of the trial balance and some other relevant information we prepare the final accounts. The objectives of preparing the final accounts are: (i) to know the net result of business activities, and (ii) to know the financial position of the business. The final accounts consist of an income statement called 'Trading and Profit and Loss Account', and a position statement called 'Balance Sheet'. The Trading and Profit and Loss Account is prepared to know whether the business unit has earned profit or incurred loss. The Balance Sheet is prepared to know the financial position of the business, i.e., what the business owns and what it owes.

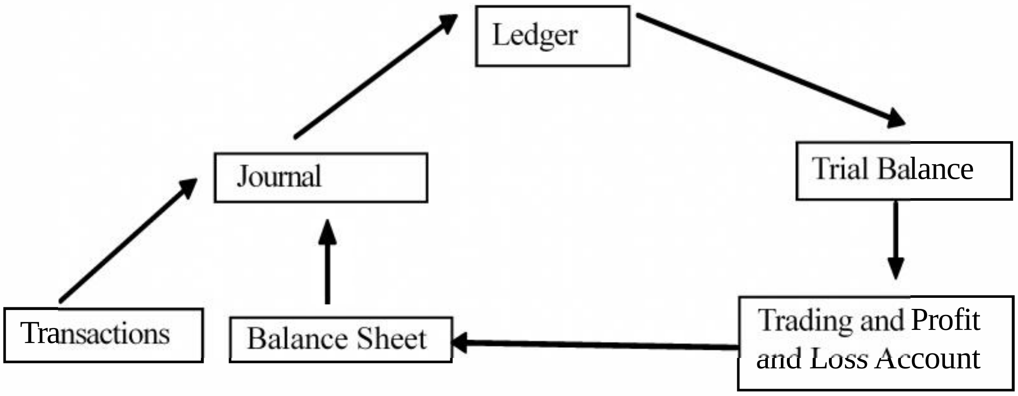
Interpreting the Results

The results are then analysed and interpreted with a view to assess the performance of the business, its future profit-earning capacity and its ability to pay short-term and long-term debts. The results and conclusions thus arrived at are reported to the interested parties like investors, management, bankers, creditors, tax authorities, etc.

The balances on various accounts shown in the Balance Sheet will then be transferred to the new books of account for the next year. The process of recording transactions for the next year is again started, this continuous process of accounting is referred to as the 'Accounting Cycle' because it repeats itself regularly and in the same order. The Accounting Cycle is presented in Chart 2.1.

Chart 2.1

ACCOUNTING CYCLE



2.3 WHAT IS AN ACCOUNT?

We have seen that an account is a summarised record of the effect of all transactions relating to a particular person or an item. Let us now learn more about this term.

An account is vertically divided into two halves and resembles the shape of the English alphabet 'T' as under:

Name of the account

Dr. **Cr.**

The left hand side is called the 'debit side'. It is indicated by writing 'Dr.' (abbreviation for debit) on the left hand top corner of the account. The right hand side known as the 'credit side' is indicated by writing 'Cr.' (abbreviation for credit) on the right hand top corner of the account. The name of the account is written at the top in the centre. The word 'Account' or its abbreviation 'A/c' is added to the name of the account. The rules of recording the transactions on the debit and credit sides shall be discussed later in this unit.

2.4 CLASSIFICATION OF ACCOUNTS

All business transactions broadly be classified into three categories: (i) those relating to persons, (ii) those relating to property (assets), and (iii) those relating to incomes and expenses. Hence, it becomes necessary to keep an account for each person, each asset, and each item of income and expense. Thus, three classes of accounts are maintained for recording all business transactions. They are: (i) Personal Accounts, (ii) Real Accounts, and (iii) Nominal Accounts. Real and Nominal Accounts taken together are called Impersonal Accounts.

Personal Accounts

Accounts which show dealings with persons are called ‘Personal Accounts’. Such dealings may relate to credit purchases of goods or credit sales of goods or loans taken, etc. A separate account is kept in the name of each person for recording the benefits received from, or given to, the person in the course of dealings with him. Examples are: Krishna’s Account, Gopal’s Account, Loan from Ratanlal Account, etc.

Personal accounts also include accounts in the names of institutions or companies called artificial persons) such as Indian Bank Account. Nagarjuna Finance Limited Account, the Andhra Pradesh Paper Mills Limited Account, etc.

The accounts which represent expenses payable, expenses paid in advance, incomes receivable and incomes received in advance are also personal accounts, though impersonal in name. For example, when salaries are due to the employees, but not paid before closing of the books of account for the year, an account called ‘Salaries Outstanding Account’ will be opened in the books. The Salaries Outstanding Account is regarded as a personal account representing the employees to whom salaries are payable by the business. Such a personal account is called Representative Personal Account’ as it represents a particular person or a group of persons. Other examples of representative personal accounts are: Interest Outstanding Account, Prepaid Insurance Account, Rent Received in Advance Account, Commission Outstanding Account. etc.

Capital Account and Drawings Account are also treated as personal accounts as they represent dealings with the owner of the business.

Real Accounts

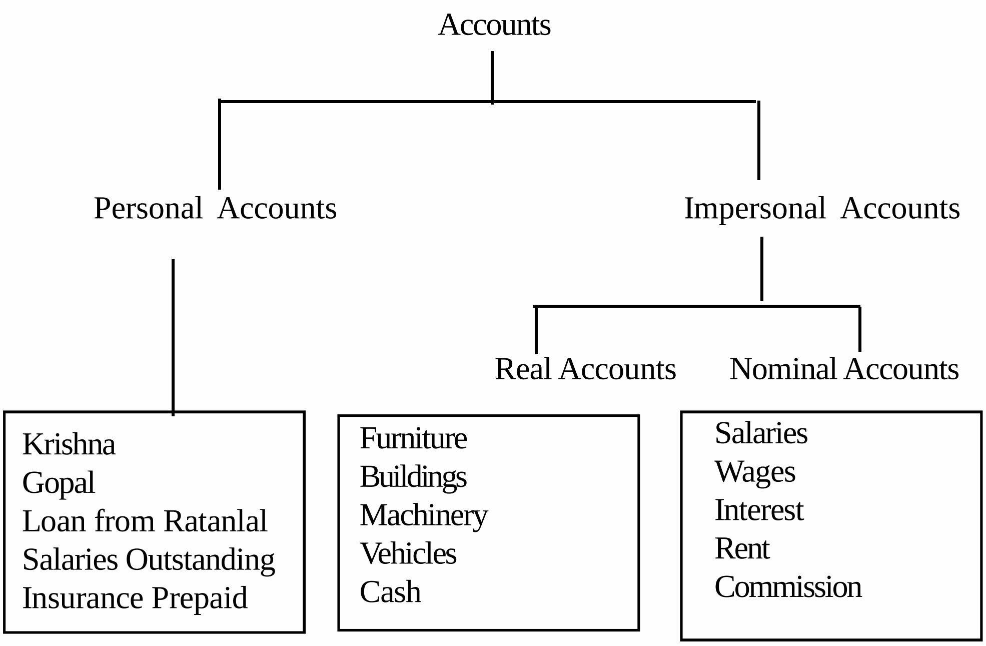
Accounts relating to properties or assets are known as ‘Real Accounts’. Every business needs assets such as Machinery, Furniture, etc., for running its activities. In. book-keeping, a separate account is maintained for each asset owned by the business. Dealings relating to purchase or sale of the asset are recorded through this account. Furniture Account, Machinery Account, Building Account, etc., are some examples of real accounts. Cash Account which shows receipts and payments of cash is also a real account. They are known as real accounts because they represent things of value owned by the business.

Nominal Accounts

Accounts relating to expenses, losses, incomes and gains are known as ‘Nominal Accounts’. Every business unit incurs certain expenses such as payment of salaries to employees, payment of wages to workers, etc., while carrying out its activities. It may also suffer losses such as loss by fire, loss by theft, etc. It may also earn certain incomes and gains such as receipt of commission, receipt of-interest, profit on sale of an asset, etc. A separate account is maintained for recording each item of expense, loss, income or gain. Thus, Wages Account, Salaries Account, Commission Received Account, and Interest Received Account are all nominal accounts. Classification of accounts is presented in Chart 2.2.

CHART 2.2

CLASSIFICATION OF ACCOUNTS



Check Your Progress A

1. State whether each of the following statements is **True** or **False.**

   a) First recording of transactions is done in Journal.

   b) Summarising of all business transactions is done in Ledger.

   c) Interpretation of the results is done by preparing Trial Balance.

   d) Right hand side of an account is called credit side.

   e) Personal accounts include accounts of persons with whom the business deals.

   f) Accounts which represent an item of asset is called Representative Personal Accounts.

   g) Accounts relating to assets held in the name of the firm are called Nominal Accounts.

2. Names of some accounts are given below, classify them into Personal, Real or Nominal.

Name of Account	Class of Account
a) Bank A/c	
b) Interest A/c	
c) Interest Outstanding A/c	
d) Patents A/c	
e) Loan from Gopal Das A/c	
f) Loose Tools A/c	
g) Commission Received in Advance A/c	
h) Prepaid Salaries A/c	
i) Stationery A/c	
j) Electricity Charges A/c	

3. State whether the following classification of accounts is correct or not. Give the correct classification, wherever necessary.

Name of Account	Class of Account	If correct, put a tick mark. If wrong, state the correct class of account
a) Fixtures A/c	Nominal Account	
b) Discount Received A/c	Personal Account	
c) Discount Received in advance A/c	Nominal Account	
d Ram & Co. A/c	Personal Account	
e) Goodwill A/c	Personal Account	
f) Office Expenses A/c	Real Account	
g) Office Equipment A/c	Nominal Account	
h) Cash A/c	Real Account	
i) Cartage A/c	Real Account	
j) Import Duty/A/c	Real Account	

2.5 PRINCIPLE OF DOUBLE ENTRY

You have learnt earlier that a transaction results in the transfer of money or money's worth i.e., goods or services. Hence, every business transaction involves a transfer and as such consists of two aspects: (i) the receiving aspect, and (ii) the giving aspect. It is necessary to note that these two aspects go together, as receiving necessarily implies giving and vice versa. For example, let us consider a transaction where machinery is purchased for cash. In this case, the receiving aspect is machinery (as machinery comes in) and giving aspect is cash (as cash goes out). Similarly, in a transaction where wages are paid to workers, the receiving aspect is the service of the workers and the giving aspect is cash. The receiving and giving take place between two parties or the accounts representing those parties. Thus, in the first example discussed above, from the point of view of the business, Machinery Account is receiving the benefit and Cash Account is giving the benefit. In the second example, Wages Account is receiving the benefit in the form of service and Cash Account is giving the benefit. These two aspects are represented in every account by the terms 'Dr'. and 'Cr.'. The 'Dr.' represents the receiving aspect and the 'Cr.' the giving aspect. The record of any business transaction will be complete only when both of these aspects are recorded. This recording of the two aspects of each transaction is known as 'Double Entry' and the system is called 'Double Entry System'.

Thus, every transaction affects two accounts and according to Double Entry system entries will be made in both of them on the debit side (left hand side) in one account and on the credit side (right hand side) in the other. In case of the first example (machinery purchased for cash), entries will be made on the debit side of Machinery Account and the credit side of Cash Account. In the case of second example (wages paid to workers), entries will be made on debit side of Wages Account and the credit side of Cash Account. Hence, for every debit there must be a corresponding credit for an equal amount and vice versa. This is known as the ‘Principle of Double Entry, and all business transactions are recorded in books of account according to this principle.

In order to develop a clear understanding of the receiving and giving aspects of various business transactions and the accounts affected thereby study Table 2.1 carefully.

Table 2.1: Dual Aspect of Transactions and the Account Affected

Transaction	First Aspect		Second Aspect	
	Receiving Receiver	**Account affected**	**Giving/Giver**	**Account affected**
1. Commenced business with Rs. 50,000 as capital.	Cash	Cash A/c	Proprietor	Capital A/c
2. Bought goods for cash Rs. 5,000	Goods	Goods A/c	Cash	Cash A/c
3. Bought goods from Ramesh & Co. on credit Rs. 10,000	Goods	Goods A/c	Ramesh & Co.	Ramesh & Co. A/c
4. Sold goods for cash Rs. 12,000	Cash	Cash A/c	Goods	Goods A/c
5. Sold goods to Ajay on credit Rs. 2,500	Ajay	Ajay’s A/c	Goods	Goods A/c
6. Paid cash to Ramesh & Co. Rs. 5,000	Ramesh & Co.	Ramesh & Co. A/c	Cash	Cash A/c
7. Received Cash from Ajay Rs. 1,000	Cash	Cash A/c	Ajay	Ajay’s A/c
8. Paid rent Rs. 1,000	Benefit of accommoda tion	Rent A/c	Cash	Cash A/c
9. Purchased Typewriter Rs. 4,500	Typewriter	Typewriter A/c	Cash	Cash A/c
10. Paid interest on loan Rs. 1,200	Benefit of using the loan	Interest A/c	Cash	Cash A/c

Check Your Progress B

Manohar had the following transactions. Determine the two aspects of each transaction and the accounts affected.

Transaction	First Aspect		Second Aspect	
	Receiving Receiver	**Account affected**	**Giving/Giver**	**Account affected**
a) Purchased machinery for Rs. 60,000				
b) Purchased goods from Karim & Co. on credit Rs. 10,000				

c) Sold goods for cash Rs. 2,400				
d) Loan taken from bank Rs. 25,000				
e) Travelling expenses paid to salesman Rs. 122				
f) Paid electricity charges Rs. 110				
g) Received Cash from Shanker Rs 1,200				
h) Paid cash to Karim & Co. Rs. 2,000				
I) Cash drawn for personal expenses Rs. 500				
j) Paid cash into bank Rs. 5,000				

2.6 ACCOUNTING RULES

We have already seen that every transaction affects two accounts and this effect will have to be entered in both of them, on the debit side in one account and on the credit side in the other account. It is, therefore, necessary to find out which of the two accounts is to be debited and which is to be credited. For this purpose, one has to first identify the class to which these two accounts belong i.e., personal, real or nominal; and then certain rules known as 'rules of debit and credit' are applied. These rules are as follows:

1. **For Personal Accounts:** The account of the person receiving the benefit (receiver) of the transaction (from the business) is debited and the account of the person giving the benefit (giver) of the transaction (to the business) is credited.

2. **For Real Accounts:** When an asset is coming into the business, the account of that asset is debited. When an asset is going out of the business, the account of that asset is credited.

3. **For Nominal Accounts:** When an expense is incurred or loss suffered, the account representing the expense or the loss is debited because the business receives the benefit thereof. When any income is earned or gain made, the account representing the income or the gain is credited. This is because the business gives some benefit.

The above rules have been shown in Table 2.2

Table 2.2 : Rules of Debit and Credit

Class of Account	Debit	Credit
Personal Accounts	The Receiver	The Giver
Real Accounts	What comes in	What goes out
Nominal Accounts	Expenses and Losses	Income and Gains

We shall now see the application of these rules, taking a few transactions.

Example 1: Paid cash to Ramesh & Co. Rs. 5,000.

In this case, the two accounts affected are Ramesh & Co.'s Account and Cash Account. Ramesh & Co.'s Account is a personal account and Cash Account is a real account. Ramesh & Co. has received the benefit (cash Rs. 5,000) from the business and, therefore, it has to be debited as per the first part of the rule for personal accounts 'debit the receiver'. As cash has gone out, Cash Account will be credited according to the second part of the rule for real accounts 'credit what goes out'.

Example 2: Received cash from Ajay Rs. 1,000.

In this case, Cash Account and Ajay's Account are the two accounts affected. Cash Account is a real account and Ajay's account is a personal account. As cash has come in, Cash Account will have to be debited according to the first part of the rule for real accounts 'debit what comes in'. Ajay has given the benefit (cash Rs. 1,000) to the business and, therefore, his account will have to be credited as per the second part of the rule for personal accounts 'credit the giver'.

Example 3: Paid rent Rs. 1,000.

In this case, the accounts affected are Rent Account and Cash Account. Rent Account is a nominal account and Cash Account is a real account. As per the first part of the rule for nominal accounts, 'debit expenses and losses', Rent Account will have to be debited as it is an expense to the business. As cash has gone out, Cash Account will have to be credited according to the second part of the rule for real accounts 'credit what goes out'.

Example 4: Received Rs 400 as commission.

In this case, Cash Account and Commission Account are the two accounts affected. Cash Account is a real account and Commission Account is a nominal account. As cash has come in, Cash Account will have to be debited according to the first part of the rule for real accounts 'debit what comes in'. As per second part of the rule for nominal accounts, 'credit incomes and gains', Commission Account will be credited as it is an income to the business.

You have seen that the three rules of debit and credit explained above, make it possible to analyse the transaction and identify the account to be debited and the account to be credited. Even though it has been explained that there are three different rules for the three classes of accounts, it is to be noted that these three rules, in reality, are a manifestation of the dual aspect concept. In other words, the account that receives the benefit of the transaction is to be debited and the account that gives the benefit is to be credited, irrespective of the class of account involved.

Let us now apply these rules to the transactions given in Table 2.1 and ascertain which account is to be debited and which account is to be credited. This has been analysed in Table 2.3. You may go through it carefully and grasp the application of the Rules of Debit and Credit.

Table 2.3 : Analysis of Accounts Affected

Transaction	Accounts affected Accounts	Class of Credit	Debit/	Reasons
1. Commenced business with Rs. 50,000 as capital	i) Cash A/c ii) Capital A/c	Real Personal	Debit Credit	Cash comes in Proprietor gives benefit
2. Bought goods for cash Rs. 5,000	i) Goods A/c ii) Cash A/c	Real Real	Debit Credit	Goods come in Cash goes out
3. Bought goods from Sohan credit Rs.10000	i) Goods A/c ii) Sohan A/c	Real Personal	Debit Credit	Goods come in Giver
4. Sold goods for cash Rs. 1,500	i) Cash A/c ii) Goods A/c	Real Real	Debit Credit	Cash comes in Goods go out
5. Sold goods to Vijay on credit Rs. 2,500	i) Vijay A/c ii) Goods A/c	Personal Real	Debit Credit	Receiver Goods go out
6. Purchased furniture Rs. 4,000	i) Furniture A/c ii) Cash A/c	RealReal	Debit Credit	Furniture comes inCash goes out
7. Sold old typewriter Rs. 500	i) Cash A/c ii) Typewriter A/c	RealReal	Debit Credit	Cash comes in Typewriter goes out
8. Purchased postage stamps Rs. 50	i) Postage A/c ii) Cash A/c	Nominal Real	Debit Credit	Postage is an expenseCash goes out
9. Paid salaries Rs. 6,000	i) Salaries A/c ii) Cash A/c	Nominal Real	Debit Credit	An expense Cash goes out
10. Received interest Rs. 200	i) Cash A/cii) Interest A/c	Real Nominal	Debit Credit	Cash comes in An income

2.7 LET US SUM UP

1. The accounting process starts with recording of transactions in the journal. From the journal, they are posted to ledger accounts. Then, a trial balance is prepared to verify the accuracy of the work done and the final accounts are prepared to know the profit or loss made and the financial position of the business. Finally, the results are analysed and reported to the interested parties.

2. Accounts are classified as Personal, Real, and Nominal Accounts. Accounts showing dealings with persons are called personal accounts. Accounts relating to assets are known as real accounts and those relating to expenses, losses, incomes and gains are known as nominal accounts.

3. Every transaction consists of two aspects: (i) the receiving aspect and ii) the giving aspect. The recording of this two-fold effect of each transaction is called 'Double Entry'. The principle of double entry is, for every debit there must be an equal and a corresponding credit and vice versa.

4. Certain rules are followed for recording business transactions. In the case of personal accounts, the rule is, 'Debit the receiver and Credit the giver. For real accounts, the rule is, 'Debit what comes in and Credit what goes out', and for nominal accounts the rule is, 'Debit expenses and losses and Credit incomes and gains'.

2.8 KEY WORDS

Account: A summarised record which shows the effect of the transactions relating to a particular person or thing.

Credit: Credit represents the giving aspect of a transaction.

Debit: Debit represents the receiving aspect of a transaction.

Double Entry Principle: Principle of recording both the receiving and the giving aspects of each transaction.

Nominal Accounts: Accounts relating to expenses, losses, incomes and gains.

Personal Accounts: Accounts which relate to persons.

Real Accounts: Accounts which relate to assets.

2.9 SOME USEFUL BOOKS

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2.10 ANSWERS TO CHECK YOUR PROGRESS

A 1. a) True b) False

c) False d) True

e) True f) False

g) False

2. a, c, e, g, h are Personal Accounts.

d and f are Real Accounts.

b, i, j are Nominal Accounts.

3. a) Real Account b) Nominal Account

c) Personal Account d) Correct

e) Real Account f) Nominal Account

g) Real Account h) Correct

i) Nominal Account j) Nominal Account

B

Transaction	First Aspect		Second Aspect	
	Receiving/Receiver affected	**Account**	**Giving/Giver affected**	**Account**
a)	Machinery	Machinery A/c	Cash	Cash A/c
b)	Goods	Goods A/c	Karim & Co.	Karim & Co. A/c
c)	Cash	Cash A/c	Goods	Goods A/c
d)	Cash	Cash A/c	Bank	Bank Loan A/c
e)	Benefit of service (Transport)	Travelling Expenses A/c	Cash	Cash A/c
f)	Benefit of service (Electricity)	Electricity Charges A/c	Cash	Cash A/c
g)	Cash	Cash A/c	Shanker	Shanker's A/c
h)	Karim &Co.	Karim & Co. A/c	Cash	Cash A/c
i)	Proprietor	Drawings A/c	Cash	Cash A/c
j)	Bank	Bank A/c	Cash	Cash A/c

2.11 TERMINAL QUESTIONS/EXERCISES

Questions

1. Discuss the various stages involved in the accounting process.
2. What is an Account? Describe the various classes of accounts with examples.
3. What do you understand by the Principle of Double Entry? Give the rules of debit and credit with suitable examples.

Exercises

I. From the following transactions, determine the accounts affected, classify them and state whether it is to be debited or credited.

		Rs.
a)	Purchased typewriter for cash	5,000
b)	Purchased furniture from R & Co. on credit	50,000
c)	Interest received	300
d)	Paid wages	800
e)	Received cash from A	2,000

f) Additional capital introduced into the business 5,000

g) Paid cash to B 1,500

h) Paid carriage 200

i) Purchased goods from F & Co. on credit 12,000

j) Sold goods for cash 1,400

Answer:

Transaction	Account to be debited	Nature of account	Account to be credited	Nature of account
a)	Typewriter A/c	Real	Cash A/c	Real
b)	Furniture A/c	Real	R & Co. A/c	Personal
c)	Cash A/c	Real	Interest A/c	Nominal
d)	Wages A/c	Nominal	Cash A/c	Real
e)	Cash A/c	Real	A's A/c	Personal
f)	Cash A/c	Real	Capital A/c	Personal
g)	B's A/c	Personal	Cash A/c	Real
h)	Carriage A/c	Nominal	Cash A/c	Real
i)	Goods A/c	Real	F & Co. A/c	Personal
j)	Cash A/c	Real	Goods A/c	Real

2. Ram had the following transactions. Determine the accounts to be debited and credited:

		Rs.
a)	Command business with cash	1,00,000
b)	Purchased goods for cash	15,000
c)	Paid for advertisement	600
d)	Bought goods from P & Co. on credit	20,000
e)	Sold goods for cash	6,000
f)	Sold goods to Z on credit	12,000
g)	Paid commission	900
h)	Paid salaries	8,000
i)	Paid rent	600
j)	Loan taken from Hiralal	50,000

Answer:

Transaction	Account to be debited	Account to be credited
a)	Cash A/c	Capital A/c
b)	Goods A/c	Cash A/c
c)	Advertisement A/c	Cash A/c
d)	Goods A/c	P & Co. A/c
e)	Cash A/c	Goods A/c
f)	Z A/c	Goods A/c
g)	Commission A/c	Cash A/c
h)	Salaries A/c	Cash A/c
i)	Rent A/c	Cash A/c
j)	Cash A/c	Loan from Hiralal A/c

Note : These questions will help you to understand the unit better. Try to write answers for them. But, do not submit your answers to the University for assessment. These are for your own practice only.

UNIT 3 ACCOUNTING PRINCIPLES

Structure

3.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the meaning of some basic terms of accounting;
- identify assets, liabilities, incomes and expenses;
- explain the need for the nature of accounting concepts;
- develop familiarity with the basic concepts to be kept in mind at the recording stage;
- decide what type of transactions are to be recorded in books of account;
- ascertain the amount of capital, liabilities and assets from the accounting equation; and
- describe about the two systems of book-keeping.

3.1 INTRODUCTION

In Unit 1, you learnt about the nature, scope and importance of accounting. You know accounting is often called the 'Language of Business'. Language is the means of communication. Accounting also serves this function. It communicates the results of business operations to interested parties. Let us understand this language first. In this unit, we intend to explain some of the terms which are commonly used in accounting and also the basic concepts underlying the accounting system.

3.2 SOME BASIC TERMS

Entity: The word entity literally means a thing that has a definite individual existence. Business entity means a specifically identifiable business enterprise like Khanna Jewellers, Prakash Pipes Ltd., etc. An accounting system is devised for a specific business entity (also called 'accounting entity').

Event and Transaction: Anything that brings about a change in the financial position of an entity is called an 'event'. In other words, an event is a happening of consequence to an entity. A transaction is a particular kind of event involving some value between two or more entities. In other words, it is any dealing between two or more persons involving exchange of goods or services for a consideration usually in money.

Transactions are of two kinds (i) cash transactions and (ii) credit transactions. Cash transaction are those in which cash is involved in the exchange. For example, purchase of goods for cash, purchase of vehicle for cash, payment of rent etc. In case of credit transactions cash is not paid immediately, the settlement is postponed to a later date. For example, goods are purchased on credit on April 15, 2018 and the cash is to be paid on August 1, 2018.

Goods: The term 'goods' refers to articles in which the business deals. Only those articles which are purchased for the purpose of sale are called goods. Other articles which are purchased for the purpose of using them in the business are not called goods. For example, in case of a fans dealer, fans are goods. He may be having tables and chairs. But they are not goods for him. In case of a furniture dealer, tables and chairs are goods. He may be having fans, but they are not goods for him.

Debtor: A debtor is one who owes some amount to the business. For example, a customer who purchases goods on credit from the business, is a debtor to the business.

Creditor: A creditor is one to whom the business owes some amount. One who supplies goods or provides some services on credit to the business is a creditor.

Books of Account: These are the different sets of records, whether in the form of bound books or loose sheets wherein the various business events and transactions are recorded e.g., journal and ledger. If necessary, the journal and also the ledger may be sub-divided into a number of books.

Entry: The recording or entering a transaction or event in the books of account is called an entry.

Journal: Journal is the book of prime entry. It is used for recording all transactions and events of a business entity in the first stage.

Ledger: The transactions recorded in the journal are transferred to a separate book called ledger. In this book, a separate account is opened and maintained for each item. For example, Capital Account, Salaries Account, Furniture Account, Building Account, etc. Ledger is the main book for accounting information and, hence, it is sometimes called the .'king of books of account'.

Account: An account is a classified statement of transactions relating to a person or a thing or any other subject. It is vertically divided into two parts in T shape (alphabet T). The benefits received by that account are recorded on the left hand side (technically called the 'debit side') and the benefits given by that account are recorded on the right hand side (technically called the 'credit side'). This type of recording helps in knowing the net result i.e., whether that account has received more or given more.

To debit an account: It means making an entry for a transaction on the debit side (left hand side) of an account.

To credit an account: It means making an entry for a transaction on the credit side (right hand side) of an account.

On account: It refers to a part receipt or a part payment of money in respect of earlier credit transaction(s). For example, Mr. X owes Rs. 5,000, of which he pays Rs. 3,000. This may be termed as, 'received Rs. 3,000 from Mr. X on account'.

Assets: Assets are things of value or economic resources (property) owned by the enterprise. In other words, cash or any thing which enables the business entity to get cash or a benefit in future is an asset. Land, buildings, machinery, vehicles, furniture, stock of goods, cash, etc., are some examples of assets.

Expenditure: Expenditure means the spending of money or incurring a liability for some benefit/ service received by the business entity. Purchase of machinery, purchase of furniture, payment of salaries, rent, etc., are some examples of expenditure. If the benefit of an expenditure is limited to one year, it is treated as an expense (also called revenue expenditure) such as payment of salaries and rent. On the other hand, if the benefit of an expenditure is available for more than one accounting year, it is treated as an asset (also called capital expenditure) such as purchase of furniture and machinery.

Equities: All claims or rights over the assets of a business firm are called equities. Equities are of two types : (i) creditors' equity, and (ii) owners' equity. The claims of the outsiders are called creditors, equity or liabilities. The claim of the owner is called owner's equity or capital.

Liabilities: Liabilities (also called creditors' equity) are the amount owed by the business firm to outsiders other than the owner(s). Loan from a bank, creditor for goods supplied, rent payable, salaries payable, interest payable to the lenders are some examples of liabilities.

Capital: Capital is the amount invested by the owner(s). It represents the owner's claim on the firm's assets and is known as owner's equity. It is also called net assets or net worth.

Drawings: Drawings refer to the amount withdrawn or the value of goods taken by the proprietor for personal use from the business.

Profit: Profit is the excess of income over expenditure during a period of time. It is owner's equity.

Loss: In one sense, loss means money or money's worth lost without receiving any benefit. For example, cash or goods lost by theft or fire accident. In the context of Profit and Loss Account, loss represents to the excess of expenditure over income during a period of time. In either case, loss decreases the owner's equity.

Income: Income, also called revenue, is the amount earned by a business entity resulting from operations which constitute its major or central activities. For example, sale of goods or services.

Gain: Gain is a profit that arises from events or transactions which are incidental to business, such as sale of an asset, winning a court case, appreciation in the value of land and buildings, etc.

Trade discount: It is a common practice these days to print the price of an article on its package. The price so mentioned on the article is called the 'catalogue price' or 'list price'. When you buy an article, the seller may agree to give you some concession and charge a price which is less than the list price. Such concession or reduction in price is called 'trade discount'. This, is an allowance given by the seller to the buyer on the list price at the time of sale. Trade discount is generally given by the manufacturer to the wholesaler and by the wholesaler to the retailer. Suppose a bookseller buys 10 copies of a book 'Principles and Practice of Accountancy' by R. Sriram, priced at Rs. 25. The publisher allows a discount of 10% and charges Rs. 225 net (list price Rs. 250 minus discount of Rs. 25). The buyer pays only the net price. Recording in books of account is also made for the net amount only. No specific entry is required for the trade discount.

Cash discount: When goods are sold on credit, the buyer is expected to pay the amount on or before the due date. However, if the buyer makes the payment before the due date, the seller may allow him some reduction in the amount due and settle the account. Such an allowance is called 'cash discount'. It is allowed at the time of payment. It motivates the debtor to make prompt payment. Suppose, the books worth Rs. 225 (net amount) were sold on February 1, 2018 on credit for one month. The due date is March 1, 2018. The bookseller offers to make the payment on February 15, 2018. The publisher accepts Rs. 220 in settlement of the account. The balance amount of Rs. 5 is the cash discount allowed. Cash discount must be recorded in the books of account in order to show that the party account stands cleared and nothing more remains due from him.

Voucher: A documentary (written) evidence of a transaction is called a voucher. For example, if we buy goods for cash we get cash memo; if we buy on credit we get an invoice; and so on. Entries in books of account are made with the help of such vouchers.

Solvent: A person who is in a position to pay his debts as they become due.

Insolvent: A person who is not in a position to pay his debts in full and is so declared by the court.

Bad debts: The amount of debt which is unrealisable from a debtor who became insolvent.

Stock: The amount of goods lying unsold or unused. It also includes stock of raw materials and semi-finished goods.

Check Your Progress A

1. Fill in the blanks :

   i) A person who owes money to the firm is ………………………

   ii) A person to whom the firm owes money is a ………………………

   iii) All articles that are purchased for resale are called ………………………

   iv) The property of the business in the form of land and buildings, machinery, etc. is called ………………………

v) Drawings refer to the withdrawal of cash or goods by the owner for ………………………

vi) The amount of debt…………………………………….. from the debtor is termed as bad debts.

vii) The amount invested by the owner in business is called ………………..

viii) The amount received in part is called receipt on …………..

2. State in each case whether the item shall be regarded as goods or an asset

i) Furniture purchased by Rama Furnishers for resale.

ii) Furniture purchased by Krishna Stationery Mart.

iii) Machinery purchased by Abdul Engineering Company for use in their factory.

iv) Electric motors purchased by Punjab Machinery Stores who deal in machinery.

v) Power looms manufactured by KCP Ltd., for sale to a textile company.

3. Mr. Rakesh started Rakesh Trading Company with a capital of Rs. 30,000. The company also borrowed Rs. 10,000 from the State Bank of India. The firm purchased a delivery van for Rs. 20,000, furniture for Rs. 5,000, typewriter for Rs. 6,000, account books and other stationery for Rs. 500. It has purchased goods on credit from M/s Gurucharan Singh & Co., for Rs. 4,000, and from M/s Lalwani Traders for Rs. 3,000. It has sold goods for cash to Mr. Peter for Rs. 2,000 and Mr. Ali for Rs. 4,000. It has also paid Rs. 300 for electricity charges, Rs. 1,000 for salaries, and Rs. 500 for rent. From the above information, list out the assets, liabilities, incomes and expenses.

Assets : ....

....

....

Liabilities : ....

....

....

....

Incomes : ....

....

....

Expenses : ....

....

....

3.3 ACCOUNTING PRINCIPLES

Accounting is a system evolved to achieve a set of objectives as stated in Unit 1.2. The objectives identify the goals and purposes of financial record keeping and reporting. In order to achieve the goals, we need a set of rules or guidelines. These guidelines are termed here as 'Basic Accounting Concepts'. The term 'concept' means an idea or thought. Basic accounting concepts are the fundamental ideas or basic assumptions underlying the theory and practice of financial accounting. These concepts are also termed as 'Generally Accepted Accounting Principles'. These are the broad working rules of accounting activity, developed and accepted by the accounting profession. They are evolved (and are still evolving) over a period in response to the changing business environment and the specific needs of the users of accounting information.

The concepts guide the identification of events and transactions to be accounted for, their measurement and recording, and the method of summarising and reporting to interested parties. The concepts, thus, help in bringing about uniformity in the practice accounting.

An indepth understanding of these concepts will place the student in a better position to appreciate accounting system. Of course, it may be difficult to comprehend all these concepts at a stretch. We, therefore, advise you to re-visit these concepts, after giving at least one reading of this course material.

These concepts may be classified into two broad groups:

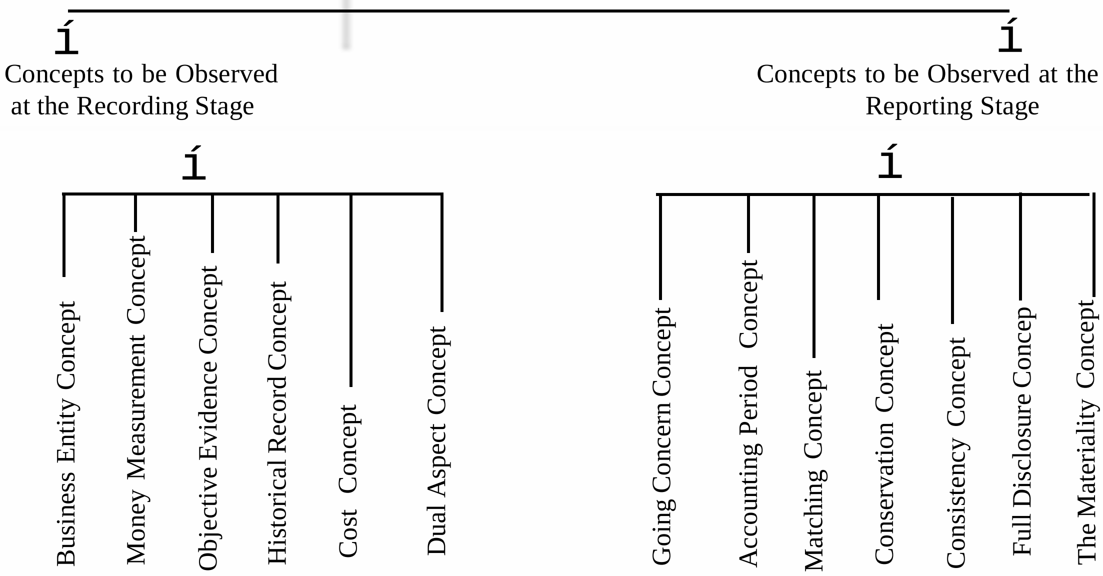
i) concepts to be observed at the recording stage i.e., while recording the transactions, and

ii) concepts to be observed at the reporting stage, i.e., at the time of preparing the final accounts.

It must, however, be remembered that some of them are overlapping and even contradictory. They are listed out in Chart 3.1.

Chart 3.1

ACCOUNTING CONCEPTS



3.3.1 Concepts to be Observed at the Recording Stage

The following concepts will guide us in identifying, measuring and recording transactions.

Business Entity Concept

Business entity means a unit of organised business activity. In that sense, a provision store, a cloth dealer, an industrial establishment or electricity supply undertaking, a bank, a school, a hospital, etc. are all business entities.

From the accounting point of view, every business enterprise is an entity separate and distinct from its proprietor(s)/owner(s). The accounting system gives information only about the business and not about its owner(s). In other words, we record those transactions in the books of account which relate only to the business. The owner's personal affairs (his expenditure on housing, food, clothing, etc.) will not appear in the books of account of his business. However, when personal expenditure of the owner is met from business funds it shall also be recorded in the business books. It will be recorded as drawings by the proprietor and not as business expenditure.

Another implication of business entity concept is that the owner of business is to be treated as a creditor who also has a claim over the assets of the business. As such, the amount invested by him (capital) is regarded as a liability for the business.

The business entity concept is applicable to all forms of business organisations. This distinction can be easily maintained in the case of a limited company because the company has a legal entity of its own. But such distinction becomes difficult in case of a sole proprietorship or partnership because in the eyes of the law, the partner or the sole proprietor are not considered separate entities. They are personally liable for all business transactions. But, for accounting purposes, they are to be treated as separate entities. This enables them to ascertain the profit or loss of business more conveniently and accurately.

Money Measurement Concept

Usually, business deals in a variety of items having different physical units such as kilograms, quintals, tons, metres, litres, etc. If the sales and purchases of different items are recorded in terms of their physical units, adding them together will pose problems. But, if these are recorded in a common denomination, their total becomes homogeneous and meaningful. Therefore, we need a common unit of measurement. Money does this function. It is adopted as the common measuring unit for the purpose of accounting. All recording, therefore, is done in terms of the standard currency of the country where business is set up. For example, in India, it is done in terms of Rupees, in USA it is done in terms of US Dollars, and so on.

Another implication of money measurement concept is that only those transactions and events are to be recorded in the books of account which can be expressed in terms of money such as purchases, sales, payment of salaries, goods lost in accident, etc., other happenings (non- monetary) like death of an efficient manager or the appointment of an accountant, howsoever important they may be, are not recorded in the books of account. This is because their effect is not measurable of quantifiable in terms of money.

This approach has its own drawbacks. The value of money changes over a period of time. The value of rupee today is much less than what it was in 1961. Such a change is nowhere reflected in accounts. This is the reason why the accounting data does not reflect the true and fair view of the affairs of the business.

Hence, now-a-days, it is considered desirable to provide additional data showing the effect of changes in the price level on the reported income and the assets and liabilities of the business.

Check Your Progress B

1. Mr. Ghansyamlal carries on ready made garments business. A few transactions are given below. Identify the transactions to be recorded in the books of his business.

   a) Purchased a typewriter for Rs. 6,000 for office use.

   b) Paid salary to the office typist at Rs. 350 per month.

   c) Bought a show case for Rs. 2,000.

   d) Sold old domestic furniture for Rs. 500.

   e) Purchased cloth for garments for Rs. 10,000.

   f) A shirt worth Rs. 250 is taken home for his son.

   g) Entered into an agreement to rent a shop in Sadar Bazar.

   h) Paid Salaries to his salesmen, Rs. 1,000.

   i) Paid Salary to his domestic servant, Rs. 100.

   j) Appointed Satish as an assistant in the shop.

   k) Borrowed Rs. 5,000 from Mr. Dyanchand for business purpose.

   l) Mr. Rakesh, one of the salesmen, met with an accident.

2. Present the following in the form of an Accounting Equation.

Machinery	Rs. 20,000
Cash	Rs. 5,000
Capital	Rs. 20,000
Creditors	Rs. 5,000

3. The assets and liabilities of Rupak Store are given below. Find out the amount of capital.

   Cash Rs. 1,800; Stock Rs. 3,000; Debtors Rs. 2,000;

   Furniture Rs. 1,200: Creditors Rs. 2,500: Wages payable Rs. 500

Objective Evidence Concept

The term objectivity refers to being free from bias or free from subjectivity. Accounting measurements are to be unbiased and verifiable independently. For this purpose, all accounting transactions should be evidenced and supported by documents such as bills, invoices, receipts, cash memos, etc. These supporting documents (vouchers) form the basis for making entries in the books of account and for their verification by auditors afterwards. As for the items like depreciation and the provision for doubtful debts where no documentary evidence is available, the policy statements made by management are treated as the necessary evidence.

Historical Record Concept

You know that after identifying the transactions and measuring them in terms of money, we record them in the books of account. According to the historical record concept, we record only those transactions which have actually taken place and not those which may take place (future transactions). It is because accounting record presupposes that the transactions are to be identified and objectively evidenced. This is possible only in the case of past (actually happened) transactions. The future transactions can hardly be identified and measured accurately. You also know that all transactions are to be recorded in chronological (datewise) order. This leads to the preparation of a historical record of all transactions. It also implies that we simply record the facts and nothing else.

As you will study later we make provision for some expected losses such as doubtful debts. This may be contrary to what is stated in historical record concept. But this is done only at the time of ascertaining the profit or loss of the business. It is not a routine item. This is done in accordance with another concept called Conservatism Concept about which you will study later.

Cost Concept

Business activity, in essence, is an exchange of money. The price paid (or agreed to be paid in case of a credit transaction) at the time of purchase is called cost. According to the cost concept, all assets are recorded in books at their original purchase price. This cost also forms an appropriate basis for all subsequent accounting for the assets. For example, if the business buys a machine for Rs. 80,000 it would be recorded in books at Rs. 80,000. In case its market value increases later on to Rs. 1,00,000 (or decreases to Rs. 50,000) it will continue to be shown at Rs. 80,000 and not at its market value.

This does not mean, however, that the asset will always be shown at cost. You know that with passage of time, the value of an asset decreases. Hence it may systematically be reduced from year to year by charging depreciation and the asset be shown in the balance sheet at the depreciated value. The depreciation is usually charged as a fixed percentage of cost. It bears no relationship with changes in its market value. In other words, the value at which the assets are shown in the balance sheet has no relevance to its market value. This, no doubt, makes it difficult to assess the true financial position of the business. It is, therefore, regarded as an important limitation of the cost concept. But this approach is preferred because, firstly it is difficult and time consuming to ascertain the market values, and secondly there will be too much of subjectivity in assessing the current values. However, this limitation has been overcome with the help of inflation accounting.

Check Your Progress C

1) Mr. Vinod Pandey started business. State which of the following transactions, and with what amount, are to be recorded in the books of his business.

   a) He purchased a machine from Bombay for Rs. 10,000. He paid for railway freight Rs.200 and total transport Rs 100.

   b) He sold goods worth Rs. 1,000 to Mr. Rakesh.

   c) Mr. Ramana, a friend of Mr. Pandey promised to purchase goods worthRs. 10,000 after three months.

   d) He purchased a building for his business from his friend for Rs. 25,000. Its market value is Rs. 30,000.

   e) Due to scarcity of raw materials, he paid Rs. 5,000 for materials worth Rs. 3,000.

Dual Aspect Concept

This is the basic aspect of accounting. According to this concept, every business transaction has a two-fold effect. In commercial context, it is a famous dictum that "every receiver is also a giver and every giver is also a receiver". For example, if you purchase a machine for Rs. 8,000 you receive machine on the one hand and give Rs. 8,000 on the other. Thus, this transaction has a two-fold effect i.e., (i) increase in one asset and (ii) decrease in another. Similarly, if you buy goods worth Rs. 500 on credit it will increase an asset (stock of goods) on the one hand and increase a liability (creditors) on the other. Thus, every business transaction involves two aspects: (i) the receiving aspect, and (ii) the giving aspect. In case of the first example you find that the receiving aspect is machinery and the giving aspect is cash. In the second example the receiving aspect is goods and the giving aspect is the creditor. If complete record of transactions is to be made, it would be necessary to record both the aspects in books of account. This principle is the core of double entry book-keeping and if this is strictly followed, it is called 'Double Entry System of Book-keeping' about which you will learn in detail later.

Let us understand another accounting implication of the dual aspect concept. To start with, the initial funds (capital) required by the business are contributed by the owner. If necessary, additional funds are provided by the outsiders (creditors). As per the dual aspect concept all these receipts create corresponding obligations for their repayment. In other words, a contribution to the business, either in cash or kind, not only increases its resources (assets), but also its obligations (liabilities/equities) correspondingly. Thus, at any given point of time, the total assets and the total liabilities must be equal.

This equality is called 'balance sheet equation' or 'accounting equation'. It is stated as under:

Liabilities (Equities) = Assets

or

Capital + Outside Liabilities = Assets

The term 'assets' denotes the resources (property) owned by the business while the term 'equities' denotes the claims of various parties against the business assets. Equities are of two types: (1) owners' equity, and (ii) outsiders' equity. Owners' equity called capital is the claim of the owners against the assets of the business. Outsiders' equity called liabilities is the claim of outside parties like creditors, bank, etc. against the assets of the business. Thus, all assets of the business are claimed either by the owners or by the outsiders. Hence, the total assets of a business will always be equal to its liabilities.

When various business transactions take place, they effect the assets and liabilities in such a way that this equality is always maintained. Let us take a few transactions and see how this equality is maintained.

1. **Mr. Gyan Chand started business with Rs. 50,000 cash.** The cash received by the business is its asset. According to the business entity concept, business and the owner are two separate entities. Hence, the capital contributed by Mr. Gyan Chand is a liability to the business. Thus

   Capital = Assets

   Rs. 50,000 = Rs. 50,000 (cash)

2. **He purchased goods on credit from Chakravarthy for Rs. 5,000.** This increases an asset (stock of goods) on the one hand and a liability (creditors) on the other. Now the equation will be

   Capital + Liabilities = Assets

   Rs. 50,000 + Rs. 5,000 = Rs. 5,000 + Rs. 50,000

   Capital Creditors Stock Cash

3. **He purchased furniture worth Rs. 10,000 and paid cash**. This increases one asset (furniture) and decreases another asset (cash). Now the equation will be:

   Capital + Liabilities = Assets

   Rs. 50,000 + Rs. 5,000 = Rs. 10,000 + Rs. 5,000 + Rs. 40,000

   Capital Creditors Furniture Stock Cash

This equation can be presented in the form of a Balance Sheet (a statement of assets and liabilities) as follows:

Gyan Chand's Balance Sheet

Capital and Liabilities	**Rs.**	**Assets**	**Rs.**
Capital	50,000	Furniture	10,000
Creditors (Mr. Chakravarthy)	5,000	Stock of goods	5,000
		Cash	40,000
	55,000		55,000

Note that the totals on both sides of the Balance Sheet are equal. This equality remains valid irrespective of the number of transactions and the items affected thereby. It is so because of their dual effect or the assets and liabilities of the business.

Check Your Progress D

1. Find out the missing amounts on the basis of the accounting equation:

   Capital + Liabilities = Assets

   a) Rs. 10,000 + Rs. 15,000 = Rs ………………

   b) Rs. 25,000 + Rs……….. = Rs. 60,000

   c) Rs………… + Rs. 30,000 = Rs. 50,000

2. Show the dual effect of the following business transaction on assets and liabilities of a business unit.

   a) Purchased goods for cash for Rs. 500

   b) Purchased goods on credit for Rs. 800

   c) Paid Rs. 300 to a creditor

   d) Received Rs. 500 from a debtor

3.3.2 Concepts to be Observed at the Reporting Stage

The following concepts have to be kept in mind at the time of preparing the final accounts. Let us discuss them one by one:

i) Going concern concept

ii) Accounting period concept

iii) Matching concept

iv) Conservatism concept

v) Consistency concept

vi) Full disclosure concept

vii) Materiality concept

Going Concern Concept

Normally, the business is started with the intention of continuing it indefinitely or at least for the foreseeable future. The investors lend money and the creditors supply goods and services with the expectation that the enterprise would continue for 1ong. Unless there is a strong evidence to the contrary, the enterprise is normally viewed as a going (continuing) concern. Hence, financial statements are prepared on a going concern basis and not on liquidation (closure) basis.

Certain expenses like rent, repairs, etc., give benefits for a short period, say less than one year. But the benefit of some other expenditure like purchase of a building, machinery, etc., is spread over a longer period. The expenditure whose benefit is limited to one accounting year is fully charged to the Profit and Loss Account of the year. But the cost of the items whose benefit is available for a number of accounting years, their cost must be spread over a number of years. Hence, only a portion of such expenditure is charged to the Profit and Loss Account every year. The balance is shown in the Balance Sheet as an asset. Let us take an example. Suppose a firm purchased a delivery van for Rs. 60,000 and its expected life is 10 years. It means the business will use the van for a period of 10 years. So, the accountant has to spread the cost of the van over 10 years. He would charge Rs. 6,000 (1/10 of its cost) every year to the Profit and Loss Account in the form of depreciation, and show the balance in the Balance Sheet as an asset. This is based on the assumption that the business will continue for long and the asset will be used for its expected life. Thus, this concept is regarded as the basic assumption in accounting according to which the fixed assets are valued at historical cost less depreciation and not at its realisable value.

Accounting Period Concept

You know the going concern concept assumes that the business will continue for a long period, almost indefinitely. But the businessmen cannot postpone the preparation of financial statements indefinitely. Therefore, he prepares them periodically. This will also enable other interested parties such as owners, investors, creditors, tax-authorities to make periodic assessment of its performance. So, the life of the business enterprise is divided into what are called accounting periods'. The profit or loss and the financial position at the end of each such accounting period is regularly assessed.

Conventionally, duration of the accounting period is twelve months. It is called an 'accounting year'. Accounting year can be a calendar year i.e., January 1 to December 31 or any other period of twelve months, say, April 1 to March 31 or Dewali to Dewali.

Normally, the final accounts are prepared at the end of each accounting year. The Profit and Loss Account is prepared for the year so as to ascertain the profit earned or loss incurred during that year, and the balance sheet is prepared as at the end of the year, so as to show the financial position as on that date. However, for internal management purposes, accounts can be prepared even for shorter periods, say monthly, quarterly or half yearly.

Check Your Progress D

1. What is the assumption under Going Concern Concept?

   ....

   ....

   ....

2. What is the accounting implication of Going Concern Concept?

   ....

   ....

   ....

3. What is the significance of an Accounting Period?

   ....

   ....

   ....

4. What is the purpose of preparing the Profit and Loss Account?

 ....

 ....

 ....

 ....

5. What does Balance Sheet reveal?

 ....

 ....

 ....

 ....

Matching Concept

This is also called 'Matching of Costs against Revenues Concept'. To work out profit or loss of an accounting year, it is necessary to bring together all revenues and costs pertaining to that accounting year. In other words, expenses incurred in an accounting year should be matched with the revenues earned during that year. The crux of the problem, therefore, is that appropriate costs must be matched against appropriate revenues. For this purpose, first we have to recognise the inflows (revenues) during an accounting period and the costs incurred in securing those inflows. Then, the sum of the costs should be deducted from the sum of the revenues to arrive at the net result of that period. Let us now understand how to recognise the revenues and costs in relation to an accounting period. For this purpose, the following rules are followed:

The Timing of Revenue Recognition

Revenue is recognised in the period in which it is earned or realised. The revenue recognition is primarily based on realisation principle which clearly states that in identifying revenues with a specific period one must look to when the various transactions occurred rather than to the period in which cash inflow occurred. Thus,

i) In case of the sale of goods (or services) revenue is regarded as realised when sales actually take place and not when cash is received. In other words, credit sales are treated as revenue when sales are made and not when money is received from the debtors.

ii) Income such as rent, interest, commission etc. are recognised on a time basis. The revenue from such items is taken to the Profit and Loss Account of the year during which it is earned. Let us assume that the business purchased some government securities on October 1, 2018 for Rs. 20,000 carrying interest at 12 per cent. The interest is payable half yearly on April 1 and October 1 every year. The first instalment of interest (Rs. 1,200) is received on April 1, 2019. The Profit and Loss Account is being prepared for the year 2018 (January 1, 2018 to December 31, 2018). The interest amounting to Rs. 600 earned during. October 1 to December 31 must be shown as the income from interest on investments in the Profit and Loss Account for 2018 though the amount has not been received in 2018.

The Timing of Costs Recognition

The matching principle holds that the expenses should be recognised in the same period as the associated revenues. Thus,

i) The cost of goods have to be matched with their sales revenue. This means that while preparing the Profit and Loss Account for a particular year, you should not take the cost of all the goods produced during that year, but consider only the cost of goods that have actually been sold during that year. The cost of goods sold is arrived at by deducting the cost of closing stock from the cost of goods produced.

ii) Expenses such as salaries, wages, interest, rent, insurance, etc., are recognised on time basis. In other words, they are related to the year in which the service is obtained or the expense is incurred, whether paid immediately or payable at a later date.

iii) Costs like depreciation on fixed assets are also allocated on time basis.

Thus, all revenue earned during an accounting year, whether received or not, and all costs incurred, whether paid or not have to be taken into account while preparing the Profit and Loss Account for the year. Similarly, any amount received or paid during the current year which actually relates to the previous year or the following accounting year, must be eliminated from the current year's revenue and costs. This gives rise to another aspect viz., the accrual basis of accounting about which you will learn later.

The Matching Concept thus has the following implications for the ascertainment of profit or loss during a particular period.

1. We should ensure that costs should relate to the same accounting period as the revenues. For example, when we prepare the Profit and Loss Account for 2017, we shall take into account all those incomes that were earned during 2017, and similarly consider only those costs which were incurred in 2017. Any costs or incomes which relate to 2018 shall be excluded.

2. We should ensure that all costs incurred during the accounting period (whether paid or not) and all revenues earned during that year (whether received or not) are fully taken into account.

3. We should consider only those costs which relate to the revenue taken into account. This is the reason why we consider only the cost of goods sold, and not the cost of goods produced during that period.

Check Your Progress E

1. What is the main implication of the Matching Concept?

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2. Name three items of revenues.

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3. Name three items of costs.

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4. Fill in the blanks.

i) Profit is the excess of revenue over ……………………………

ii) Costs incurred during an accounting year should be matched against

…………………………………….

iii) Revenue realisation does not mean that revenue must be realised in……………………………..

iv) Cost of goods are matched with their sales revenue......................?

v) Revenue such as interest, commission, etc., are recognised as earned with reference to …………………………………….

i) Expenses such as wages, rent, etc., are recognised on …………..basis.

Conservatism Concept

This is also known as Prudence Concept understatement of assets or revenues, and overstatement of liabilities or costs. This is in accordance with the traditional view which states 'anticipate no profits but anticipate all losses'. In other words, you should account for profits only when they are actually realised. But in case of losses, you should take into account even those losses which may be a remote possibility. This is why closing stock is valued at cost price or market price whichever is lower. Provision for doubtful debts and provision for discounts on debtors are also made according to this concept.

Consistency Concept

The principle of consistency means 'conformity from period to period with unchanging policies and procedures'. It means that accounting method adopted should not be changed from year to year. For example, the principle of valuing closing stock 'at cost price or market price whichever is lower' should be followed year after year. Similarly, if depreciation on fixed assets is provided on straight line basis, it should be followed consistently year after year. Consistency eliminates personal bias and helps in achieving comparable results.

If this principle of consistency is not followed, the accounting information about an enterprise cannot be usefully compared with similar information about other enterprises and so also within the same enterprise for some other period. Consistent use of the same methods and bases from one period to another, enhances the utility of the financial statement.

However, consistency does not prohibit change. Desirable changes are always welcome. But such changes should be completely disclosed while presenting the financial statements.

Full Disclosure Concept

You know the financial statements are the basic means of communicating financial information to all interested parties. These statements are the only source for assessing the performance of the enterprise for investors, lenders, suppliers, and others. Therefore, financial statements and their accompanying foot-notes should completely disclose all relevant information of a material nature which relate to the profit and loss and the financial position of the business. This enables the users of the financial statements to make correct assessment about the profitability and financial soundness of the enterprise. It is therefore, necessary that the disclosure should be full, fair and adequate.

Materiality Concept

This concept is closely related to the Full Disclosure Concept. Full disclosure does not mean that everything should be disclosed. It only means that all relevant and material information must be disclosed. Materiality primarily relates to the relevance and reliability of information. An item is considered material if there is a reasonable expectation that the knowledge of it would influence the decision of the users of the financial statements. All such material information should be disclosed through the financial statements and the accompanying notes. For example, commission paid to sole selling agents, if any, should be disclosed separately in the Profit and Loss Account. Similarly, if there is a change in the method or rate of depreciation, this fact must be duly reported in the financial statements.

A strict adherence to accounting principles is not required for items of little significance or of non-material nature. For example, erasers, pencils, scales, etc., are used for a long period, but they are not treated as assets. They are treated as expenses. This does not affect the amount of profit or loss materially.

Similarly, while showing the amounts of various items in the financial statements, they can be approximated up to paise. Even if they are shown to the nearest rupee or hundreds, there may not be any material effect. For example, if an amount of Rs. 1,45,923.28 is shown as Rs. 1,45,900 it does not make much difference for assessment of the performance of the enterprise.

However, there are no specific rules for ascertaining material or non-material items, It is just a matter of personal judgement.

Check Your Progress F

1. What is the aim of Conservatism Concept ?

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2. What do you mean by the Principle of Consistency?

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3. Why is full disclosure of relevant information considered necessary?

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4. How do you make a distinction between material and non-material items?

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3.4 SYSTEMS OF BOOK-KEEPING

Book-keeping as explained earlier is the art of recording business transactions in a systematic manner. Broadly, there are two systems of book-keeping:

i) Double Entry System, and

ii) Single Entry System.

3.4.1 Double Entry System

Under the dual aspect concept you learnt that every business transaction has two aspects: (i) the receiving aspect, and (ii) the giving aspect. For example, when you purchase goods for cash, goods come in and cash goes out. Thus, a transaction affects two items (also called accounts) at the same time. When you record the transaction in the books of account of a business, it would be better if you record the effects relating to both the items. In the above example, the items affected are goods and cash, stock of goods increases and cash decreases. So, we should record the increase in stock of goods and also the decrease in cash. This involves two entries, one in Goods Account and the other in Cash Account. This method of recording business transactions is called 'Double Entry System'. It recognises and record both the aspects of every transactions. According to this system, the account which involves receiving aspect is debited and the account which involves giving aspect is credited. Thus, for every debit there will be an equivalent credit. For this purpose certain rules have been framed. These are discussed in Unit 5.

Advantages of Double Entry System

This system has the following advantages:

i) It provides complete and reliable record of all business transactions because it records both effects.

ii) It supplies full information about the incomes and expenses, assets and liabilities of the business. It, thus, helps the management in taking appropriate decisions.

iii) The arithmetical accuracy of the books of account can be ascertained by preparing a trial balance.

iv) The financial result of the operations of the business i.e., profit or loss, can be easily ascertained.

v) The financial position of the business can also be ascertained at any point of time.

3.4.2 Single Entry System

Single entry system does not mean that only one aspect of a transaction is recorded. An incomplete or defective double entry system is generally called single entry system. Under this system, all transactions are not recorded and all accounting records are not maintained. The two aspects of a transaction are recorded in certain cases, but in certain cases only one aspect is recorded. Certain transactions are ignored, they are not even recorded. The single entry system is thus a mixture of double entry, single entry and no entry. The accounts maintained under this system are incomplete and unsystematic and, therefore, not reliable. The main defect of this system is that the arithmetical accuracy of the books of account cannot be checked, because a trial balance cannot be prepared. The profit and loss account and balance sheet also cannot be prepared. This system is normally followed by small business firms.

3.5 LET US SUM UP

1. There are number of terms commonly used in accounting. The understanding of these terms is necessary for preparing accounting records.

2. Accounting involves identifying, measuring, recording, summarising and communicating events and transactions. For this purpose, certain guidelines or ground rules are necessary. Basic accounting concepts or generally accepted accounting principles guide the accountant in record keeping and reporting.

3. Certain principles or concepts have been agreed upon. Some are observed at the recording stage while others are relevant at the reporting stage.

4. According to business entity concept, the business enterprise and its proprietor are treated as two separate entities, distinct from each other.

5. According to money measurement concept, all the transactions should be recorded in terms of the standard currency of the country.

6. According to the historical record concept, only those transactions which have actually taken place should be recorded in the order of their occurrence i.e., date-wise.

7. The cost concept states that the amount actually received or paid for any goods or service should be recorded and not its value.

8. As per the dual aspect concept, every transaction has two aspects. Both the aspects are to be recorded in the books of account.

9. Double entry is a system which recognises and records both aspects of a transaction.

10. Single entry system is an incomplete record of business transactions.

11. For ascertaining the profit and loss and the financial position of the business, two financial statements are prepared: (i) Profit and Loss Account, and (ii) Balance Sheet. These are called final accounts.

12. Final accounts are prepared at the end of each accounting year.
13. While preparing the final accounts, nine basic accounting concepts have to be observed.
14. According to the Going Concern Concept, the firm should be considered as a continuing unit and not as one closing down.
15. According to the Matching Concept, appropriate costs have to be matched against the appropriate revenues for the accounting period.
16. The Concept of Conservatism implies that while calculating the profit for an accounting period, take all losses into account but include only those incomes which have actually arisen.
17. The Concept of Consistency implies that there should be consistency in all accounting methods followed from period to period so as to ensure possibility of meaningful comparisons.
18. According to Full Disclosure Concept financial reports should disclose fully all relevant information of material nature, so that the users of those reports can draw rational conclusions about the enterprise.
19. The Materiality Concept implies that while measuring income of a business for an accounting period the non-material facts can be ignored.
20. There are two bases of accounting viz., cash basis and accrual basis. The accrual basis of accounting is considered more rational.

3.6 KEY WORDS

Account: A classified statement of transactions relating to a person or a thing or any other subject.

Assets: Anything which has economic value.

Business Entity: A business enterprise.

Capital: Owner's investment or equity in a firm.

Cash Discount: An allowance given by the creditor to the debtor on the amount due for prompt payment.

Creditor: One to whom the business owes some amount.

Debtor: One who owes some amount to the business.

Drawings: Amount withdrawn by the owner from the business for personal use.

Equity: The claim or right over the assets of the firm. It includes both the owner's and the creditor's claims.

Expenditure: Spending of money or incurring a liability for some benefit or service received by the business.

Gain: Profit arising from peripheral or incidental transactions.

Goods: Goods are the mercantile things in which the business deals.

Income: It is the amount earned through business operations.

Revenue: Amount realised for the goods sold or services rendered.

Stock: Raw materials, semi-finished goods and finished goods lying in stores.

Trade Discount: An allowance given by the seller to the buyer on the list price at the time of sale.

Transaction: Transfer of money or money's worth between two entities is called a transaction.

3.7 SOME USEFUL BOOKS

Bierman, Harold & Drebin, Allan R., Financial Accounting: An Introduction (Philadelphia: W.B. Saunders Company, 1998)

Briston, R.J., Introduction to Accounting and Finance. (London: The Macmillan Press Ltd., 1991) Part-B. Fank Wood : Book-Keeping and Accounts. (London : Pitman, 1996)

Maheshwari, SN., Principles and Practice of Accountancy, Part I. (New Delhi : Arya Book Depot, 2018)

Paul V.A. & Korlahalli, J.S., Principle and Practice of Accountancy. (New Delhi : S. Chand & Co., 2018)

3.8 ANSWERS TO CHECK YOUR PROGRESS

A 1. (i) Debtor (ii) Creditor (iii) Goods (iv) Assets (v) Personal use (vi) Unrealisable (vii) Capital (viii) Account

2. (i) Goods (ii) Asset (iii) Asset (iv) Goods (v) Goods

3. Assets :Delivery van, furniture, typewriter, cash in hand, stock of goods not yet sold.

   Liabilities: Bank loan. M/s. Gurucharan Singh & Co., M/s. Lalwani Traders.

   Income : Amounts received from Mr. Peter and Mr. Ali.

   Expenses : Account books and stationery. electricity charges, salaries and rent.

B 1. Except d, g, i, j and l all other transactions are to be recorded.

2. C + L = A

   Capital: Rs. 20,000 + Creditors Rs. 5,000 = Machinery Rs. 20,000 + Cash Rs. 5,000

3. Capital = 1800+3000+2000+1200–2500-500 = Rs. 5000

C. Except 'c' all other transactions have to be recorded in the business books with the following amounts:

a) Rs. 10,300 b) Rs. 1,000

d) Rs. 25,000 e) Rs. 5,000

D 1. a) Rs. 25,000 b) Rs. 35,000 c) Rs. 20,000.

2. a) Stock increases and cash decreases

b) Stock increases and creditors increase

c) Cash decreases and creditors decrease

d) Cash increases and debtors decrease

3.9 TERMINAL QUESTIONS/EXERCISES

1. What do you mean by double entry system? Distinguish it from single entry system.

2. What do you mean by accounting concepts? Briefly explain the accounting concepts which guide the accountant at the recording stage.

3. Krishna has invested a capital of Rs. 80,000 on June 30, 2018. He purchased goods from Suresh on credit, amounting to Rs. 20,000. Find out the value of assets. (Ans: Rs. 1,00,000)

4. The assets of a business on December 31, 2018 are Rs. 50,000 and capital is Rs. 30,000. Find out the amount of liabilities. (Ans: Rs. 20,000)

5. The following is the assets and liabilities position of Srinivasa Traders on October 1, 2018:

   Assets: Cash Balance Rs. 3,000; Furniture Rs. 5,000;

   Building Rs. 50,000; Debtors Rs. 22,000.

   Liabilities: Bank Loan Rs. 10,000; Creditors Rs. 15,000.

   Find out the amount of capital on that date. (Ans: Rs. 55,000).

6. Write short notes on the following:

   a) Going Concern Concept

   b) Accounting Period Concept

7. What do you understand by matching costs against revenue? Explain briefly the importance of the Matching Concept.

8. Explain briefly the following concepts:

   a) Conservatism

   b) Consistency

c) Full Disclosure

d) Materiality

9. Distinguish between cash basis and accrual basis of accounting with examples.

10. Explain briefly the main accounting concepts to be observed at the time of preparing final accounts.

Note : These questions will help you to understand the unit better. Try to write answers for them. But, do not submit your answers to the University for assessment. These are for your own practice only.

UNIT 4 ACCOUNTING STANDARDS

Structure

4.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the concept of the accounting standards;
- discuss the benefits of accounting standards;
- discuss the procedures of issuing accounting Standards in India;
- describe International Financial Reporting Standards, GAAP, IAS etc;
- develop the insights about the need and procedure of issuing IFRS;
- understand how Indian economy is converging towards implementing IFRS.
- make comparison between Indian AS and International AS;
- describe the procedure for measuring business income;
- explain the accounting concepts that are relevant to measurement of business income; and
- state the objectives of measurement of business income of business income.

4.1 CONCEPT OF ACCOUNTING STANDARDS

Accounting is the language of business. All financial information (i.e. nature of financial activities, financial position, financial results, present trend and further prospects etc.) are available through accounting. The so-called financial information is communicated to the users (both internal as well as external) of accounting information by preparing and presenting the financial statements. As such, it becomes necessary to develop some Generally Accepted Accounting Principles (GAAP) while preparing the financial statements by which the language of the business can be communicated to the users.

As per section 129 of Companies Act, 2013 the financial statements of a company must present a true and fair view of the income and financial position of the company. However, it does not define what constitutes a true and fair view of a company. Since the beginning of accounting, a number of Generally Accepted Accounting Principles have been developed consisting of accounting concepts and conventions so as to bring comparability and uniformity in the financial statements of various business organizations. However, even these GAAP allow many alternatives for the treatment of same item that can be followed by the business organizations while preparing financial statements which leads to lack of consistency, uniformity and comparability among the financial statements of different originations. In addition, there must not be any ambiguity and uncertainty relating to the facts, figures and terms which are contained in the financial statements and will be presented to the users of accounting information.

Hence, there is a need to develop some standards which must be followed by all the organizations so as to achieve uniformity in the financial statements. For this purpose, International Accounting Standards Committee (IASC) was established on 29th June, 1973. The Institute of Chartered Accountants of India and Institute of Cost Accountants of India are members of IASC. ICAI is also developing its own accounting standards patterned on International Accounting Standards modified to the requirements of Indian accounting community.

Definition

In the words of Kohler, an accounting standard may be defined as 'a code of conduct imposed on accountants by custom, law or professional body.'

Thus, accounting standards may be defined as the accounting principles and rules which are to be followed for various accounting treatments while preparing financial statements on uniform basis and which will reveal the same meaning to all the interested groups who will use the same. Thus, the Standards are considered as a guide for maintaining and preparing accounts.

Nature of Accounting Standards

On the basis of forgoing discussion, we can say that accounting standards are guide, dictator, service provider and harmonizer in the field of accounting process.

Serve as a guide to the accountants: Accounting standards serve the accountants as a guide in the accounting process. They provide basis on which accounts are prepared. For example, they provide the method of valuation of inventories.

Act as a dictator: Accounting standards act as a dictator in the field of accounting. Like a dictator, in some areas accountants have no choice of their own but to opt for practices other than those stated in the accounting standards. For example, Cash Flow Statement should be prepared in the format prescribed by accounting standard.

Serve as a service provider: Accounting standards comprise the scope of accounting by defining certain terms, presenting the accounting issues, specifying standards, explaining numerous disclosures and implementation date. Thus, accounting standards are descriptive in nature and serve as a service provider.

Act as a harmonizer: Accounting standards are not biased and bring uniformity in accounting methods. They remove the effect of diverse accounting practices and policies. On many occasions, accounting standards develop and provide solutions to specific accounting issues. It is thus, clear that whenever there is any conflict on accounting issues, accounting standards act as harmonizer and facilitate solutions for accountants.

4.2 BENEFITS OF ACCOUNTING STANDARDS

There are many benefits of accounting standards. Let us discuss the main benefits of Accounting Standards one by one.

1) **Standardized Accounting:** Perhaps the most important advantage of the FASB standard setting for businesses is the uniform set of accounting principles it promotes. The FASB clearly states the generally-accepted accounting principles that businesses must follow to avoid confusion. For example, the FASB prevents businesses from using one method for calculating inventory at the beginning of a fiscal year and finishing the year with another method. Without the accounting standards set forth by the FASB, businesses could use accounting methods that portray financial data inaccurately to investors.

2) **Problem Identification:** The FASB standard setting provides a framework upon which potential accounting problems are identified and corrected. Because all businesses in the US use the same accounting principles, any problems or inadequacies in the accounting process are quickly identified and reported to the FASB. The FASB then investigates the problem and, if needed, modifies or writes a new accounting rule for the accounting process. For example, if businesses find that reporting a certain type of liability on their income statement unfairly lowers their net income, they can appeal to the FASB so that it can identify problems with the standard setting.

3) **Private Regulation:** The FASB is a private entity with no affiliation to the US government. Despite this, the Securities and Exchange Commission relies on the FASB to set the accounting rules that all companies in the US must follow. The SEC can technically create an accounting oversight board or government agency to set accounting rules. However, using the FASB eases the burden on the US government and lets the private sector dictate accounting rules.

4) **International Accounting Standard:** The FASB is advantageous because it actively promotes an internationally recognized set of accounting rules. Globalization has deeply connected foreign financial markets; a standard set of accounting rules would make financial reporting more accurate and fair between countries. One of the goals of the FASB is to make financial reporting more uniform globally with the cooperation of the International Accounting Standards Board (IASB).

4.3 PROCEDURE FOR ISSUING AS IN INDIA

There is a set procedure for issuing AS in India. Let us discuss this prodedure in detail.

1) **Determination of the need of an AS**

   First, the Accounting Standard Board determines the broad areas in which accounting standards needs to be formulated.

2) **Constituting Study Group**

   Study Group will be constituted consisting the members of the Institute of Chartered Accountants of India. The motive behind constitution of this group is to assist the accounting Standard Board in its activities.

3) **Drafting the Standard**

   The Study Group Prepares draft of the proposed Standard. The proposed draft enlists the following areas:

   a) Objective of the standard.

   b) Scope of the Standard.

   c) Definitions of the terms used in the standard

   d) Recognition & Measurement Principles

   e) Presentation & Disclosure requirements.

4) **Analyzing the Draft**

   ASB in this stage considers the Preliminary draft prepared by the Study Group. In case anything needs to be revised than Accounting Standard Board takes the following steps.

   a) ASB makes the revision

   b) ASB refers the same to the study Group

5) **Circulation of the Draft**

   In this step, the ASB circulates the AS draft to the council members of the Institute of Chartered Accountants of India and the following specifies bodies for their comments.

   a) The Institute of Works & Cost Accountants of India

   b) The Institute of Company Secretaries of India.

   c) Ministry of Company Affairs.

d) Comptroller & Auditor General of India

e) Central Board of Direct Taxes

f) Standing Committee of Public Enterprises

g) Reserve Bank of India

h) Indian Banks Association.

i) Securities & Exchange Board of India.

j) Associated Chamber of Commerce & Industry, Confederation of Indian Industry and Federation of Indian Chambers of Commerce & Industry.

k) Any other body considered relevant by the ASB.

6) Holding Discussion and Finalizing Exposure Draft

ASB holds meeting with the representatives of above mentioned bodies for the purpose of determining their views on the Draft Accounting Standard. Based on analyses of the discussion, ASB finalizes the exposure draft of proposed accounting standards.

7) Circulation of Exposure Draft

The exposure Draft of the proposed standards is issued for comments the members of the ICAI and the public.

8) Finalizing the Exposure Draft

Based on the comments received, the ASB finalizes the draft of the proposed standards. Finally ASB submits the same to the council of the ICAI.

9) Modifying & Issuing the Accounting Standard

The council of the ICAI then considers the finalized draft standard and if necessary modifies the same in consultation with the ASB. The ICAI then issues the Accounting Standard after modification if any on the relevant subject.

4.4 SALIENT FEATURES OF FIRST TIME ADOPTION OF INDIAN ACCOUNTING STANDARDS (Ind-AS):101

Ind-AS 101 lays out the accounting principles for first-time adoption of Ind-AS. It prescribes the various requirements to be fulfilled during the transition period when a company adopts Ind-AS for the first time, i.e., when it moves from making the financial statements in accordance with Accounting Standards (Indian GAAP) to make them in accordance with Ind-AS.

Conceptually, the accounting under Ind-AS should be applied retrospectively at the time of transition of companies from applying Accounting Standards (Indian GAAP) to Ind-AS. However, for and easy transition, Ind-AS 101 has provided some exemptions for retrospective application of Ind-AS. The exemptions are clearly categorised into those which are mandatory in nature (i.e., cases where the company is prohibited to apply Ind-AS retrospectively) and those which are voluntary in nature (i.e., it is upto the company to apply or not to apply certain requirements of Ind-AS retrospectively).

Ind-AS 101 also lists out presentation and disclosure requirements to explain the transition to the users of financial statements. It also requires a company to explain how the transition will affect its reported balance sheet, financial performance and cash flows. It does not provide any exemption from the disclosure requirements in other Ind-AS.

Objective of Ind-AS 101

The objective of Ind-AS 101 is to ensure that the entity's first Ind-AS Financial Statements, and its interim financial reports for the period covered by those financial statements, contain high quality information that:

1. Is transparent for users and comparable over all periods presented,
2. Provide a suitable starting point for accounting in accordance with the Indian Accounting Standards (Ind-AS), and
3. Can be generated at a cost that does not exceed benefits.

Scope of Ind-AS 101

An entity shall apply the Indian Accounting Standard-101 (first time adoption of Indian Accounting Standards) in:

a) First Financial Statements after implementing Ind-AS.

b) Each Interim Financial Report in accordance with Ind-AS 34 *Interim Financial Reporting* for the part of the period covered by its first Ind-AS financial Statements.

4.5 CURRENTLY PREVAILING ACCOUNTING STANDARDS IN INDIA

Section 133 of Companies Act, 2013 requires the companies to comply with the prevailing accounting standards. As on 1st April, 2016 there are 32 accounting standards specified by ICAI, all of which are mandatory to be complied by the companies. Following is the list of these standards:

- AS 1 Disclosure of Accounting Policies
- AS 2 Valuation of Inventories
- AS 3 Cash Flow Statements
- AS 4 Contingencies and Events Occurring after the Balance Sheet Date
- AS 5 Net Profit or Loss for the period, Prior Period Items and Changes in Accounting Policies
- AS 6 Depreciation Accounting
- AS 7 Construction Contracts (revised 2002)
- AS 8 Accounting Policies, Chanages in Accounting estimates and Errors.

- AS 9 Revenue Recognition
- AS 10 Accounting for Fixed Assets
- AS 11 The Effects of Changes in Foreign Exchange Rates (revised 2003),
- AS 12 Accounting for Government Grants
- AS 13 Accounting for Investments
- AS 14 Accounting for Amalgamations
- AS 15 Employee Benefits (revised 2005)
- 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
- AS 30 Financial Instruments: Recognition and Measurement
- AS 31 Financial Instruments: Presentation
- AS 32 Financial Instruments: Disclosure

Check Your Progress A

1. Define the term 'Accounting Standard'.

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2. What are the main objectives of accounting standards?

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3. Discuss the procedure of issuing accounting standards in India.

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4. Give any three limitations of accounting.

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4.6 INTERNAT1IONAL FINANCIAL REPORTING STANDARDS

Accounting provides companies, investors, regulators and others with a standardized way to describe the financial performance of an entity. Accounting standards present and prepares of financial statements with a set of rules to abide by when preparing an entity's accounts, ensuring this standardization across the market. Companies listed on public stock exchanges are legally required to publish financial statements in accordance with the relevant accounting standards.

International Financial Reporting Standards (IFRS) is a single set of accounting standards, developed and maintained by the International Accounting Standards Board with the intention of those standards being capable of being applied on a globally consistent basis — by developed, emerging and developing economies. Thus, providing investors and other users of financial statements with the ability to compare the financial performance of publicly listed companies on a like-for-like basis with their international peers.

IFRS are now mandated for use by more than 100 countries, including the European Union and by more than two-thirds of the G20. The G20 and other international organisations have consistently supported the work of the Board and its mission of global accounting standards.

4.7 NEED AND PROCEDURE OF IFRS

With the increasing globalization of financial markets and of companies, the use of a single set of financial reporting standards across countries is viewed as having increased the comparability of financial statements across borders. It also reduces the cost of preparing the consolidated financial statements of groups made up of companies conducting business all around the world.

Financial reporting standards have been in the spotlight since the banking crisis, more specifically those requiring the measurement of financial assets and liabilities at fair value. In September 2009, G20 leaders in Pittsburgh asked the accounting standard setters IASB and, its US counterpart, the FASB to work towards a single set of high quality global accounting standards by June 2011. Convergence, however, is proving challenging and is likely to be pushed back.

Initially, IFRS begun as an academic project aimed at creating a single set of global standards, their actual use was kick-started by the European Union.

An EU regulation requires listed companies in Europe to adhere to International Financial Reporting Standards (IFRS) from financial years commencing on or after 1 January 2005 when preparing their consolidated accounts. In implementing this in UK legislation, the Government has not yet made the use of IFRS compulsory for any further categories of accounts, but the legislation permits all companies to use them for individual and consolidated accounts if they wish.

Changes have been made to UK tax legislation to accommodate these new rules for tax purposes.

International Financial Reporting Standards (IFRS) are developed through an international consultation process, the "due process", which involves interested individuals and organisations from around the world.

The due process comprises six stages, with the Trustees of the IFRS Foundation having the opportunity to ensure compliance at various points throughout:

1. Setting the agenda
2. Planning the project
3. Developing and publishing the Discussion Paper, including public consultation
4. Developing and publishing the Exposure Draft, including public consultation
5. Developing and publishing the Standard.
6. Procedures after a Standard are issued.

The IFRS issued by IASB and the corresponding Ind- AS are given below:

S. No.	IFRS No.	Title	Corresponding converged Ind-AS
1)	IFRS 1	First-time Adoption of Indian Accounting Standards	Ind-AS 101
2)	IFRS 2	Share based Payment	Ind-AS 102
2)	IFRS 3	Business Combinations	Ind-AS 103
3)	IFRS 4	Insurance Contracts	Ind-AS 104
4)	IFRS 5	Non-current Assets Held for Sale and Discontinued Operations	Ind-AS 105
5)	IFRS 6	Exploration for and Evaluation of Mineral Resources	Ind-AS 106
6)	IFRS 7	Financial Instruments: Disclosures	Ind-AS 107
7)	IFRS 8	Operating Segments	Ind-AS 108
8)	IFRS 9	Financial Instruments	Exposure Draft Issued
9)	IFRS 10	Consolidated Financial Statements	Exposure Draft Issued
10)	IFRS 11	Joint Agreements	Exposure Draft Issued
11)	IFRS 12	Disclosure of Interests in Other Entities	Exposure Draft Issued
12)	IFRS 13	Fair Value Measurement	Exposure Draft Issued

4.8 CONVERGENCE TO IFRS

For a country, there are two alternatives available for compliance and implementation of the IFRS, which are (i) Adoption, (ii) Convergence

Adoption: It means acceptance of IFRS in its original form. If a country adopts IFRS in its original form, then it is not allowed to make any change in the language or format of the IFRS formed by IASB.

Convergence: It means implementing IFRS with modification wherever necessary so as to suit the requirements of a particular country.

India has decided to converge it existing accounting standards to IFRS. In India, the converged accounting standards are called Ind-AS

As per the road-map announced by Ministry of Corporate Affairs (MCA) in March 2010, the Indian Accounting Standards (Ind-AS) converged with International Financial Reporting Standards (IFRS) were to be applied to specified class of companies in phases beginning with the financial year 1 April 2011. Audit observed that MCA could not notify the date of implementation of Ind-AS as per its notified road-map. Slippages in the implementation of Ind-AS were discussed in Chapter 4 of Audit Report No. 2 of 2014.

Subsequently, in pursuance of the Budget Statement of the Finance Minister in February 2014, MCA after consultations with various stakeholders and regulators, issued a press note on 2 January 2015 wherein a revised Road map for implementation of Ind-AS converged with IFRS was laid down for companies other than Banking Companies, Insurance Companies and Non-Banking Finance Companies (NBFC). The Ind-AS shall be applicable to the companies as follows:

(i) On voluntary basis for financial statements for accounting periods beginning on or after 1 April 2015, with the comparatives for the periods ending 31 March, 2015 or thereafter;

(ii) On mandatory basis for the accounting periods beginning on or after 1 April 2016, with comparatives for the periods ending 31 March 2016, or thereafter, for the companies specified below:

   a) Companies whose equity and/or debt securities are listed or are in the process of listing on any stock exchange in India or outside India and having net worth of Rs. 500 crore or more.

   b) Companies other than those covered in (ii) (a) above, having net worth of Rs.500 crore or more.

   c) Holding, subsidiary, joint venture or associate companies of companies covered under (ii) (a) and (ii) (b) above.

(iii) On mandatory basis for the accounting periods beginning on or after 1 April 2017, with comparatives for the periods ending 31 March, 2017, or thereafter, for the companies specified below:

   a) Companies whose equity and/or debt securities are listed or are in the process of being listed on any stock exchange in India or outside India and having net worth of less than Rs. 500 crore .

b) Companies other than those covered in paragraph (ii) and paragraph (iii)(a) above that is unlisted companies having net worth of Rs. 250 crore or more but less than Rs. 500 crore.

c) Holding, subsidiary, joint venture or associate companies of companies covered under paragraph (iii) (a) and (iii) (b) above.

However, companies whose securities are listed or in the process of listing on SME exchanges shall not be required to apply Ind-AS. Such companies shall continue to comply with the existing Accounting Standards unless they choose otherwise.

(iv) Once a company opts to follow the Ind-AS, it shall be required to follow the Ind-AS for all the subsequent financial statements.

(v) Companies not covered by the above roadmap shall continue to apply existing Accounting Standards prescribed in Annexure to the Companies (Accounting Standards) Rules, 2006.

Companies Act, 2013 specified that the financial statements shall comply with accounting standards notified by Central Government and shall be in form or forms as may be provided for class or classes of companies. This would facilitate implementation of Ind-AS in phases. Accordingly, MCA vide its notification dated 16 February 2015 notified the Companies (Indian Accounting Standards) Rules 2015 specifying 39 Ind-AS to be implemented as per the above road-map. The Ind-AS have been formulated by MCA in consultation with National Advisory Committee on Accounting Standards (NACAS).

Challenges to convergence

1. As Ind-AS are essentially based on the concept of fair value measurement of assets and liabilities, corresponding standards under the Income Tax Act are essential to ensure smooth and harmonised transition. Draft Income Computation and Disclosure Standards released by Ministry of Finance in this regard in January 2015 are under finalisation.

2. Banks and Insurance Companies have been kept out of the proposed road map for transition to Ind-AS in view of the specific needs and concerns of these two sectors.

3. Issues such as cost of compliance, capacity building, managing two sets of standards (one for entities that seek transition and the other for those which do not) and the impact of exceptions or ‘carve outs’ on the achievement of objectives of convergence would need to be addressed through a well-coordinated mechanism among MCA, DPE and ICAI.

4.9 DISTINCTION BETWEEN INDIAN AS AND INTERNATIONAL AS

The detail of difference between Accounting Standards and Ind- AS is enormous. Also, the impact of these differences vary from industry to industry and even from company to company. However, the major differences are listed below. Let us discuss them in defant.

Basic of Distinction	Accounting Standards(AS)	Ind-AS
Need	When businesses were not that complicated and accounting was done at local level, then accounting standards based on local GAAP were enough.	Today, businesses have become complicated and a globalised world is in the need of a comprehensive accounting standards that can be consistently applied globally and facilitate compatibility. Introduction of Ind-AS is the need of the hour for India to compete in this globalised world
Objective	The basic objective of Accounting standards is to remove variation in the treatment of several accounting aspects and to bring about standardization in presentation. They intent to harmonize the diverse accounting policies in the preparation and presentation of financial statements by different reporting enterprises so as to facilitate intra-firm and inter-firm comparison.	Ind-AS are Indian version of IFRS because it will be impractical to just adopt the IFRS blindly without taking into consideration the current Indian scenario. International Financial Reporting Standards are principles based standards, interpretation and the framework adopted by the International Accounting Standards Board (IASB). Since India is a member country so it has to adopt these standards. However, any changes in these IFRS would have an impact on books of Indian companies to adopt these IFRS as and when amended. So to fill the difference, Ind-AS have been introduced which is nothing but IFRS. These standards have been made applicable to Indian companies through a road map i.e., in a systematic manner. The benefit of these standards is that any change in IFRS would not impact Ind- AS directly. The Ministry of corporate affairs can analysis such changes and incorporate the same in Ind-AS if it thinks it is suitable.
Pervasiveness	AS are not so pervasive or widespread.	Ind-AS are pervasive and cover every area comprising reported revenues, expenses, assets, liabilities and equity.
Basis	AS are driven by 'legal' form in a number of areas and are rule based.	Ind-AS focus on 'substance' rather than the legal form. They are principal based, Ind-AS will also result in accounting which more closely reflects the underlying business rationale and true economics of transaction.
Disclosure requirements	Disclosure requirements are comparatively less detailed.	Disclosure requirements are more comprehensive and multifold under Ind-AS to enhance the transparency and accountability of financial statements.

The government of India has issued notification regarding Ind- AS. Following is the list of Ind-AS notified:

1) Ind-AS 1 Presentation of Financial Statements
2) Ind-AS 2 Inventories
3) Ind-AS 7 Statement of Cash Flows
4) Ind-AS 8 Accounting Policies, Changes in Accounting Estimates and Errors
5) Ind-AS 10 Events after the Reporting Period
6) Ind-AS 11 Construction Contracts
7) Ind-AS 12 Income Taxes
8) Ind-AS 16 Property, Plant and Equipment
9) Ind-AS 17 Leases
10) Ind-AS 18 Revenue
11) Ind-AS 19 Employee Benefits
12) Ind-AS 20 Accounting for Government Grants and Disclosure of Government Assistance
13) Ind-AS 21 The Effects of Changes in Foreign Exchange Rates
14) Ind-AS 23 Borrowing Costs
15) Ind-AS 24 Related Party Disclosures
16) Ind-AS 27 Consolidated and Separate Financial Statements
17) Ind-AS 28 Investments in Associates
18) Ind-AS 29 Financial Reporting in Hyper-inflationary Economies
19) Ind-AS 31 Interests in Joint Ventures
20) Ind-AS 32 Financial Instruments: Presentation
21) Ind-AS 33 Earnings per Share
22) Ind-AS 34 Interim Financial Reporting
23) Ind-AS 36 Impairment of Assets
24) Ind-AS 37 Provisions, Contingent Liabilities and Contingent Assets
25) Ind-AS 38 Intangible Assets
26) Ind-AS 39 Financial Instruments: Recognition and Measurement
27) Ind-AS 40 Investment Property

Check Your Progress B

1. Define the term 'IFRS'.

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2. What is the need of forming IFRS?

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3. What are the challenges of converging accouniting standards to IFRS in India?

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4. Describe the difference between AS and Ind-AS?

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4.10 MEASUREMENT OF BUSINESS INCOME

One of the most significant accounting concepts is "**Concept of Income**". Similarly, measurement of a business income is also an important function of an accountant. In General term, payment received in lieu of services or goods are called income. But we are here more concerned for a business income. Surplus revenue over expenses incurred is called as "Business Income.

Measurement of Business Income

There are following two factors which are helpful in the estimation of an income –

- **Revenues** - Sale of goods and rendering of services are the way to generate revenue. Therefore, it can be defined as consideration, recovered by the business for rendering services and goods to its customers.

- **Expenses** - An expense is an expired cost. We can say the cost that have been consumed in a process of producing revenue are the expired cost. Expenses tell us - how assets are decreased as a result of the services performed by a business.

Measurement of Revenue - Measurement of the revenue is based on an accrual concept. Accounting period, in which revenue earned, is the period of revenue accrues. Therefore, a receipt of cash and revenue earned are the two different things. We can say that revenue is earned only when it is actually realized and not necessarily, when it is received.

Measurement of Expenses

- In case of delivery of goods to its customers is a direct identification with the revenue.

- Rent and office salaries are an indirect association with the revenue.

There are four types of events (given below) that need proper consideration about as an expense of a given period and expenditure and cash payment made in connection with those items –

- Expenditure, which are expenses of the current year.
- Some expenditure, which are made prior to this period and has become expense of the current year.
- Expenditure, which is made this year, becomes expense in the next accounting periods. For example, purchase of fixed assets and depreciation in next up-coming years.
- Expense of this year, which will be paid in next accounting years. For example, outstanding expenses.

4.11 OBJECTIVES OF MEASUREMENT OF BUSINESS INCOME

The measurement of income is useful for more than one purpose and therefore its objectives may be studied form different points of view:

i) **As a guide to future investment**: The current income positively influences the expectations about the future. The prospective investor looks to the income of the business enterprise as a guide to his investments decisions of the future. The investors attempt to maximize their returns on their investments and their decisions will be guided by income. So the allocation of investment funds and selections of securities depend upon income levels of an enterprise.

ii) **As a tax base**: Though the Income Tax Act does not define yet it does specify what is taxable and what is deductible in arriving at the taxable income. Accounting income provides income of a business enterprise. The tax authorities can conveniently mobilize the revenues through taxes which are one of the main sources of the Government's income.

iii) **As a guide to dividend policy**: The dividend policy at present is directed to determine the proportion of the current income which should be retained and the proportion which should be distributed as dividends. So long as dividends are aid out of current income, the rights of the creditors are adequately protected since other resources of the business enterprise would not be used to pay dividends. There are clear rules for measurement of distributable profits in the Companies Act with a view to protect the interests of the creditors.

iv) **As an indicator of managerial efficiency**: The efficiency of management as decision makers and as trustees of resources is judged by the reported income of the current year. The auditors therefore certify that the income statement presents true and fair view of operational results. The measurement of business income therefore provides a suitable criterion for the efficiency of management in a competitive economy.

v) **As a measure of overall efficiency and credit worthiness**: Income is the lifeblood of any business enterprise and therefore it provides that basic standard by which the overall efficiency of the business is assessed. For creditors, profitable enterprise faces no difficulty in making timely payment on its debts. Banks and other credit institutions too depend upon current income levels as a guide about a firm's ability to repay loan out of future income.

4.12 APPROACHES FOR MEASURING INCOME

In order to measure income, four main methods or approaches can be used: the operation approach, activities approach, balance sheet approach, or value added approach. Let's take a look at each of these.

Transaction/Operation Approach

Transactions are mostly related to production or the purchase of goods and the sale of goods and all these transactions directly or indirectly related to the revenue or to the cost. Therefore, surplus collection of the revenue by selling goods, spent over for production or purchasing the goods is the measure of income. This system is widely followed by the enterprises where double entry system adopted.

The Balance Sheet or value added Approach: Comparison of the closing values (Assets minus outsider's liabilities) of a firm with the values at the beginning of that accounting period is called as Balance Sheet approach. In above value, an addition to capital will be subtracted and addition of drawings will be added while computing the business income of a firm. Since, income is calculated with the help of Balance Sheet hence called as Balance Sheet approach.

4.13 ACCOUNTING CONCEPT THAT IS RELEVANT TO MEASUREMENT OF BUSINESS INCOME -REALIZATION CONCEPT

Realization concept in accounting, also known as revenue recognition principle, refers to the application of accruals concept towards the recognition of revenue (income). Under this principle, revenue is recognized by the seller when it is earned irrespective of whether cash from the transaction has been received or not.

In case of sale of goods, revenue must be recognized when the seller transfers the risks and rewards associated with the ownership of the goods to the buyer. This is generally deemed to occur when the goods are actually transferred to the buyer. Where goods are sold on credit terms, revenue is recognized along with a corresponding receivable which is subsequently settled upon the receipt of the due amount from the customer.

In case of the rendering of services, revenue is recognized on the basis of stage of completion of the services specified in the contract. Any receipts from the customer in excess or short of the revenue recognized in accordance with the stage of completion are accounted for as prepaid income or accrued income as appropriate.

Example: Motor Hundai is a car Dealer. It receives orders from the customers in advance against 20% down payment. Motor PLC delivers the cars to the respective customers within 30 days upon which it receives the remaining 80% of the list price. In accordance with the revenue realization principle, motor Hundai must not recognize any revenue until the cars are delivered to the respective customers as that is the point when the risks and rewards incidental to the ownership of the cars are transferred to the buyers.

Importance

Application of the realization principle ensures that the reported performance of an entity, as evidenced from the income statement, reflects the true extent of revenue earned during a period rather than the cash inflows generated during a period which can otherwise be gauged from the cash flow statement. Recognition of revenue on cash basis may not present a consistent basis for evaluating the performance of a company over several accounting periods due to the potential volatility in cash flows.

4.14 LET US SUM UP

1. Accounting Standards are defined as written statements of accounting rules and guidelines or practices for preparing the uniform and consistent financial statements.

2. Objectives of issuing accounting standards are to provide information, to harmonise different accounting processes and to facilitate uniformity, consistency and comparability.

3. Benefits of accounting standards – (i) true and fair financial position, (ii) easy comparability, (iii) enhances the value of accounting information, (iv) efficiency of management, (v) useful to accountants and auditors and (vi) enhances credibility and reliability.

4. The authority to make accounting standards in India is Accounting Standard Board. It follows the prescribed procedure to issue an accounting standard.

5. Procedure for issuing accounting standards-ASB assisted by study group-exposure draft- circulation- ASB after incorporating suggestions submit to ICAI. After that ICAI will issue standard.

6. Ind-AS 101 lays out the accounting principles for first-time adoption of Ind-AS. It prescribes the various requirements to be fulfilled during the transition period in moving from Accounting Standards (Indian GAAP) to Ind-AS.

7. Section 133 of Companies Act, 2013 requires the companies to comply with the prevailing accounting standards. As on 1st April, 2016 there are 32 accounting standards specified by ICAI, all of which are mandatory to be complied by the companies.

8. International Financial Reporting Standards is a single set of accounting standards, developed and maintained by the International Accounting Standards Board with the intention of those standards being capable of being applied on a globally consistent basis.

9. With the increasing globalisation of financial markets and of companies, the use of a single set of financial reporting standards across countries is viewed as having increased the comparability of financial statements across borders.

10. India has decided to converge its existing accounting standards to IFRS. In India, the converged accounting standards are called Ind-AS.

4.15 KEY WORDS

Accounting Standards: Accounting Standards are defined as written statements of accounting rules and guidelines or practices for preparing the uniform and consistent financial statements.

ASB: The board constituted by ICAI to concieve, formulate, examine and review the accounting standards.

GAAP: Generally Accepted Accounting Principles consist of accounting concepts and conventions so as to bring comparability and uniformity in the financial statements of various business organizations.

International Financial Reporting Standards: IFRS is a single set of accounting standards, developed and maintained by the International Accounting Standards Board with the intention of those standards being capable of being applied on a globally consistent basis.

ICAI: Institute of Chartered Accountants of India- the apex body of accounting professionals of India.

Ind-AS: In India, the converged accounting standards are called Ind-AS.
Ind-AS 101: Ind-AS 101 lays out the accounting principles for first-time adoption of Ind-AS.

4.16 SOME USEFUL BOOKS

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4.17 TERMINAL QUESTIONS

1. What are Accounting standards? What is the need of issuing accounting standards?
2. Describe the procedure of issuing AS in India.
3. Explain the concept of IFRS.
4. Describe the convergence of AS to Ind-AS.
5. What is business income? Why income should be computed?
6. What are the principles that govern the measurement of accounting income?
7. What are the features of Ind-AS 101?