Unit I

Introduction of Accounting

Accounting is a business language which elucidates the various kinds of transactions during the given period of time.

Accounting is broadly classified into three different functions viz.

- Recording
- Classifying and
- Summarizing

American Institute of Certified Public Accountants Association defines the term accounting as follows "Accounting is the process of recording, classifying, summarizing in a significant manner of transactions which are in financial character and finally results are interpreted."

There are many definitions of accounting. Some of the most important definitions are given below:

1. As per Robert N. Anthony – "Accounting system is a means of collecting, summarizing, analysing and reporting, in monetary terms, information about the business".
2. The American Accounting Association (AAA) has defined accounting as, "the process of identifying, measuring and communicating economic information to permit informal judgments and decisions by users of information".
3. The Committee on Terminology of American Institute of Certified Public Accountants gave a generally accepted definition of accounting – "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 a financial character, and interpreting the results thereof."

On the basis of above definitions, we conclude that accounting is a science as well as an art of recording of activities of the business which can be measured in money and analysing and interpreting them.

Accounting Terminology

Account

An account is a record used to properly classify the activity recorded in the General Ledger.

Accounting

Accounting is recording and reporting of financial transactions, including the origination of the transaction, its recognition, processing, and summarization in the financial statements.

Accrual Basis

Accrual basis is a method of accounting that recognizes revenue when earned, rather than when collected and expenses when incurred rather than when paid. The college uses the accrual basis for its accounting.

Asset

An asset is anything of use to future operations of business and belonging of an enterprise. An asset is what the college owns. For example- land, property, buildings, equipment, cash in bank accounts, other investments and accounts receivable.

Credit

A credit is an entry on the right side of a double-entry accounting system that represents the reduction of an asset or expense or the addition to a liability or revenue.

Debit

A debit is an entry on the left side of a double-entry accounting system that represents the addition of an asset or expense or the reduction to a liability or revenue.

Double-Entry Accounting

Double-entry accounting is a method of recording financial transactions in which each transaction is entered in two or more accounts and involves two-way, self-balancing posting. Total debits must equal total credits. The college uses this method of accounting.

Expense/Costs

It is the expenditure incurred by enterprise to earn revenue. An expense is funds paid by the college. For example-pay checks to employees, reimbursements to employees, payments to vendors for goods or services. Equity: It refers to total claims against enterprise. It is further dividers into Owner's Claim (Capital) and Outside's Claim (Liability).

GAAP

GAAP stands for Generally Accepted Accounting Principles which are conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. The highest levels of such principles are set by FASB.

FASB

FASB stands for Financial Accounting Standards Board, which is an independent, private, nongovernmental authority for the establishment of accounting principles in the United States.

General Ledger

The general ledger is the collection of all assets, liability, fund balance (net assets), revenue and expense accounts.

Journal Entry

A journal entry is a group of debit and credit transactions that are posted to the general ledger. All journal entries must net to zero so debits must equal credits.

Liability

A liability is what the college owes. For example-loans, taxes, payables, long term debt from a bond issue, funds held by the college for a third party such as a student group.

Subsidiary Ledger

A subsidiary ledger is a group of accounts containing the detail of debit and credit entries. For example, detail information contained in Accounts Payable.

Revenue

Revenue is funds collected by the college; it can also be called income. It is monetary value of products/services sold to customers during the period. For example-tuition, fees, rentals, income from investment.

Cash Book

Cash book was used to record all cash and bank related transactions. Some records only the cash related transactions while other use the cash book for both type of transactions. A cash book which is used to record both cash and bank transactions is referred to as Two-column Cash Book. Some accountants use cash book as Cash Book cum Journal. One column of the cash book on both the pages is used for cash transactions and other column for recording all other entries including bank transactions.

Journal

The journal is used for recording all transactions which cannot be recorded in the Cash Book. Sometimes it is supported by some subsidiary books e.g., Purchase Book, Sales Register, etc.

General Ledger

The General Ledger contains all the accounts of an enterprise. Since the final information pertaining to the financial position of a business emerges only from accounts and, therefore, the Ledger is also called the Principal Book.

Trial Balance

In accounts every amount that is placed on the debit side of an account must have a corresponding entry on the credit side of some other account. This is the technical aspect of the principle of double entry system. This being the case, it is but natural that the total of all debit balances should agree with the total of all credit balances. In fact, all businesses periodically tabulate the debit and credit balances separately in a statement to see whether the total of debit balances agrees with the total of credit balances or not. Such a statement is known as Trial Balance. The accountant heaves a sigh of relief when the Trial Balance drawn by him tallies because it is a good proof that the ledger has been correctly written up. However, it is not a conclusive proof of accuracy.

Profit and Loss Account

This is prepared to see the loss incurred or profit earned by an enterprise within specific period. This is usually made on a yearly basis.

Balance Sheet

The Balance Sheet is a statement summarizing the financial position of a business on a given date. Its summaries on the right-hand side the assets of the business and on the left hand side the liabilities of the business including what the business owes to the proprietor viz., the capital invested by him. The total of all the assets must be equal to the total of all the liabilities. So, an accountant has to write the cash book and journal first, and then post all those entries written

in cash book and journal to general ledger. Then he prepares the Trial Balance – the most difficult job. After this he prepares the Profit & Loss Account and Balance Sheet. He also has to reconcile the banks, prepares other report like sale register, inventory position, list of debtors and creditors, purchase and sales returns etc. Doing all this work manually not only requires lot of patience but it is a time consuming and very much laborious job.

Scope of Accounting

The Scope of accounting is divided into following two parts:

1. Branches of Accounting
2. Accounting as a science or an art

Branches of Accounting

The main objectives of accounting are to record the business transactions and to provide the necessary information to the internal and external users of the financial statements. In order to achieve the above objectives, the accounting is classified into followings branches:

1. *Financial Accounting:* It is the original form of accounting. It refers to the recording of daily business financial transaction. Recording of the transaction is done in such a way that the profit of the business may be ascertained after a definite period and the picture of the financial position of the business may be presented.
2. *Cost Accounting:* As the name indicates, this accounting is related with the ascertainment of cost of the product in a period. Under this system, record of raw materials used in production, wages and labour paid and other expenses incurred on production are kept controlling the costs.
3. *Management Accounting:* The accounting which provides the necessary information to the management is called management accounting. Under this, the analysis and interpretation of the accounts, prepared by financial accounting, are done in a manner so that the managers may forecast, plan for future and frame the policy.
4. *Tax Accounting:* Under tax accounting, the accountants prepare the accounts as per the provisions of taxation. The accounts prepared as per taxation provisions may differ from the accounts prepared as per financial accounting.
5. *Inflation Accounting:* The financial statements are prepared on the basis of historical cost which do not present the true picture of the financial position and correct profit or loss of the business due to inflation. Thus, the fresh financial statements are prepared keeping in mind the price level changes under inflation accounting.
6. *Human Resource Accounting:* Human Resource Accounting means the accounting for human being as now in an organization human being is treated as an asset like other physical assets. It is recorded in the books like other assets. HRA deals with the measurement of costs on recruiting, selecting, hiring, training, placing and development of the employees in one side and on the other side it deals with the present economic value of the employees. For the determination of the value of human being different methods are used under HRA.
7. *Responsibility Accounting:* Responsibility accounting is a special technique of management under which accountability is established according to the responsibility delegated to the various levels of management. Management information and reporting system is instituted to give adequate feedback in terms of the delegated responsibility.

Under this system, units of an organization, under a specified authority in a person, are developed as responsibility centre and evaluated individually for their performance.

Accounting as Science or an Art

Accounting is both the science and art. Study of science is based on some principles and it is systemized. It is a science because the business transactions are recorded on the basis of some principles and journal of transaction, ledger posting, trial balance and preparation of final statements are done in a sequence. Art is the creation of practical applications and rules for the completion of any work. On the basis of it, accounting is an art as we do not only study principles of accounting but also, we learn to apply these principles in practice to record the business transaction. Thus, accounting is both science and art.

Characteristics of Accounting

On the basis of above definitions, the characteristics of accounting may be drawn as follows:

1. *Accounting is the art of recording of financial transactions of the business:* All those transactions of business which are financial in nature are recorded in accounting and those which are not of financial nature are not recorded in accounting. As the honesty of the workers cannot be measured in money, it cannot be recorded into accounting.
2. *Classifying and summarising of recorded data is done in accounting:* In accounting the financial transactions are recorded in the journal. With the help of journal, the recorded data are classified into ledger under appropriate heads. Then with the help of ledger the trial balance and financial statements are prepared.
3. *Data are recorded in terms of money:* In accounting, the financial data are recorded in a definite term i.e., money. No other unit is accepted to record the business transaction. If there is sale of 100 articles at the rate of 50 per article, only the monetary value of these articles i.e., 5,000 (100 x 50) is recorded.
4. *Accounting is a science also:* On account of recording of business transactions in a systematic manner, it is also called a science. First the business transactions are recorded in the primary books i.e., journal, for classification the ledger is prepared. With the help of ledger, the trail balance, profit and loss account and balance sheet are prepared. Profit and loss account is prepared after a period to find the result of the business and balance sheet to know the financial position of the business.
5. *Analysing and interpretation of the results is done in accounting:* It not only record classifies and summaries the business data but also analyse and interprets the results for the future decisions. On the basis of data forecasting regarding profit, sales, etc., may be done.

Objectives of Accounting

1. *To maintain the systematic records of the business:* The primary objective of the accounting is to maintain the records of all transactions of the business. As the memory of human being is very limited and short, it would be very difficult to remember all the transactions especially if there is a huge amount of transaction. So, it is very necessary to record all business transactions properly to determine the amount of profit or loss and the financial position of the business on a particular date.
2. *To ascertain the profit or loss of the business:* The main objective of the business is to earn a profit. Exact profit can be ascertained with the help of financial accounting which

helps to determine the net profit or loss of the business over a period. For the determination of the amount of profit or loss, a trading and profit and loss account is prepared at the end of a period. If there is excess of revenue for a period over the expenses incurred to earn that revenue, it is said to be a profit. And if there is excess of expenses over the revenue, it is said to be a loss. In the case of profit the management can take the decisions relating to selling price and output etc. In the case of loss, the causes of such a loss are investigated and remedial action is taken by the management.

3. *To present the financial position of the business:* The objective of the accounting is not only recording of the financial transactions of the business and determination of profit or loss but also to present the financial position of the business. To present the financial position, financial accounting helps in the preparation of balance sheet. Balance sheet is the statement of assets and liabilities of the business. It also gives the information about the borrowed capital as well as owned capital along with different assets such as fixed assets, current assets and miscellaneous. Balance sheet is the reflector of the financial position of a business (solvency and insolvency).
4. *To provide the financial information to the various users:* One more objective of the accounting is to provide the required financial information to the different users - internal as well as external users. Internal users of the financial statements are owners, shareholders, management and external users of the financial statements are debenture holders, creditors, investors, employees, government, etc.
5. *For Decision Making:* These days accounting has taken upon itself the task of collection, analysis and reporting of information at the required points of time to the required levels of authority in order to facilitate rational decision-making.

<u>Need of Financial Accounting</u>

1. Accounting provides necessary information for decisions to be taken initially and it facilitates the enterprise to pave way for the implementation of actions.
2. It exhibits the financial track path and the position of the organization.
3. Being business in the dynamic environment, it is required to face the ever-changing environment. In order to meet the needs of the ever-changing environment, the policies are to be formulated for the smooth conduct of the business.
4. It equips the management to discharge the obligations at every moment.
5. Obligations to customers, investors, employees, to renovate/restructure and so on.

<u>Users of Accounting Information</u>

1) *Internal Users:* These are: (a) Shareholders, (b) Management, and (c) Trade unions employees, etc.
   a) Shareholders are interested to know the welfare of the business. They can know the operational results through such financial statements and the financial position of the business.
   b) Management is interested to take important decisions relating to fixing up the selling prices and making future policies.
   c) Trade unions and employees are interested to know the operational results because their bonus etc. is dependent on the profit earned by the business. Financial statements also help in their negotiations for wages/salaries.
2) *External Users:* The following are most important external users of financial statements:

a) Investors: They are interested to know the earning capacity of business which can be known through financial statements. They can also know the financial soundness of the business through financial statements.
b) Creditors, Lenders of Money etc.: The creditors and lenders of money etc. can also know the financial soundness through financial statement. They have to see two things (i) Regularity of income and (ii) solvency of the business so that their investment is risk free.
c) Government: Government is interested to formulate laws to regulate business activities and also law relating to taxation etc. Financial statements help while computing National Income statistics etc.
d) Taxation authorities: Financial statements provide information relating to operational results as well as financial position of the business. Tax authorities decide the amount of tax as per financial statement. It is very useful to other taxation authorities such as sales tax etc.
e) Stock Exchanges are meant for dealing in share/securities. Purchase and sale of such shares and securities are possible through stock exchanges which provide financial information about each company which is listed with them.
f) Consumer: Consumer is interested in information on the continued existence of the Notes business and thus probability of the continued supply of the products, parts and after sale services. They ensure continuous existence of a business, especially in case of durable products which require after sales service and spare parts.

Importance and Advantages of Accounting

1) *Replacement of human memory:* As the human's memory is limited and short, it is difficult to remember all the transactions of the business. Therefore, all the financial transactions of the business are recorded in the books. By this way the businessmen cannot only see the records at the required time but can also remember them for a long time. Thus, recording of the transactions is the replacement of human's memory.
2) *Helpful in the determination of financial results and presentation of financial position:* Accounting is very useful in the determination of the profit and loss of a business and showing the financial position of the business.
3) *Helpful in assessing the tax liability:* Generally, a businessman has to pay corporate tax, VAT and excise duty, etc. Therefore, it is necessary that proper accounts should be maintained to compute the tax liability of the business.
4) *Helpful in the case of insolvency:* Sometimes the businessman becomes the insolvent. If he has properly maintained the accounts, he will not face the problems in explaining few things in the court.
5) *Helpful in the valuation of business:* If the business is shut down and sold, accounting helps the businessman to determine the value of business. It would be possible only in that case when the accounts of the business are properly maintained.
6) *Helpful in the valuation of goodwill and shares:* If accounts of the business are properly maintained, it would be quite convenient to determine the value of goodwill. Goodwill is very important for the determination of the value of shares of the company.
7) *Accounting makes comparative statement possible:* Proper and adequate accounting helps in comparing the income, expenditure, purchase, sale of the current year with that of the previous years. And then future plans, policies and forecasting may be possible.

8) *Raising of funds become easy:* It helps in raising funds from investors or financial institutions by promising investors a fixed claim (interest payments) on the cash flows generated by the assets, with a limited or no role in the day-to-day running of the business.

Limitation of Accounting

1) *Recording of monetary items only:* In accounting only those transactions, which have the monetary value, are recorded. And those transactions which do not have the financial value whether those are important in business, are not recorded in the accounting. For example, efficiency of the management, honesty of the workers, etc.
2) *Effect of inflation:* In accounting the transactions are recorded at the historical cost. Accordingly, the assets of the business are shown at cost in the balance sheet. Thus, the balance sheet prepared on the basis of historical cost ignores the price-level changes (inflation). In this way the balance sheet of the business does not present the true and fair picture of the business.
3) *Conflict between accounting principles:* In accounting, one accounting principle conflicts another. For instance, inventory should be valued on the basis of 'least of the cost and market price' as per the principle of the conservatism. If in the first year, inventory is valued on the basis of cost (being lower than market price) and in the second year at the market price (being lower than cost), this principle conflicts the accounting principle of the consistency.
4) *Financial statements are affected by personal judgment of the accountants:* Personal decisions of the accountants regarding the adoption of accounting policies, affects the results of the financial statements. As a result, the financial statements lose their objectivity.
5) *Financial statements do not reflect the right picture of the business:* Sometimes the profit and loss account of the business does not show the accurate profit/loss and the balance sheet does not show the true picture of the business because the assets shown in the balance sheet are shown at the realizable (resalable) value which is wrong. Some worthless figures are also shown in the balance sheet as preliminary expenses, discount on issue of shares/debentures, etc.

Cash System

The revenues are recognized only at the moment of realization, but the expenses are recognized at the moment of payment. For example, sale of goods will be considered under this method that only at the moment of receipt of cash out of sale of goods. The charges which were paid only will be taken into consideration but the outstanding, not yet paid will not be considered.

Accrual System

The revenues are recognized only at the time of occurrence and expenses are recognized only at the moment of incurring. Whether the cash is received or not out of the sales, that will be registered/counted as total value of the sales. The next most important step is to record the transactions. For recording, the value of the transaction is inevitable, to record values; the classification of values must be essentially done.

Values

There are four different values in the business practices that should be followed or recorded in the system of accounting:

1) *Original Value:* It is the value of the asset only at the moment of purchase or acquisition.
2) *Book Value:* It is the value of the asset maintained in the books of the account. The book value of the asset could be computed as follows:

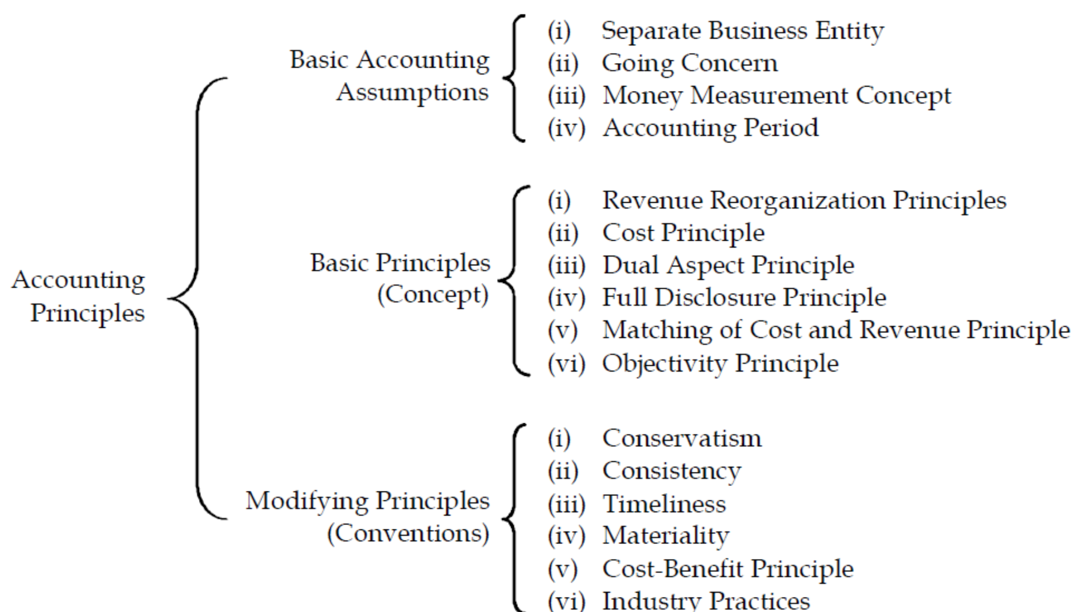
   Book Value = Gross (Original) value of the asset – Accumulated depreciation

3) *Realizable Value:* Value at which the assets are realized.
4) *Present Value:* Market value of the asset.

Accounting Principles

Accounting principles are those rules of actions on the basis of which the transactions of the business are recorded, classified and summarized. If the financial statements are not prepared on the basis of these principles, there will be low acceptability and difficulty to understand them, and the comparison will be impossible and unreliable. These common concepts and conventions of accounting have become the basic accounting concepts and conventions as these are commonly accepted by the body of the professional accountants all over the world to prepare the financial statements, Therefore, they are termed as Generally Accepted Accounting Principles (GAAP). Accounting principles are broadly classified into three categories, these are:

- Basic Assumptions
- Basic Principles (Concepts)
- Modifying Principles (Conventions)



Basic Accounting Assumptions

Separate Business Entity: As per this assumption, business is considered a separate entity from its owner(s). This assumption helps in keeping the business transactions strictly free from the effect of personal affairs of the owner. For instance, when a person starts the business with cash of 2,00,000 then this amount increases the balance of cash from the point of business and on

the other hand the owner is treated as a liability, and this is shown in the liability side of the balance sheet as owner's capital. For this transaction this journal entry is passed:

Cash A/c	Dr.	2,00,000
To Owner's Capital A/c		2,00,000

Going Concern Concept: As per International Accounting Standards, it is a fundamental accounting assumption underlying the preparation of financial statements. Under this assumption, "the enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. Under this all assets are shown at cost price and not at market price and depreciation is provided on cost price in order to calculate true profit. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the sale of its operations." Under this assumption the assets of the business are valued by the accountants on the basis of going concern concept, historical cost and expected life of the assets.

Money Measurement Concept: Money is medium to value quantities. As per this assumption, only those transactions of the business are recorded in the accounting which can be measured in money. Those transactions/activities of the business which cannot be measured in money are not recorded in accounting.

Accounting Period Assumption: As per the going concern concept, the income of the business can be measured at the time of the liquidation of the business or at the time when business is sold. But it is very difficult to wait such a long period that is also not definite. Generally, this segment of time is one year either calendar year or a financial year. Sometimes it may be less than twelve months i.e., quarterly, half yearly, etc. Reports made for less than twelve months are called interim reports and are less reliable than annual reports. At the end of each segment (period) profit and loss account and balance sheet are prepared.

Basic Accounting Principles (Concepts)

Money Measurement Concept

This is the concept tunes the system of accounting as fruitful in recording the transactions and events of the enterprise only in terms of money. The money is used as well as expressed as a denominator of the business events and transactions. The transactions which are not in the expression of monetary terms cannot be registered in the book of accounts as transactions.

Example:

1. 5 machines, 1 ton of raw material, 6 forklift trucks, 10 Lorries and so on. The early mentioned items are not expressed in terms of money instead they are illustrated only in numbers. The worth of the items is getting differed from one to the other. To record the above enlisted items in the book of accounts, all the assets should be converted into money.

- The transactions which are not in financial in character cannot be entered in the book of accounts.

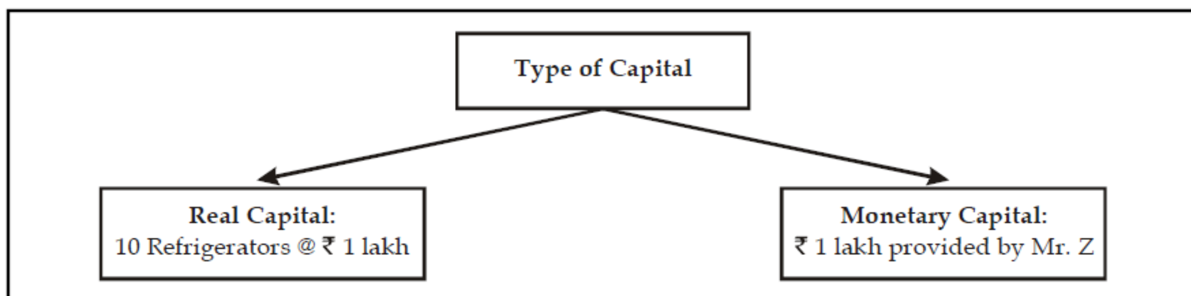
2. 5 machines worth 1,00,000; 1 ton of raw materials worth amounted 15,00,000 and so on.

- Recording of transactions are only in terms of money in the process of accounting.

Business Entity Concept

This concept treats the owner as totally a different entity from the business. To put into nutshell "Owner is different, and Business is different". The capital, which is brought inside the firm by the owner, at the commencement of the firm is known as capital. The amount of the capital, which was initially invested, should be returned to the owner considered as due to the owner, who was nothing but the contributory of the capital.

Example: Mr. Z has brought a capital of 1 lakh for the commencement of retailing business of refrigerators. The brought capital of 1 lakh is utilized for the purchase of refrigerators from the Godrej Ltd. He finally bought 10 different sized refrigerators. Out of 10 refrigerators, one was taken away by himself as the owner.



In the Angle of the Firm

The amount of the capital 1 lakh has to be returned to the owner Mr. Z, which considered being as due. Among the 10 newly bought refrigerators for trading, one was taken away by the owner for his personal usage. The one refrigerator drawn by the owner for his personal usage led the firm to sell only 9 refrigerators. It means that 90,000 out of 1 Lakh is the volume of real capital and the 10,000 worth of the refrigerator considered to be as drawings, which illustrates the capital owed by the firm is only 90,000 not 1 lakh.

In the Angle of the Owner

The refrigerator drawn worth of 10,000 nothing but 10,000 worth of real capital of the firm was taken for personal use as drawings reduced the total volume of the capital of the firm from 1 lakh to 90,000, which expected the firm to return the capital due amounted 90,000.

Notes: Owner and business organizations are two separate entities.

Going Concern Concept

The concept deals with the quality of long-lasting status of the business enterprise irrespective of the owners' status, whether he is alive or not. This concept is known as concept of long-term assets. The fixed assets are bought in the intention to earn profits during the season of the business. The assets which are idle during the slack season of the business retained for future usage, in spite of that those assets are frequently sold out by the firm immediately after the utility leads to mean that those assets are not fixed assets but tradable assets. The fixed assets are retained by the firm even after the usage is only due to the principle of long lastingness of the business enterprise. If the business disposes the assets immediately after the current usage by not considering the future utility of the assets in the firm which will not distinguish in between the long-term assets and short-term assets known as tradable in categories.

Revenue Recognition Principle

It is also called revenue realization principle which means profit should be considered only when realised. As per this principle the revenue is recorded in accounting when the sales have taken place. If there is expectation that will be a particular transaction there in future, that is not recorded in accounting. Revenue/sales is considered to be made when title of ownership of Notes goods passes from the seller to buyer and the buyer become legally liable to pay. However, this principle has some exemptions which are as follows:

1. In the case of sales made on the basis of hire purchase system where ownership is not transferred at the time of sales while it is transferred at time of final payment. Herewith, sales are presumed to the extent of instalment received.

2. In the case of contract accounts, if the contract is for long period revenue cannot be realized until the contract is not completed. Here, only a part of total revenue is treated as realized.

Cost Principle

This principle is closely related to the going concern concept. As per this principle every transaction of the business should be recorded at its historical cost and not at its market price. At the time of recording of the transactions, their market price is not considered. Sometimes its market price may be less than or more than its actual cost, but its actual cost is recorded in accounts because of cost principle. Under this principle the historical cost of a transaction becomes the base cost for the subsequent years. On the basis of this cost, the depreciation is charged on the assets and the balance is shown in the balance sheet. All the fixed assets and current assets are recorded at historical cost. Thus, we observe that the balance sheet prepared on the basis of historical cost does not give us actual results for those applicable of fixed assets and current assets. Due to the changing in the price level changes, the financial statements become irrelevant for the users. This led to the inflation accounting to came into existence.

Dual Aspect Principle

This is the basic principle of accounting. As per this principle every financial transaction of the business has dual effect and recorded at two places. Therefore, it is called double entry system. On the basis of this principle, it is said that every debit must have an equivalent credit and every credit must have an equivalent debit because every transaction of the business has two aspects. For instance, if Mr. Aditya Raj started a business for cash 2,00,000 there will be two aspects of this transaction. In one aspect cash is coming into business while in the other aspect the business has to pay this amount to Mr. Aditya Raj. Because Mr. Aditya Raj has given the amount to the business. For this transaction the following journal entry will be passed:

Cash A/c *Dr.*

To Mr. Aditya Raj

Or

To Capital A/c

This transaction can be expressed in the following equation:

Capital = Assets (Cash)

2,00,000 = 2,00,000

Here cash (assets) is the resource of the business and capital is the claim of the proprietor as business has to return this amount to the proprietor.

If the business purchases furniture of 20,000 on credit, the above equation will change as follows:

Capital + Creditors = Cash + Furniture

2,00,000 + 20,000 = 2,00,000 + 20,000

Capital + Liabilities = Assets

Full Disclosure Principle

As per this principal, the financial statements should disclose true and fair view so that these may provide accurate and sufficient information to the users of financial statements. Disclosure principle means to give all the information relating to the economic activities of the business to the owner, creditors and investors.

Matching of Cost and Revenue Principle

As per the going concern concept, the accurate profit/loss of the business can be determined at the time of liquidation of the business or sale of the business. But it will generate a lot of problems. Therefore, the economic life of the business is divided into different segments in order to determine the profit/loss of the business. Generally, a segment of the economic life of the business becomes of a year. To compute the operational profits/loss of the business in a year, it is necessary to find the expenses and revenues relating to the period. Then all the revenues of that period are matched with all the expenses/costs incurred to earn that revenue. This matching is called the principle of matching of cost and revenue. The result of this match becomes as follows:

Profit = Revenue – Expenses

Herewith the matching means an appropriate association between the revenues of a period and expenses/costs of that period. In other words, the incomes/loss of the business can be determined if the revenues (incomes) of a period are compared (matched) with the expenditure of that period. For the recognition of the revenues/expenses the accurate system of accounting is adopted. Therefore, a proper adjustment is also made in the accounts for the outstanding expenses, prepaid expenses, accrued incomes and unaccrued incomes. At the time of reorganization of the revenue/ expenses, the following points are kept in mind:

1. The expenses which are being spent to earn revenue must be of the same period for which profit is being computed.
2. Revenues/expenses of a period must be computed on the basis of accrual accounting system.
3. If some revenues are received in advance, they must be treated as the income of that period in which goods are supplied/services are rendered.

Objectivity Principle

It is also known as objective evidence concept. As per this principle the transactions which are recorded in accounting must be on the objective and factual basis. There should be a voucher or documentary evidence behind each entry in the accounting. The entry must be free from personal bias and based on the rational approach. If the entries are made without evidence, it will lose the confidence of the several users of the financial statements about their reliability. For the auditing of the financial statements, there is also a need of objective evidence.

The Modifying Accounting Principles (Conventions)

Basic accounting assumptions and principles provide us the various rules to prepare the financial statements. If these financial statements are relevant and reliable, they will give much useful information to the various users of the financial statements. In order to prepare the true and fair financial statements, there is a need to modify the accounting assumptions and principles. These modified accounting principles are as follows:

Conservation (Prudence)

As per the law of conservatism, at the time of preparing the financial statements, all the possible losses must be kept in mind and all anticipated profits/gains should be left out. In other words, the accounts must follow the policy of playing safe. Likewise, stock-in-trade is valued at 'market price or cost whichever is least', provision for bad and doubtful debt, provision for depreciation on fixed assets, etc., are maintained. This principle is being criticized nowadays on the ground that it goes against the principle of disclosure.

Consistency: In order to enable the management to do the comparison of the results of the several years of the business, whatever accounting policy is adopted in a year, must be adopted in the coming years. There should be uniformity in accounting process, rules & methods. As a result, biasness of accountant is removed. According to Kohlar there are three forms of consistency:

a) Vertical Consistency is used in the different financial statements of the business on the same date. For instance, depreciation on fixed assets is used in the income statement and the balance sheet on the same date.
b) Horizontal Consistency enables the comparison of the profit or performance of a business in a year with the performance of another year for example the depreciation methods.
c) Third Dimensional Consistency refers to the same principles or practices of accounting adopted by the different firms in an industry.

Timeliness

Accounting information given in the financial statements must be reliable and relevant. In order to be relevant, this information must be supplied in time. If late and obsolete information is provided, it will hamper the management and the users of the financial statements to take appropriate, timely and rational decision.

Materiality

Herewith, the materiality means that only that information should be disclosed and attached with financial statements which influence the decisions of shareholders, investors, and creditors, etc. and the other insignificant details must be ignored. Moreover, an item of

information may be material for one purpose while that may be immaterial for other. This is a subjective matter. For example, the cost of the component may be very much significant for small businessman while it may be insignificant for a large businessman. In one more example, the Companies Act permits to ignore the paise at the time of preparation of financial statements while for the income tax purpose the income is rounded off to the nearest ten.

Cost-Benefit Principle

As per this principle the cost of using an accounting principle should not exceed its benefits. It does not mean that to curtail the costs, no information or a little information should be given to the users of the financial statements.

Industry Practice

Different accounting principle/practice is adopted in the different industries. At the time of preparing the financial reports and presenting the accounting information the prevailing accounting practices in a particular industry should be kept in mind. For example, disclosing of investments and stock at the cost or market price whichever is lower. Thus, we see that the prevailing accounting practices in an industry play an important role in adopting the accounting practices.

Accounting Equation

The basic accounting equation is the foundation for the double-entry bookkeeping system. It shows how assets were financed: either by borrowing money from someone (liability) or by paying your own money (shareholders' equity).

Assets = Liabilities + Capital (Shareholders or Owners equity)

The accounting equation is also the basis for the most basic of accounting reports, the aptly named Balance Sheet. A balance sheet reports what a business owns (assets), what it owes (liabilities) and what remains for the owners (equity) as of a certain date. This equation should remain in balance at all times because of double-entry accounting or bookkeeping.

An owner's investment into the company will increase the company's assets and will also increase owner's equity. When the company borrows money from its bank, the company's assets increase, and the company's liabilities increase. When the company repays the loan, the company's assets decrease, and the company's liabilities decrease. If the company pays cash for a new delivery van, one asset (cash) will decrease and another asset (vehicles) will increase. If a company provides a service to a client and immediately receives cash, the company's assets increase, and the company's owner's equity will increase because it has earned revenue. If the company provides a service and allows the client to pay in 30 days, the company has increased its assets (Accounts Receivable) and has also increased its owner's equity because it has earned service revenue. If the company runs a radio advertisement and agrees to pay later, the company will incur an expense that will reduce owner's equity and has increased its liabilities.

Example:

1) Mr. Kamlesh started business with cash of 2,00,000. In this transaction, one side cash is coming into business and in the other side capital is being brought by Mr. Kamlesh. Thus:

Capital = Assets (Cash)

₹2,00,000 = ₹2,00,000

2) In the next transaction, if a plant of 50,000 is purchased in cash, this transaction will also leave two sides. In one side cash is going and in other side plant is coming. In this situation, the accounting equation will be as follows:

Capital = Plant + Cash (Assets)

₹2,00,000 = ₹50,000 + (₹2,00,000 – ₹50,000)

3) If a loan of 1,50,000 is taken from the SBI, it will also affect the accounting equation by two sides. On one side, cash will increase and on the other side, liabilities of the business will increase. This may be depicted as follows:

Capital + Liability (Loan) = Plant + Cash

₹2,00,000 + ₹1,50,000 = ₹50,000 + (₹1,50,000 + ₹1,50,000)

₹3,50,000 = ₹3,50,000

4) If some goods of 20,000 are purchased on credit, it will also affect the accounting equation in two ways. On one side it increases the goods and on the other side it increases the liability (creditors). Now the changed form of the above accounting equation will be as follows:

Capital + Liabilities = Assets Capital + Loan + Creditors = Plant + Cash + Goods

₹2,00,000 + ₹1,50,000 + ₹20,000 = ₹50,000 + ₹3,00,000 + ₹20,000

₹3,70,000 = ₹3,70,000

Depreciation

Depreciation means the fall or decrease in the value of assets. Depreciation is a permanent fall in the value of depreciable assets on using in the operation of business. In the depreciable assets land, forest, goodwill, livestock, R&D are not included. Depreciation is not visible like other expenses of the business which are clear and considered at the time of calculation of profit/loss of the business. But it is not so in the case of depreciation on assets. Its amount is also not fixed. It is based on past experience. Some businessmen do not provide depreciation on assets and do not deduct from the gross profit to calculate the net profit.

Generally, there is depreciation in all fixed assets due to some reasons. There are a few cases in which the values of the assets appreciate as land, antiques and old paintings, etc. As per Accounting Standard-6 the depreciable assets are those which:

1) Are expected to be used during more than one accounting period, and
2) Have a limited useful life, and

3) Are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.

In the AS-6 the depreciation is defined as, "Depreciation is a measure of wearing out, consumption or other loss of value of a depreciable asset, arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to change a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined."