<u>Financial Accounting and Management</u>

<u>UNIT 1</u>

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.

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.

Need of Financial Accounting

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.

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 to control 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.

Users of Accounting Information

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

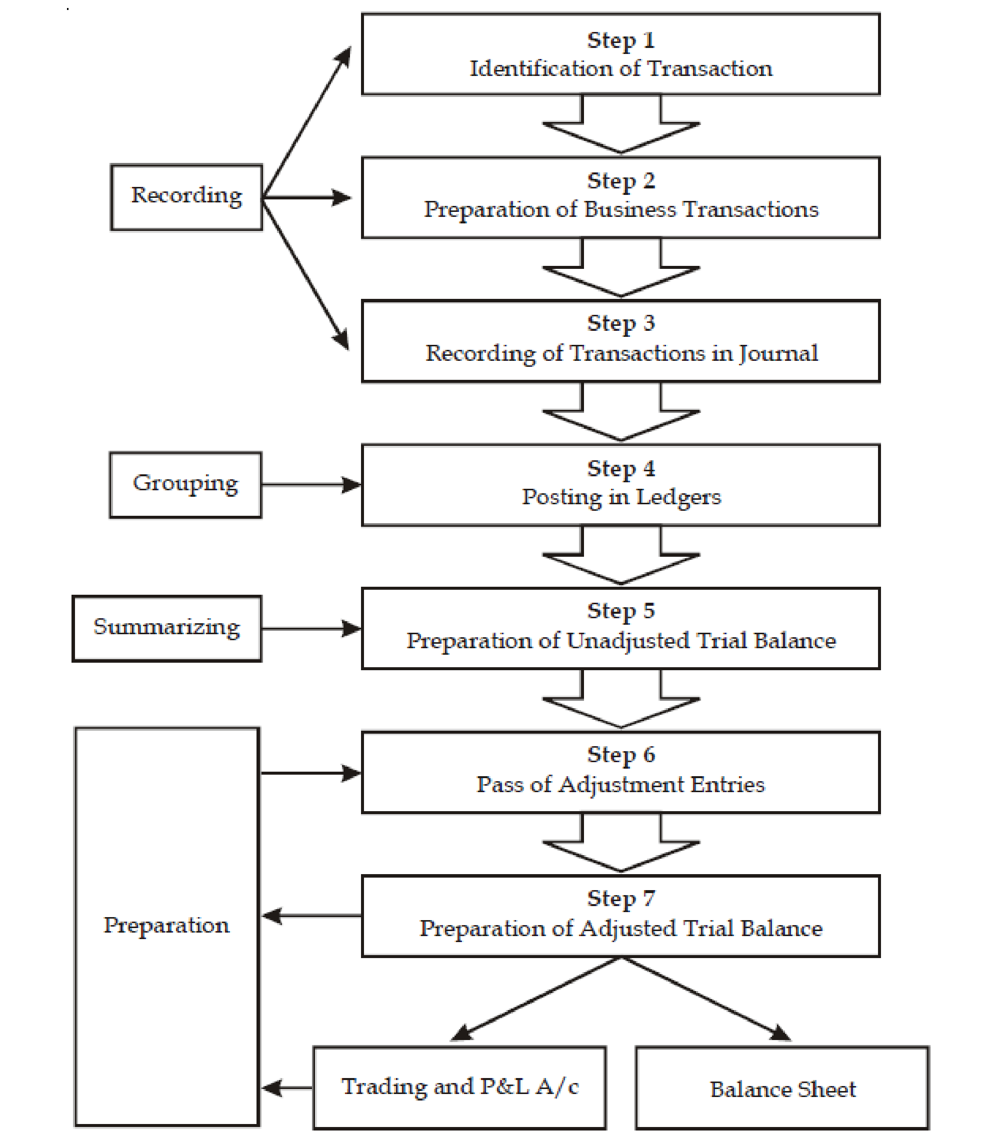
1) Recording of monetary items only: In accounting only those transactions, which have the monetary value, are recorded. And those transactions which do not have the financial value whether those are important in business, are not recorded in the accounting. For example, efficiency of the management, 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.

Process of Accounting

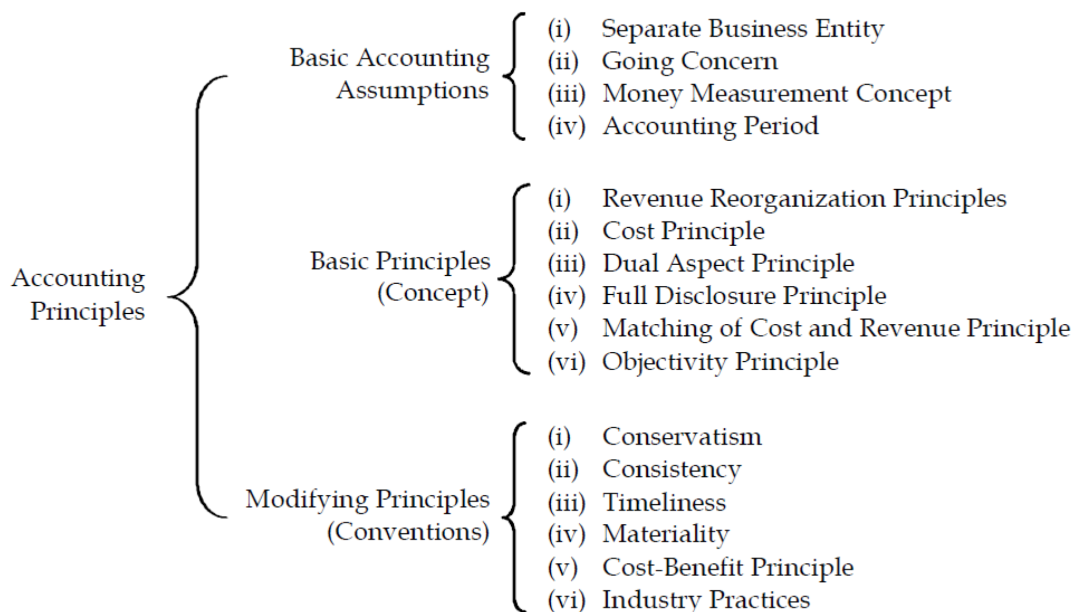
Accounting is described as origin for the creation of information and the continuous utility of information. There is a step-by-step process, as shown in figure below:



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 start 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.

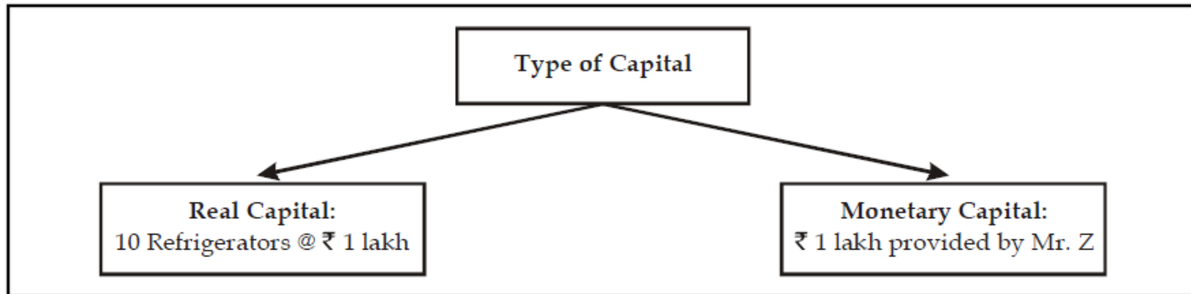
2. 5 machines worth 1,00,000; 1 ton of raw materials worth amounted 15,00,000 and so on.

- 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

Accounting Standards in India

In India, accounting standards are formulated and issued by the Accounting Standards Board (ASB) under the authority of the Institute of Chartered Accountants of India (ICAI). These standards are aligned with the International Financial Reporting Standards (IFRS) to ensure consistency, transparency, and comparability in financial reporting.

Indian Accounting Standards (Ind AS):

- The Ministry of Corporate Affairs (MCA) mandates the adoption of Indian Accounting Standards (Ind AS) for certain classes of companies, including listed companies, certain unlisted companies, and specified categories of private companies.
- Ind AS is largely converged with IFRS and aims to improve the quality and reliability of financial reporting in India.
- The adoption of Ind AS enhances transparency, comparability, and consistency in financial statements, aligning Indian accounting practices with global standards.

Convergence with IFRS:

- The ICAI has been actively working towards convergence of Indian accounting standards with IFRS to facilitate international comparability and enhance the quality of financial reporting.
- Several Ind AS are converged with corresponding IFRS to ensure consistency and harmonization with global accounting practices.

Disclosure Requirements:

- Accounting standards in India prescribe extensive disclosure requirements to ensure transparency and full disclosure of relevant information in financial statements.
- Disclosures are aimed at providing users with a comprehensive understanding of the organization's financial position, performance, risks, and uncertainties.

Regulatory Oversight:

- The Ministry of Corporate Affairs (MCA) and the Securities and Exchange Board of India (SEBI) regulate financial reporting practices in India.
- These regulatory bodies oversee compliance with accounting standards, ensure adherence to disclosure requirements, and enforce corporate governance principles to safeguard the interests of investors and stakeholders.

Continuous Evolution:

- Accounting standards in India undergo continuous review and evolution to keep pace with changing business dynamics, emerging trends, and international developments.
- The ASB regularly updates accounting standards to address new accounting issues, improve clarity, and enhance the relevance of financial reporting practices.

Aspect	**Financial Accounting**	**Management Accounting**
Purpose	Provides financial information to external stakeholders for decision-making, investment, and regulatory compliance.	Provides financial and non-financial information to internal stakeholders (management) for planning, control, decision-making, and performance evaluation.
Reporting Period	Periodic (quarterly, annually)	As needed, often more frequent (monthly, weekly)
Users	External stakeholders (investors, creditors, regulators, etc.)	Internal stakeholders (management, department heads, budget holders, etc.)
Scope	Focuses on recording, summarizing, and reporting historical financial transactions and events.	Encompasses a broader range of activities including budgeting, cost accounting, performance measurement, variance analysis, forecasting, and decision analysis.
Compliance	Follows regulatory standards such as GAAP or IFRS.	Flexible and adaptable, tailored to meet internal management needs and objectives.
Information	Provides standardized financial statements (income statement, balance sheet, cash flow statement) based on historical data.	Generates various reports, analyses, and forecasts to support internal decision-making processes and strategic planning.
Decision-making	Supports external stakeholders' decisions regarding investment, lending, and regulatory compliance.	Aids management in making strategic, tactical, and operational decisions to optimize resources, improve performance, and achieve organizational goals.
Focus	Historical perspective, external orientation.	Forward-looking perspective, internal orientation.