Central University of Kashmir

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MBA-C 105

Accounting for Managers

Unit I

Objectives: To enable the students to study the principles and procedures used in collection, analysis and utilization of accounting information to assist the management in the performance and evaluation of their functions

Unit-I

Financial Accounting–Need, development and functions; Generally Accepted Accounting Principle (GAAP); Accounting Concepts & Conventions; Journalizing Transactions-Rules of Debit and Credit; Ledger. Accounting as an information system

Course Title: Accounting for Managers

Course Code: MBA- C105

Department: Management Studies

Year: 2016

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Central University of Kashmir

Unit I

Introduction

Accounting, in its crude form, has been in existence since the barter era when goods were not bought and sold for money but exchanged for goods. In fact a number of ancient civilizations of the world stressed the need for instituting a proper system of accounting and auditing. In ancient India, Chanakya, the prime minister of the Maurya Empire, realized the importance of keeping the proper record of accounts as early as 300 BC. In the chapter, 'The Conduct of Corporations' of his book 'Arthashastra', Chanakya described the methods of maintaining and checking accounts. However, accounting as a distinct activity received impetus with the introduction of money as the medium of exchange.

Earlier, the science and art of accounting was not as developed as it is today. Over the period of time a great deal of development took place in the field. In olden days, the number and volume of business transactions was so small that the trader was able to memorize the transactions and there was hardly any need to put them in black and white. And where the number of such transactions was relatively large and the trader was not in a position to memorize them all, he would himself record and check these transactions.

Till 15th century AD, accounting was practised by businessmen in the ways and forms that suited them and there were absolutely no theories and principles of accounting practice. It was actually Luca Fra Pacioli, an Italian,who first came out with a standard set of accounting principles. As a matter of fact, Pacioli propounded the principles of Double Entry System in 1490s, the principles that form the base of the modern system of accounting. Hence, Luca Pacioli is rightly considered as the father of modern accounting system. Despite the fact that accounting has been in practice for centuries now, it is only since 1930s that the subject has been studied and applied systematically and professionally.

Meaning and Definition of Accounting

Every prudent businessman is interested to know whether his business has made profit or suffered loss during a particular period of time. The businessman is also desirous to know the financial position of his business on a particular date. Besides, in case of large businesses, information is also required for planning of activities, evaluation and control of performance and for making numerous other economic decisions. The results of a business during a specific period, its financial position on a particular date and various other facts can be made known only when business transactions are recorded, classified and summarized properly. These functions are ensured only through a well devised system of accounting. In other words, business transactions are properly recorded, classified, and summarized through the systematic process of accounting. In addition to the recording, classifying and summarizing of business transactions, accounting is also the analysis and interpretation of such recorded transactions. Strictly speaking, the former three functions (recording, classifying and summarizing of business transactions) are a function of 'book keeping' and the later two (analysis and interpretation of the recorded transactions) are termed as 'accounting'. However, for the sake of generality, accounting comprises of all these functions.

Accounting is rightly called as the language of business. This is so because accounting not only arrives at the results of business operations but through accounting reports also communicates the effectiveness of business to various stakeholders including creditors, suppliers, financial institutions, investors and government. On the basis of various business related facts made available through accounting, these stakeholders take numerous economic decisions vis-à-vis the business concern.

Before reproducing a few popular definitions of accounting, it may be noted that there is no agreement among experts about its one and universally accepted definition. Of the numerous definitions, the widely accepted one is that given by the American Institute of Certified Public Accountants (AICPA). According to AICPA, "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."

American Accounting Association (AAA) has defined accounting as "the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of the information."

In the words of Smith and Ashburne, " Accounting is the science of recoding and classifying business transactions and events primarily of financial character and the art of making significant summaries, analysis and interpretation of those transactions and events and communicating the results to persons who must make decisions or form judgment."

Anthony R.N. defines accounting as "a means of collecting, summarizing, analyzing and reporting in monetary terms the information about the business."

Gordon and Gordon have given a detailed definition of accounting. According to them, "Accounting has come to be recognized as a tool for mastering the various economic problems which a business organization may have to face. It systematically writes the economic history of the organization. It provides information that can be drawn upon by those responsible for decisions affecting the organization's future. This history is written mostly in quantitative terms. In consists partly of files of data, partly of reports summarizing various portions of these data, and partly of the plan established by management to guide its operations."

Upon analysis of the above definitions, the following characteristics, attributes, elements or features of accounting emerge:

(i) Accounting is the art of identifying, recoding and classifying business transactions.

(ii) Accounting recognizes only those business transactions which have, completely or partially, a financial nature.

(iii) Business transactions or events are described in monetary terms and non-monetary transactions or events are outside the purview of accounting.

(iv) Accounting summarizes and analyses business transactions so as to ensure a meaningful interpretation.

(v) Accounting also communicates the results obtained after analysis and interpretation of transactions to people who are to make various economic decisions.

Distinction between Book Keeping and Accounting

As stated earlier, accounting is a comprehensive process comprising of a number of steps. These include recording, classifying and summarizing of business transactions in terms of money or money's worth. These activities are undertaken to obtain the results of the operations of business. The results so obtained are subsequently analyzed and interpreted to facilitate various economic decisions related to business. These decisions are to be made not only by the insiders like owners and managers but also by the outside stakeholders like creditors, supplies, financers etc.

For the sake of classification, book keeping is confined to the recording, classifying and summarizing of business transactions in a systematic and methodic manner. As compared to it, accounting is concerned with the analysis and interpretation of the recorded transactions so as to arrive at meaningful economic facts. On the basis of this broad difference, a number of points of distinction emerge between book keeping and accounting. These distinction points are summarized here under:

Book Keeping	**Accounting**
1. Book Keeping is the starting point in the comprehensive accounting process.	1. Accounting is the secondary process and starts from the point where book keeping ends.
2. Book keeping is confined to the recording, classifying and summarizing of business transactions.	2. Accounting is the analysis and interpretation of financial transactions and operational results.
3. The object of book keeping is to maintain analyze proper record of business transactions.	3. The object of accounting is to and interpret the result of business transactions
4. Book keeping entries are made from the original documents like bills, vouchers etc.	4. Accounting is done from the records maintained by book keeping.
5. Book keeping is generally done by lower	5. Accounting statements are usually made

rank employees like clerks etc.

6. Book keeping shows the net results and financial position of the business as it Confines to the preparation of final accounts.

7. Book keeping is mainly concerned with properly maintaining the record of business transactions.

8. Book keeping is completely an internal affair and outsiders are no way interested in it.

by middle and top level management.

6. Accounting analyses the operating results of the business and interprets the financial statements.

7. Accounting after analysis and inter--pretation of operating results of business provides important information for decision making.

8. Accounting concerns insiders as well as outsiders.Outsiders like creditors, Investors, supplies bankers etc. are interested in the data made available through the process of accounting.

Functions of Accounting

Accounting performs a number of functions as given below:

1. **Recording:** One of the basic functions of accounting is recording the money aspect of all the transactions of business in an orderly and systematic manner. This is done for future reference and further processing and analysis. Such recording is done in a book called ‘journal’ which is further subdivided into a number of other subsidiary books for the sake of convenience and order.

2. **Classifying:** The transactions recorded in the journal or other subsidiary books are classified and posted to the main book called ‘ledger’. This book (ledger) contains individual account heads to which all transactions of a similar nature are posted.

3. **Summarizing:** The transactions recorded in the ledger are summarized and the balance in each account ascertained. Subsequently, a list of such balances called ‘trial balance’

is prepared at the end of accounting period. The trial balance serves as the basis for the preparation of final accounts.

4. **Analyzing and Interpreting:** One of the crucial steps in the accounting process is the analysis and interpretation of data contained in the final accounts. It involves arriving at meaningful interpretations of the results of business operations. Such interpretations are useful for making numerous economic decisions both by insiders as well as outsiders.

5. **Communicating results:** An important function of accounting is to communicate the operational results of business to various stakeholders who are interested in knowing such results. These stakeholders, comprising of owners, managers, creditors, suppliers, government and even customers, make their decisions vis-à-vis the business concern on the basis of the data made available to them through financial statements, prospectus, reports etc.

In addition to the above primary functions, accounting also performs certain subsidiary functions. Some important subsidiary functions of accounting are:

I. **Protecting properties of business:** Accounting helps in protecting the assets and properties of business. However, this is possible only when a proper system of accounting is in place. By virtue of a scientific accounting system, an accountant is able safeguard the assets of the business and protect its properties from being put to unjustified and unwarranted use.

II. **Controlling performance:** Accounting provides useful interpretations of the operations of business. These interpretations are used to evaluate the performance procedures and systems, identify the limitations therein and offer suggestions for improvement.

III. **Meeting legal requirements:** Accounting enables a business enterprise to comply with a number of legal requirements. Joint stock companies are, for instance, required to prepare their financial statements in accordance with the provisions of the Companies Act. Similarly, business houses are required to file various returns and statements e.g., income tax return, sales tax return etc. These legal requirements can be met only when a proper accounting system is in place.

Objectives of Accounting

Keeping in view the functions of accounting as outlined above, the following are the main objectives of accounting:

- To keep a proper record of the transactions of business for future reference.
- To ascertain the operational profit or loss for a particular period on account of carrying on the business during that period.
- To ascertain the financial position of the business on a particular date i.e., the assets owned and the liabilities owed by the business. This is done by preparing the balance sheet on that date.
- To arrive at information that is useful to management in planning, evaluating and controlling the activities of business.
- To provide required information to various external parties including creditors, investors, suppliers, bankers etc. These parties use such information for rational decision making.
- To protect the business properties from unjustified and unwarranted use.

Use and advantages of Accounting

1. Accounting makes a complete, systematic and scientific record of financial transactions of a business during the accounting period.
2. Accounting provides the results of business operations during the accounting period. It also shows the financial position of the business on a specific date.
3. Accounting facilitates the comparison of the current year's costs, expenses, sales, profits etc. of the business with those of the previous years; with other units/branches of the same enterprise; and with other firms in the industry.
4. Accounting helps in complying with legal formalities such as filling of periodic returns of income tax, sales tax etc.
5. Properly maintained accounts supported by authentic documents can be produced as an evidence in the court of law in case of any dispute.
6. Accounting helps in ascertaining the true value of business at the time of its sale.

7. Accounting facilitates raising of loans from banks and financial institutions as these institutions approve loans after analyzing the financial statements of the business.

8. Accounting guides the owners and management in planning, evaluating and controlling the operations of business and taking various other management decisions.

9. Accounting facilitates the rational decision making of various outside parties.

10. Last but not the least, accounting protects the properties of the business from being misused.

Limitations of Accounting

Despite its tremendous utility, accounting suffers from a number of limitations. It may be noted that the accounting concepts and conventions that form the basis of accounting principles and practice are to a large extent responsible for the limitations of accounting. Following are some main limitations and drawbacks of accounting:

1. Accounting records only monetary transactions: One of the greatest limitations of accounting is that it records only those transactions which can be measured in terms of money. Those events and transactions which do have positive or negative impact on business but are not measurable in monetary terms are not recorded anywhere in the accounts. For instance, the death of a proficient salesman or the quit of an efficient manager has a direct bearing on the profitability of a business concern. However, these events do not find any place in the accounts of the business simply because their impact cannot be measured in terms of money.

2. Accounting ignores price level changes: In accounting, the effect of price level changes (increase or decrease in prices) is not considered. For example, a 10 percent increase in sales over the previous year is in essence a decrease in effective sales if the selling price has increased by more than 10 percent in the current year. Thus, comparison of results is at times meaningless because accounting does not take into account the change in the price level.

3. Accounting is historical in nature: Accounting is essentially historical in nature. The financial statements which are prepared at the end of the accounting period are in fact a summary of what has already happened. Hence, the information available through accounting has hardly any use for future.

4. **Accounting principles permit contradiction:** Some of the accounting principles are conflicting in nature and conforming to one principle at times leads to contravening the other. For examples, according to the principle of conservatism, current assets are valued on the basis of cost price or market price whichever is lower. Therefore, in valuing current assets (closing stock, for example) cost basis may be taken in one year, while as in another year, these assets may be valued at market price. This principle of conservatism contravenes the accounting principle of consistency.

5. **Accounting policies allow personal bias:** Some of the accounting policies are left to the discretion of accountants. These policies include the adoption of methods of depreciation (straight line method or written down value method); valuation of closing stocks (LIFO or FIFO); amortization of fixed assets etc. Such personal discretion of accountants in choosing the significant accounting policies leaves a great scope for subjectivity at the cost of objectivity.

6. **Accounting does not always provide realistic information:** Accounting information is not always realistic and reliable as the accounting and financial statements are prepared by adopting accounting concepts and conventions which are not absolutely foolproof. Moreover, accountants sometimes resort to what is known as 'window dressing'. Such accounting practices render the significant accounting interpretations unrealistic and meaningless.

7. **Profits as revealed by accounting are not the real test of efficiency:** As revealed by accounting, the profits earned by a business during an accounting period cannot be the real test of managerial efficiency because accounting is prone to manipulation at the hands of accountants.

8. **Accounting permits alternative treatments:** Since accounting allows alternative treatment of certain items like depreciation, stock valuation, deferred revenue expenditure etc., the comparison of accounting results may be misleading. It may, however, be noted that these alternative treatments are allowable within the 'Generally Accepted Accounting Principle' (GAAP).

Users of Accounting Information

Accounting is a comprehensive process of recoding, classifying and summarizing the transactions and events of financial nature and analyzing and interpreting the results thereof. The information obtained as a result of accounting process is useful to both the insiders as well as outsiders for making numerous economic decisions. Various stakeholders, parties and groups who are interested in the information that is made available through accounting include owners and management, employees, creditors, investors, suppliers, customers, government and researchers.

1. Owners: Owners are the people who have invested their money in the business. Since their capital is at stake, they are interested to know whether the business has earned profit or suffered loss during a particular period and also its financial position on a particular date. In addition to past performance, owners are also interested in knowing the future prospects of business.

2. Management: Accounting information is more useful to management than any other party. Management of a business needs this information to plan business activities, and evaluate and control performance. Managers also need accounting information for making various routine and strategic business decisions. Moreover, managers use accounting information widely because they are directly responsible for the operational efficiency of business and are answerable to the owners for their performance and effectiveness.

3. Investors: People who have invested their funds in the business are interested not only knowing the profitability of the business but also its financial strength and solvency. Moreover, prospective investors would like to know about the past performance of the business before making investment decision. By accounting information, these investors can have an about the expected return and the risk involved in making the investment in a particular business enterprise.

4. Creditors: Creditors are the people who have advanced their money or money's worth to the business. The welfare of creditors is directly dependent upon the prosperity of the business. Before extending credit to the business, creditors are interested in knowing its profitability, repaying capacity, solvency and creditworthiness. Creditors can come to know

about all these facts by studying and analyzing accounting information and financial statements.

5. **Employees:** The bread and butter of employees ultimately depends upon the earnings of the business enterprise. Employees' salaries, bonus, pension schemes etc. are all dependent upon the firm's earning capacity. Employees are also interested in their job security and career prospects. By analyzing financial statements, employees can draw conclusions about all these issues.

6. **Government:** Government is interested in the accounting information because its policies relating to taxation, providing of subsidies, framing of pricing policies etc. all depend upon the performance of an enterprise. Moreover, tax collection is also based on accounting records.

7. **Customers and Public:** Customers who have developed loyalties to a business by using their products are certainly interested in the continuation of the business. Likewise an enterprise affects the public at large in many ways. The business enterprise is the provider of employment to the public, the provider of amenities to the locality, a cause of concern for polluting the environment etc. Hence, customers and general public are interested in knowing the socio-cultural commitment of the enterprise and its future direction. An important way to know these facts is to peep through the financial statements of the enterprise.

8. **Researchers:** Researchers need accounting and financial information for testing hypothesis and development of new theories and models. The financial statements provide them the required information.

Branches of Accounting

Broadly speaking, there are three main branches of accounting. These are:

1. **Financial Accounting:** Financial accounting is concerned with the recording, classifying and summarizing financial transactions of a business. It is also concerned with the analysis and interpretation of the results thereof. This exercise is done to ascertain the profit or loss made by the business during the accounting period and know the financial position of the business on

a particular date. This process ends with the preparation of financial statements in accordance with the generally accepted accounting principles.

2. **Cost Accounting:** Cost accounting is concerned with determining the cost of goods produced or services rendered by the business enterprise. Besides, cost accounting helps in making the best possible use of material and manpower resources by exercising cost control.

3. **Management Accounting:** Management accounting makes use of financial and cost data for the purpose of planning the activities of business, and evaluating and controlling its performance. It also enables management in making numerous other economic decisions.

Accounting—Science or Art

There is often a debate as to whether accounting is a science or an art. In fact, there are arguments in favour of both the prepositions, i.e., accounting embraces features of both the science as well as the art. Before we proceed to discuss how accounting is a science and also an art, it is essential that we understand the meaning and essence of the two terms—science and art.

Science may be defined as a systematic body of knowledge based on a well-knit theory comprising of certain rules and principles that have universal applicability. The scientific knowledge proves its certainty and essence without failure or deviation through repeated testing and verification. Art, on the other hand is the skilful application of accumulated body of knowledge comprising of accepted concepts, principles and theories. Art is the application of scientific knowledge in real situations in a way that the benefits of science are availed.

Going by the above characteristics of science and art, accounting is certainly both science as well as art. However, it is not as pure a science as physics or engineering because the accounting principles and concepts though universally applicable are not capable of defining the cause and effect relationship. Moreover, some accounting concepts and conventions offer alternatives as far as adoption is concerned. Accounting is an art of recording, classifying and summarizing the business transactions in the manner that the results of the business are ascertained. Moreover, though analysis and interpretation of accounting results is done within the framework laid by accepted concepts, principles and standards, the efficiency of this

analysis and interpretation depends more on the proficiency and art of the accounting expert. To conclude, it can be reiterated that accounting is a science as there is a composite body of knowledge of accounting comprising of well developed concepts, principles and theories. It is an art as the accounting knowledge is useless in case the accountants do not possess the requisite skill and art of application of this knowledge.

Basis of Accounting

Literally speaking, basis of accounting are the approaches that are adopted in recognizing and recoding the business transactions. These approaches are: (1) Cash basis; (2) Accrual or mercantile basis; and (3) Mixed or hybrid basis. These approaches or basis are discussed hereunder:

1. Cash basis of accounting: Under cash basis of accounting, only actual cash receipts and payments are recorded in the books of accounts. Credit transactions are not recorded at all until cash involved in such transactions is actually received or paid. Thus, if sales are made in the year 2009 on credit and the cash is received in 2010, such sales shall be considered as the revenue of 2010 and shall not be recorded in the books in 2009 when actual sales were made. Cash basis of accounting is generally followed by non-trading concerns like clubs, charitable institutions etc. and professional people like lawyers, doctors, chartered accounts etc.

Advantages of Cash Basis

Following are some advantages of cash basis of accounting:

(i) Cash basis of accounting is simple from the application point of view. Only those transactions which involve cash inflow or outflow are recognized as transactions and hence recorded.

(ii) Cash basis of accounting is more objective as it leaves less scope for estimates and personal judgments of accountants.

(iii) Cash basis of accounting is more verifiable and less prone to manipulation.

(iv) Cash basis of accounting is suitable for non-trading concerns and professional firms where most of the transactions are cash based.

Disadvantages of Cash Basis

Despite certain advantages, cash basis of accounting suffers from a number of limitations as listed below:

(i) Cash basis of accounting is unrealistic as it does not give a true and fair view of profit and loss, and financial position of the business. This is so because cash basis of accounting does not take into account transactions like prepaid and outstanding expenses, and accrued incomes and incomes received in advance.

(ii) Cash basis of accounting is prone to manipulation. For various reasons, receipts and payments can be delayed or made prematurely.

(iii) Cash basis of accounting violates one of the fundamental accounting principles, i.e., the matching principle. The receipts and payments are recorded in the books as and when they are made without any regard to the period such receipts and payments belong to.

(iv) Cash basis of accounting does not make any distinction between the revenue and capital items as a result of which the enterprise does not reflect genuine profit or loss for a particular period.

2. Accrual or Mercantile Basis: According to accrual or mercantile basis, all business transactions pertaining to the specific period are recorded as soon as they take place irrespective of the fact whether these transactions are cash or credit based. Accrual or mercantile basis of accounting emphasizes that revenue is recognized when it is earned and expense is recognized when obligation for payment arises. Under this basis of accounting, actual movement of cash i.e., receipt or payment is irrelevant.

Advantages of Accrual Basis

Being a perfect approach to accounting, accrual or mercantile basis offer a number of advantages. Some of these are:

(i) Accrual basis of accounting has a universal appeal. Most accountants around the world adopt accrual basis as it is more scientific and follows most of the accounting principles including revenue recognition and matching principle.

(ii) Once understood well, accountants achieve proficiency in adopting the accrual basis. In other words, accrual basis is simple to adopt.

(iii) Mercantile or accrual based accounting gives a true and view of the profit and loss and the financial position of the enterprise as it takes into account all the transactions that take place during the specific period and not only those involving cash receipts and payments.

(iv) Mercantile or accrual basis meets the legal requirement as Section 209 of the Companies Act, 1956 provides that all companies must maintain their accounts under accrual basis.

Disadvantages of Accrual Basis

Important disadvantages of mercantile or accrual accounting basis are:

(i) Accrual basis of accounting is too elaborate and cumbersome as a lot of adjustments are required to be made.

(ii) Accrual basis is not as simple as cash basis of accounting.

(iii) For ascertaining the profit or loss and the financial position of the business, a detailed and comprehensive process of accounting is needed.

Illustration

Sameer and Co. made cash sales of Rs. 12,000 and credit sales of Rs. 8,000 during the year 2010. During this period expenses amounted Rs. 9,000 were incurred out of which Rs. 3,000 were yet to be paid. Calculate Sameer and Co's profit for the year 20100, following:

(i) Cash basis of accounting

(ii) Accrual basis of accounting

Solution

(i) Calculation of profit adopting cash basis	**Rs.**
Revenue received in 2010 (cash sales)	= 12,000
Less: expenses paid in 2010 (cash expenses)	= 6,000
(Rs. 9,000 – 3,000)	
Profit for the year 2010	= 6,000

Note: Under cash basis, credit transactions are ignored. Hence credit sales and expenses outstanding are not accounted for.

(ii) **Calculation of profit adopting accrual basis**		**Rs.**
Total revenue (Cash sales + Credit Sales) (Rs. 12,000 + 8,000)	=	20,000
Less: Total expenses (Cash expenses + expenses 0utsanding)	=	9,000
Profit for the year 2010	=	11,000

Note: Under accrual basis all transactions relating to the accounting period whether in cash or on credit are accounted for. Hence, total sales (cash as well as credit) and all expenses (paid and outstanding) relating to the accounting period (year 2010) are taken into account while calculating profit of the business for the year.

3. Hybrid or Mixed Basis: Hybrid or mixed basis of accounting is the combination of cash basis and mercantile basis. Under mixed basis, some items especially sales and other revenues are treated on cash basis and some items especially expenses, costs and long term assets treated on accrual or mercantile basis. This is the most conservative basis as only those incomes and revenues which are received in cash are considered, while as all expenses relating to the period whether actually paid or not are taken into account. Hence, incomes are treated on cash basis and expenses on matching principle. The mixed basis of accounting is popular among professionals like chartered accountants, lawyers, doctors, consultants etc.

Systems of Accounting

There are two systems of accounting viz., single entry system and double entry system. Both of them have been explained below:

(1) Single Entry System: Single entry system of accounting is a system under which only personal accounts i.e., accounts of debtors and creditors are maintained, while as real and impersonal accounts are ignored. Since this system does not keep a complete record of business transactions, neither the trial balance nor the final accounts can be prepared. Hence, the process of ascertaining the profit or loss and the financial position of the business is not only tedious and difficult but also unscientific and unreliable. Single entry system is suitable for small business concerns where the number of transactions is not large.

(2) Double Entry System: Double entry system is a scientific and foolproof system of accounting. As the name suggests, under double entry system, every business transaction is entered or recorded in the books of accounts twice. Since every transaction has two aspects, these two aspects are recorded in the account books at two different places. For instance, if the business purchases goods for cash, it involves two aspects; goods which come into the business and cash which goes out of the business. Similarly, if goods are purchased on credit, the goods come into the business and the business owes money to the supplier who becomes its creditor. Hence, every transaction involves two accounts and upon application of the rules of book keeping, one account is debited and the other credited. Thus for every debit, there is an equal and corresponding credit and that is why the trial balance which is the summary of balances of all accounts and is prepared at the end of the accounting period tallies i.e., the total debits of the trial balance are equal to the total credits. In view of its scientific character and compactness, double entry system has universal appeal and is adopted by the business houses across the world.

Accounting and other disciplines—*Relationship*

Accounting is closely related to numerous other disciplines and subjects. These include economics, law, management, mathematics, statistics, engineering etc. The relationship between accounting and some of these disciplines is discussed below:

Accounting and Economics: Economics is the science of wealth. It studies the areas of production, exchange, consumption and distribution of wealth in a socio-economic setup. Economics also studies the relationship between limited and scare resources and unlimited wants and desires of human beings and attempts to maximize the satisfaction of human wants by trying the optimal use of resources. Thus economics confines its study to the economic aspect of human efforts. Accounting on the other hand also records, analyses and interprets the monetary and economic nature of transactions that take place in the business as a result of human effort.

Accounting is related to economics in many other ways also. The data that is made available by practising accounting is of immense use in economics. Economists choose alternative courses,

devise various monetary and fiscal policies and base their decisions on the accounting information of business and industry.

Similarly, the economic policies of a state or nation have long range implications for the theory and practice of accounting. Thus, accountants and economists must for the sake of mutual benefit, know the concepts and principles of the subjects of each other.

Accounting and Mathematics: Accounting is all about figures and analysis and interpretation of these figures. The basic system of accounting, popularly known as 'Accounting Equation', is essentially a mathematical equation. In addition, simple mathematical operations involved in accounting are addition, subtraction, multiplication, division etc. Besides, many aspects of accounting involve calculations which need strong knowledge of mathematics. Accounting operations and calculations that need strong mathematics base include, for instance, calculation of simple and compound interest, bifurcation of a hire purchase installment into cash price and interest components, calculation of annuity needed to depreciate an asset with a defined rate of interest over its estimated useful life etc. Thus for effectiveness, an accountant is required to have sufficient knowledge of mathematics and mathematical operations.

Accounting and Statistics: Accounting is not confined to the preparation of financial statements and thereby providing important accounting information. It also involves the interpretation and presentation of such information in the useful and meaningful form. The interpretation aspect of accounting information involves making absolute and relative comparisons with the help of ratio analysis and other operations. Similarly, the presentation of accounting information involves creation of tables, graphs and diagrams, the knowledge of which essentially lies in the discipline of statistics. Moreover, with the application of various statistical techniques, the likely changes in the business prospects can be predicted with some degree of accuracy. Such forecasts are highly useful to management and accountants.

Accounting and Law: Accounting essentially operates within the legal environment and therefore, the accountants must be fully aware of the commercial, business and corporate laws in vogue. Many business organizations are regulated by the respective statutes which prescribe even the ways and forms of preparing and presenting the accounting and financial statements. For instance, Companies Act, 1956 prescribes the rules for calculation of managerial remuneration. It also prescribes the formats of Balance Sheet and Profit and Loss Account for a joint stock company. Likewise, the companies carrying banking, insurance and electricity businesses prepare their final accounts as per the requirements of the respective laws governing these companies. Moreover, accountants must be well versed with income tax laws, sales tax laws etc. so that they can make adequate provision for income tax and other such obligations.

Accounting and Management

Management of a business is primarily concerned with improving its productivity and efficiency. Management tries to achieve these objectives through effective planning, organizing, coordinating, directing and controlling the operations of business. In fact, management has to make numerous decisions while performing these functions and the efficacy of these decisions depends upon the accuracy and reliability of the information that is made available by accounting. As a matter of fact, accountants are a part of management of the business and their efficiency as accountants reflects on the overall efficiency of management.

Accounting and Sociology

Precisely speaking, sociology is the science of society. It is that area of knowledge which studies the action, interaction and dynamics of individuals and groups operating within the social structure. The aim of sociology is to study the impact of the social operations on the socio-economic growth of a society. Accounting information helps the management in ensuring efficient utilization of scare resources which has an ultimate bearing on the socio-economic development of a society. So accountants are not merely concerned with preparing accounts in

a mechanical way but they are also an effective instrument of socio-economic change and welfare of the state.

Role of Accountants in the Society

Accountants or more precisely professional accountants in India are those who have undergone and qualified a professional course from the Institute of Chartered Accountants of India or the Institute of Cost and Works Accountants of India. Accountants with their specialized knowledge, extensive training and experience are not merely suitable for drawing accounts. They are rather best equipped to provide varied services to the managers of business as well as to the society at large.

Accounting plays a crucial role in the efficient and effective use of firm's resources. Decision makers operate in a complex economic environment which is constantly changing. They need information that has relevance in the changing environment and accounting has been adapting to meet these changing needs of decision makers. As stated earlier, accounting plays a role in the effective management of business which has a bearing on the socio-economic development of a society. In addition to this indirect and long lasting role, accountants render various valuable and direct services to the society in the following ways:

- They maintain proper books of accounts which reflect the true and fair view of the state of affairs of the business enterprise.
- Accountants provide consultancy services regarding drawing of feasibility and project reports, ascertaining financial requirements of business enterprises etc.
- They provide crucial information to the management which facilitates its decision making.
- Accountants act as statutory auditors to authenticate the fairness of the accounts of joint stock companies.
- They operate as internal auditors and check the manipulation of accounts.
- Due to their in-depth knowledge, accountants are best advisors regarding investment, banking, expansion, diversification etc.

- Accountants provide their services in tax assessment, incorporation of companies, drawing of Memorandum and Articles of Association etc.
- In case of mergers and acquisitions, accountants act as values and arbitrators.

Some Important Accounting Terms

Transaction: The whole process of accounting begins with the identification and recording of a transaction. A transaction is an event that takes place in the business and has a financial implication. In other words, those business events which do not involve money or money's worth are not transactions from the accounting point of view and hence not recorded in the books of accounts. When there is an exchange of value or benefit between the business and some one else and the value or benefit is measurable in terms of money, such exchange is known as a business transaction. Thus sales or purchases made in cash or on credit, salary paid or due to a salesman, interest received or accrued etc. are all transactions and therefore, recorded in the account books. On the contrary, deaths of a proficient salesman or a conflict with a customer are not transactions as the impact of these events is not measurable in monetary terms.

Capital: The amount contributed to the business by owners or the amount invested in the business by owners is known as capital. Capital is the owner's financial holding in the business and is represented by the excess of assets over outside liabilities. Capital increases by the amount of profits made by the business and additional capital, if any, brought in by the owner. It decreases by the amount of loss suffered by the business and the drawings, if any, made by the owners.

Assets: The economic resources of an enterprise that can be expressed in monetary terms and whose benefit or use has a lasting nature are known as assets. Assets are broadly classified as *fixed assets* and *current assets.* Fixed assets are those which are acquired for use in business and not for resale. Fixed assets may be tangible or intangible. Tangible fixed assets are those which are physically in existence such as land, building, machinery, plant, furniture etc. Intangible fixed assets are those which are not physically present like goodwill, patent rights,

trade marks etc. Current assets, on the other hand, are those which are acquired or manufactured by the enterprise for sale.

Liabilities: Liabilities are the obligations or debts owed by the business to the outsiders as well as insiders. Liabilities may be long term or short term. Long term liabilities are payable usually after a period of one year, while as short term liabilities, generally called as current liabilities, are payable within a period of one year such as creditors, bills payable, bank overdraft etc.

Purchases: Purchases represent the cost of goods purchased by a business for resale, production or consumption. It includes both cash as well as credit purchases. However, purchases do not include purchase of properties or assets intended for long term use in business.

Sales: Sales represent the value of goods sold or services provided. Sales include both cash as well as credit sales. However, sales do not include the revenue realized due to sale of a fixed asset originally acquired for long term use in business.

Revenue: Revenue represents the amount of sale of goods or services and earnings of enterprise from rent, dividend, interest etc. arising during the course of business operations.

Expenditure: Expenditure is the amount spent on acquiring goods or assets or hiring the services of somebody. Almost all transactions that result in the immediate or postponed outflow of cash are expenditure.

Expense: Expense is the cost of an operation during the accounting period. It is the cost of an operation whose benefit is availed during the same accounting period. Expense is a charge against the profits of the year. All expenses are expenditure, while as all expenditures are not expenses. For instance, cost of goods sold, rent and salaries paid are expenses, while as cost of assets acquired or rents and salaries paid in advances are expenditure but not expenses. Expenses are determined on the matching concept and those expenditures whose benefit is derived for more than one year are capitalized and not charged against the profit of the accounting year.

Debtors: Persons who owe money to the business are known as debtors. Such sums may be due for goods sold or services rendered.

Creditors: Persons to whom the business owes money are known as creditors. Such sums may be due to creditors for goods purchased or services received from them.

Drawings: Withdrawal of cash or goods by the owner from the business for personal use are known as drawings. Drawings are deducted from the capital of the owner as they reduce his financial holding in the business.

Profit: Excess of income over expenses during the accounting year is profit. Profit earned not due to normal business operations is termed as capital profit. For example, profit earned on sale of a fixed asset is a capital profit. All profits including capital profits, if any, earned during the accounting year belong to the owner and are added to his capital.

Loss: Excess of expenses over income or revenue is loss. Loss suffered by the business during the accounting year is borne by the owner and deducted from his capital.

Balance Sheet: Balance sheet is a statement of assets and liabilities of the business on a particular date. This statement shows the financial position of the business on such particular date.

Accounting Theory

A theory is the coherent set of hypothetical, conceptual and pragmatic principles forming the general framework of reference for a field of inquiry. Theories are composed of words or other symbols. They are statements and do not have a physical form. Theories are needed to systematically create new knowledge in a particular area.

Accordingly, accounting theory is the logical reasoning in the form of a set of broad principles that provide a general framework of reference by which accounting practices can be evaluated and subsequently, development of improved practices and procedures ensured. It comprises of the systematic statement of principles and methodology which underlie the accounting practice. Accounting theory is also used to explain existing practices to obtain a better understanding of them. With the social and economic development, accounting theory too has been evolving. Today, accounting is not considered as merely concerned with the historical description of financial activities. In the contemporary business world, accounting encompasses

the spectrum of issues and addresses the concerns of all stakeholders having interest or stake in the business. Based on the purpose and focus, accounting theories can be classified into:

- **Descriptive Theories**: Descriptive theories are theories that explain a particular phenomenon e.g. accountants charge depreciation against profits because there is a gradual decrease in the value of assets due to wear and tear, obsolescence, and afflux of time.

- **Predictive Theories**: Predictive theories are theories which predict the outcome of a particular accounting operation e.g. cosmetic accounting practices will have no long term impact on the intrinsic value of shares.

- **Prescriptive Theories**: Prescriptive theories are theories which recommend or prescribe a particular accounting operation and practice e.g. cost accounting techniques should be used to provide more useful information

Formulation Process of Accounting Theory

The following steps are involved in the formulation of accounting theory:

(a) Observation of a specific problem or an issue or an event.

(b) Formation of hypothesis i.e., an assumption or idea relating to the cause of that problem or event or issue.

(c) Experimentation i.e., testing again and again to prove whether such hypothesis are correct or not.

(d) Drawing conclusions or inferences and then test them repeatedly to ascertain that the inferences so made are valid beyond any doubt.

Classification of Accounting Theories

Basically there are three classes of accounting theory. These are:

(i) Decision theory

(ii) Measurement theory

(iii) Information theory

1. Decision Theory: Decision theory of accounting attempts to aid managers, owners, investors and similar other parties in the decision making process. These parties base their

decisions, to a great extent, on the information made available through the accounting statements and reports. Decision theory is concerned with establishing standards for arriving at the best accounting and financial decisions. The process of decision making involves the following steps:

(a) Recognition of a problem.

(b) Determining all possible alternative solutions to the problem.

(c) Collecting all information relevant to those alternative solutions.

(d) Evaluating the merits of all alternative solutions.

(e) Deciding upon the best alternative solution which is most desirable.

(f) Evaluating the validity of the decision by means of feedback information.

2. Measurement Theory: Measurement theory is of great importance to an accountant for rational decision making because this theory is concerned with providing of information that is expressed in measureable accounting facts. A decision maker expects accounting measurements to represent the truth of a phenomenon. Thus, it is the duty of the accountant to provide measureable facts to the users of accounting information so that they can base their decisions on such facts. Measurement is the assignment of numbers to objects and events. Measurements can be quantitative as well as financial. Unlike quantitative measurements, money measurements provide a more useful means of measurement because money serves a common denominator by means of which heterogeneous facts about a business can be expressed in terms of numbers which are capable of additions and subtractions.

3. Information Theory: Information is an organization’s resource which helps it to achieve its objectives by the efficient use of its various resources. Information theory is based on the efficient use of information as a resource so that appropriate and right decisions are taken. Basically, decision theory described above is an extension of the information theory

Accounting, being a means and source of information, attempts to provide information in the form of reports, statements, charts and graphs to help the decision makers in taking rational decisions. The flow of accounting information to the owners about the operations of the business is as essential as the flow of raw materials to the manufacturing plant or goods to a retail business.

Why study Accounting Theory?

An account should have the knowledge of various accounting theories because of the following reasons:

- Knowledge of accounting theory helps accountants to understand the logic behind the accounting practices.
- Accounting theory helps accountants to maintain the accounts in a way that gives an accurate picture of financial position of the business.
- It helps an accountant to make the best choice of accounting methods and procedures out of a various available alternatives.
- Accounting theory also helps an accountant to know the deficiencies in the existing framework of accounting practices and procedures and, therefore, paves the way for development of improved accounting theories.

Accounting Principles

Introduction

Accounting, as we know, is concerned with recording, classifying and summarizing of business transactions, and analyzing, interpreting, communicating and reporting on the economic activities and financial health of an enterprise. This communication and reporting on the economic viability through financial statement analysis of an enterprise is done to help various user groups and stakeholders in objective decision making. In this backdrop, it is essential that financial statements of different enterprises are prepared on a uniform basis. Moreover, an enterprise should follow consistency in the preparation of annual accounts over a period of time. Being the language of business, accounting information and reports should convey the same meaning to all the concerned parties consistently over a period of time. In case different business enterprises follow their own notion and interpretation about accounting terms and practices or the same enterprise adopts inconsistent practices over the period, there will be complete chaos and confusion and the information so provided will be misleading and unrealistic.

In order to have uniformity and consistency in the preparation and presentation of financial statements and to ensure that the accounting information convey same thing to all concerned, accountants worldwide operate within a framework of well developed and universally accepted rules, procedures, norms and conventions. This framework, mostly referred to as 'Generally Accepted Accounting Principles' (GAAP), is the composition of rules, procedures, concepts, conventions, postulates and principles followed in the practice of accounting. Thus GAAP as a conceptual framework of accounting principles deals with the attributes, objectives, elements, preparation and presentation of financial statements.

GAAP evolve as a result of traditions, conventions, experience and official decree and require authoritative support, professional acceptability and regulatory enforcement. The generally accepted accounting principles relate to various aspects of measurement, treatment and disclosure of accounting transactions and events with a view to harmonize and standardize accounting policies and practices. These standards provide the theory base of accounting and are intimately related to each other.

It may be noted that accounting is a man made system and therefore, must evolve and adopt itself to the changing needs of mankind. Thus, the theory base of accounting, comprising of accounting principles, conceptual framework and policy documents, is not as exact and rigid as the laws of natural sciences. It is bound to be inexact as it is a part of the social system. As a result, accounting theory is not and probably will never be in a completely stable state. It is constantly evolving and is influenced by changes in the social, legal and economic environment; needs of the users of financial statements and observations of professional accountancy bodies like the Institute of Chartered Accountants of India (ICAI), the American Institute of Certified Public Accountants (AICPA), International Accounting Standards Board (IASB), Financial Accounting Standards Board etc. In the contemporary globalised world, where large business houses and MNCs operate through the length and breadth of nations, there is a greater need for harmonization of accounting systems and practices. This harmonization of accounting procedures and practices is to a great extent performed by Generally Accepted Accounting Principles (GAAP).

Nature and Meaning of Accounting Principles

Strictly speaking the term 'principle' connotes a 'fundamental belief' or a 'general truth' which is everlasting and has universal applicability. Going by these standards, it is incorrect to use the term 'principle' with reference to accounting which is not as perfect a science as physics or chemistry. However, there are experts who feel that the term principle means only 'rule of action or conduct' and as such can be very rightly used with reference to the rules used in accounting. Even the American Institute of Certified Public Accountants (AICPA) has supported the use of the term 'principle' in the sense in which it means 'rule of action'. Accordingly, AICPA has defined the term 'principle' as 'a general law or rule adopted or practice'. Paton and Littleton, in order to avoid the confusion created as a result of using the term principle, have purposely used the new term 'standard' in place of principle. They argue that 'principle' would generally suggest universality and a degree of permanence which cannot exist in a human service institution such as accounting. However, there are people who contend that the terms 'principle' and 'standard' cannot be used interchangeably. According to them, accounting principles are guidelines to sound accounting procedures and practices, while as accounting standards are policy documents issued by professional bodies and regulatory authorities and relate to diverse areas including recognition, measurement, treatment and disclosure of accounting transactions and events in the financial statements of business entities.

Features of Accounting Principles

Based on the above discussion, some main features of accounting principles are:

❖ Accounting principles are man made and not eternal.

❖ Accounting principles are not in the finished form. They are rather in the evolution stage and are adaptable to the changing requirements of the users of accounting information.

❖ Accounting principles provide the framework for the accounting theory and practice.

❖ Accounting principles ensure uniformity and consistency in the preparation and presentation of financial statements.

❖ Accounting principles facilitate objective decision making of stakeholders.

❖ Last but not the least, accounting principles enhance reliability and objectivity of accounting information.

It may be noted that most of the above stated features of accounting principles serve the purpose of users of accounting information and enhance their utility and acceptability in case they (accounting principles) in general meet the three criteria. These criteria are:

(i) Relevance and usefulness: Accounting principles are relevant and useful as it is because of these principles the accounting information becomes, relevant, useful and meaningful to the users.

(ii) Objectivity: Accounting information obtained through financial statements is useful only when it is free from the subjectivity and personal bias of those who are responsible for the preparation of such statements. Accounting principles ensure this objectivity as they leave minimum room for the personal notion and whims of accounting practitioners.

(iii) Feasibility: Accounting principles are feasible and practicable to the extent that they eliminate complexity and minimize cost of accounting operations. For instance, assets are reflected in the accounts at cost less depreciation and not at market price. It is because of the feasibility characteristic of accounting principles that accountants do not require to ascertain every now and then the realiseable value of assets carried by the business over a period of time.

Classification of Accounting Principles

Accounting principles are generally being classified into:

(i) Accounting Concepts, and

(ii) Accounting Conventions

More often than not, accounting concepts and accounting conventions are used interchangeably. However, at times a slight distinction is made between the two terms 'accounting concepts' and 'accounting conventions'. The term 'concepts' is used to connote the accounting postulates and assumptions which are fundamental to the accounting practice. The term 'conventions' is used to signify the traditions followed in the preparation of financial statements. Hence, accounting concepts are concerned with the maintenance of books of

accounts, while as accounting conventions are applied in the preparation of financial statements i.e., profit and loss account, and balance sheet.

Accounting Principles

Accounting Concepts	**Accounting Conventions**
Separate Entity Concept	Convention of Conservatism
Going Concern Concept	Convention of Consistency
Money Measurement Concept	Convention of Materiality
Convention of Full Disclosure	Cost Concept
Dual Aspect Concept	Objectivity Concept
Accounting Period Concept	Accrual Concept
Revenue Recognition or Realization Concept	Matching Concept

Accounting Concepts

There is no final and exhaustive list of accounting concepts. However, concepts listed above have approval of most of the experts. These concepts have been explained below:

Separate Entity Concept

Separate entity concept is also known as 'business entity concept' or 'accounting entity concept'. According to this concept, from the accounting point of view, business is treated as an entity separate or different from the owner or proprietor and partners and the transactions that take place relate to business and not its proprietor or partners. This concept makes it possible to keep the business affairs strictly free from the private affairs of the owners. The

implication of this concept is that the money invested by the proprietor by way of capital in the business is considered as a liability of the business. Similarly, in case the proprietor withdraws some cash or goods for personal use from business, they are treated as drawings which reduce the balance of his capital.

Accounting entity concept ensures that accounting records reflect only the activities of business and not the private affairs of the businessman. This concept applies to all forms of businesses, e.g., sole proprietorship, partnership, joint stock companies etc. However, the law recognizes the separate existence or entity of business from that of the owner in case of corporate form of business only and no such distinction whatsoever is made in case of sole proprietorship or partnership forms of business. Hence, in legal sense, owner and business may not be different for some form of business enterprises but in accounting sense, owners and their businesses are always regarded as different. It must therefore be noted that when it comes to the preparation and maintenance of accounting records, separate entity or business entity will prevail over the legal entity.

Going Concern Concept

Going concern concept assumes that the business will continue to exist in the foreseeable future. In other words, the assumption is that the business activities will continue for a fairly long period of time, unless and until the business has entered into a process of liquidation. However, it does not imply permanent existence of business but simply, stability and continuity for a period sufficient to carry business plans. Here an analogy can be drawn with living beings that continue to work on the assumption that they will remain alive for a fairly long period unless they are terminally ill. Thus, the business activities are assumed to continue at least for a span of time necessary to meet its present contractual obligations and to recover the original cost of its fixed assets during their commercially useful life. Therefore, continuity of activities implies that assets are acquired for utilization and not for resale and as such, income is determined after charging cost of utilized resources to the revenue of that period. In other words, assets are depreciated on the basis of their expected life and not on the basis of their market or realizable value. It is, in fact, going concern concept that supports the

use of historical costs as opposed to market value or liquidation value. Going concern being a fundamental concept underlying the preparation of financial statements, justifies;

- the deferred recognition of revenue to specific time periods; and
- the systematic expiration of costs (depreciation) over future time periods.

However, there are situations when going concern concept does not hold goods. These are:

(i) When the business was set up for a specified time period and the period has elapsed; or the business was set up for a particular purpose and the purpose has been achieved or is being achieved shortly.

(ii) When the liquidator or the official assignee or receiver has been appointed to proceed with the process of liquidation of business.

(iii) When due to financial or other reasons the business is expected to be wound up shortly.

Money Measurement Concept

According to this concept, only those transactions or events which are capable of being expressed in terms of money are included in the accounting records and those which are not capable of being expressed in monetary terms are outside the purview of accounting.

Numerous events or transactions affect the business in a number of ways. However, recording, classifying and summarizing of these heterogeneous events and transactions require that these be expressed in some common denominator or unit of measurement. For accounting purpose, it is assumed that money serves as a common denominator for expressing or recording those business transactions. Hence, transactions even if they affect the results or financial health of the business materially are not recorded if they are not expressible or measurable in money terms.

Money measurement concept puts a serious handicap on the utility and usefulness of accounting records for decision making. It restricts the scope of accounting as it does not record various facts which are not measureable in monetary terms but have serious implications for the financial health of the enterprise. For instance, facts like entry of a new competitor in the market, rift between the production and marketing departments, ill health of the managing director, death of a competent financial executive etc. are some significant events but will not find any place in accounting records simply because these facts cannot be expressed in terms of money value. Thus, accounting does not give a complete account of the happenings in the business enterprise and the users of the accounting information must not, therefore, completely base their decisions on such information.

Another limitation of money measurement concept is that it does not take into account the fluctuation in the purchasing power of money due to change in the level of prices. Money, of course, serves as a common denominator but its efficacy is lost when there are significant changes in the price level and consequently the purchasing power of money. Hence, during inflationary times, accounting records do not reflect a complete picture of the affairs of the business.

Despite the above two limitations, money measurement concept is indispensible as money continues to remain the acceptable common unit of measurement in accounting. Significance of money measurement concept is illustrated as under:

A business enterprise has the following assets and liabilities as on 31st Dec. 2010:

(i) A three story building constructed on 1,000 sq. m. piece of land.

(ii) Cash in hand and at bank Rs. 65,000.

(iii) Furniture consisting of 10 chairs, 6 tables and 4 almirahs.

(iv) 1500 units of a product held for sale.

(v) 500 units of a product sold to a customer on credit.

(vi) 300 products sold for cash Rs. 3,00,000.

(vii) Rs. 2,50,000 payable to a bank on account of loan.

(viii) Amount payable to the supplier for 500 units of a product supplied on credit.

From the above details, it is rather impossible to assess the financial health of the business as items are given in different units of measurement which cannot be added to arrive at the total assets and liabilities of the business. In the absence of any other common denominator, it is essential that these items are expressed in money values.

Cost Concept

Cost concept emphasizes that in the ordinary course of business, an asset is recorded in the books of account at the price paid to acquire it and the cost becomes the basis for accounting during the period of acquisition and subsequent accounting periods. Accordingly, if nothing is paid to acquire an asset, the same will not be usually recorded in the books of account. For example, a favorable location or a competent workforce will remain unrecorded despite the fact that these are very valuable assets of the business. Thus a big limitation with the cost concept is that those resources or assets which enhance the earning capacity of a business are not at all recorded and valued in case the business has not borne any cost to acquire such resources.

Another limitation of cost concept is that it does not take into account the change in the price level and the assets are shown in the balance sheet at historical cost minus depreciation provided up to date and not at the prevailing or market value.

In spite of there limitations, cost concept has universal appeal and accountants all over the world prefer this principle over others because of the merits it enjoys. These merits are:

(i) Cost Concept ensures objectivity and verifiability in the accounting records.

(ii) Cost concept minimizes subjectivity and leaves least scope for personal bias or judgment of those who are responsible for ascertaining the market value or realizable value of assets.

(iii) Fixed assets which are always valued at cost are procured for use in business and not held for resale by the enterprise. Thus any ups and downs in the value of such assets need not be taken into account on the yearly basis.

(iv) Cost concept ensures feasibility as ascertaining market values of assets every year is a process that consumes time and entails cost as well.

Dual Aspect Concept

Dual aspect concept is a basic concept of accounting and a fundamental of double entry system. According to this concept, every business transaction involves two aspects; one aspect yields the benefit and the other parts with the benefit. For instance, if the business acquires an asset, say goods, it must part with the cash instantly or in future. Or when Rs. 10,000 is contributed by owner as capital, it results in the increase of resources of business in the form of cash. As every transaction has a two-fold effect, introduction of funds by the owner also creates a corresponding obligation for their payment, which is recorded as capital. Similarly, if a bank loan of Rs. 5,000 is arranged, it results in increase in the assets of business in the form of bank balance and a corresponding obligation to repay Rs. 5,000 to bank. In the accounting parlance, resources are called asset;, obligation to parties external to business are called liabilities and obligation towards owner is recorded as capital (which again is a liability). Thus, sum of assets must be equal to the sum of liabilities and the phenomenon or the relationship is expressed in the form of basic accounting equation as given below:

Resources	=	Obligations
or		or
Assets	=	Liabilities + Capital
or		or
Cash +Bank balance	=	Bank loan + Capital
or		or
Rs. 10,000 + Rs. 5,000	=	Rs. 5,000 + Rs. 10,000
or		or
Rs. 15,000	=	Rs. 15,000

This accounting equation holds good at any point of time and is more often expressed as:

$$A - L = P$$

Where,

A stands for assets of the business entity,

L stands for liabilities of the business entity, and

P stands for the proprietor's claim on the business entity.

Objectivity Concept

Objectivity or objective evidence concept connotes that accounting records are based on documentary evidence which can be verified objectively. Such evidence substantiates the recorded events and materially enhances the reliability and dependability of accounting records. Source documents such as the invoices and vouchers for purchases and sales, pay-in slips and bank statements for bank transactions, cash memos, physical stock statements for stock in hand etc. are examples of objective evidence which are capable of verification. Objective evidence ensures, to a great extent, that accounting records are unbiased and free from the personal and judgmental errors, and intentional frauds and manipulation.

Accounting Period Concept

Accounting period refers to the span of time at the end of which financial statements are prepared. The owners of business and also other stakeholders, at frequent intervals, want to know how things are going on in the business. Therefore, to throw light on the results of business operations during a particular period and know the financial position of the business at the end of that particular period, financial statements are prepared at the end of each accounting period. Accounting period, generally comprising of twelve months can begin on any day of the year. However, for convenience and in some cases as a legal requirement, accounting periods mostly cover a period of one year, beginning from January, 1 and ending on December, 31 or beginning from April, 1 and ending on March, 31 next year.

Going concern concept implies that business activities will continue indefinitely and as such complete picture of the financial affairs of the business can be available only at the time the business is liquidated. But information made available to the owners and other interested parties at the time of liquidation of business has hardly any utility. Therefore, to provide timely and useful information to the users of accounting information, indefinite life of the business is split into shorter intervals called accounting period. Moreover, differentiation of capital expenditure from revenue expenditure is possible because of accounting period concept. Revenue expenditure or the cost of resources used within one accounting period is charged against the profit of that year. Contrarily, capital expenditure or the cost of resources utilized over several accounting periods is capitalized and split over the estimated life of the resources (assets) and gradually charged against the profits of the relevant account periods. Thus, accounting period concept is complimentary to another equally important concept, the 'matching concept' and helps in determining the correct profit or loss for a particular accounting period. Consequently, it is also useful in ascertaining the correct state of affairs of a business on a particular date.

Revenue Recognition or Realisation Concept

Business enterprises utilize resources to earn revenue by production and sale of goods or rendering of services. This revenue is considered as being earned or realized on the date when the sale process is complete and the transfer of title or ownership in goods has taken place. It may be noted that earning of revenue has nothing to do with the inflow of cash. Goods may be sold for cash or on credit and the revenue is assumed to have been earned or realized when the sale is complete in all respects irrespective of the fact whether cash has been instantly received or not. According to Robert Anthony, "revenue is considered as being earned on the date at which it is realized, that is the date when goods or services are furnished to the customers in exchange for cash or for other valuable consideration including the commitment to pay cash at some future date."

Accrual Concept

According to accrual concept, revenues, costs, assets and liabilities are reflected in the accounts of the period in which they accrue. This is in contrast to the 'cash principle' under which transactions are recorded in the accounts of the period in which flow of cash takes place i.e., sale is recorded as revenue only when cash is received and an expense is recognized only when the actual cash has gone out.

Accrual concept is complementary to the 'matching concept' and extension of the 'revenue recognition concept'. The essence of accrual concept is that revenue is recognized when it is earned or realized that is when the sale is complete or services provided and it is immaterial whether cash is actually received or not. Similarly, as per this concept, expenses or costs are recognized when they are incurred, whether paid or not. Expenses are called to be incurred in the period or year in which they help in earning the revenue. Thus, accrual concept necessitates adjustments to be made in relation to accrued revenue and prepaid and outstanding expenses while preparing financial statements. In relation to revenue, accounts should exclude revenues relating to past or subsequent periods and in relation to costs, accounts should include costs incurred but not paid (outstanding expenses) and exclude costs paid for subsequent periods (prepaid expenses).

Matching Concept

Matching concept is related to accounting period concept. The most important objective of matching concept is to ascertain the correct profit or loss made by the business during the accounting period. According to matching concept, costs or expenses incurred in an accounting period should be matched with the revenue recognized in that period to arrive at the net results of the operations of the business during the accounting period. Thus, the determination of profit or loss of a particular accounting period is essentially a process of matching the revenue recognized during the period with the costs to be allocated to that period to earn the revenue.

It may be noted that the whole revenue earned by the business is not income. To earn revenue, resources are consumed and the cost of resources consumed must be matched with

the revenue to obtain profit or loss made. Resources consumed to earn revenue are of two types; cost of goods or merchandise sold and cost of fixed assets utilized. Cost of goods sold is directly attributable and completely deductible from the revenue of the period, while as cost of fixed assets consumed or utilized is not directly attributable as it is not the entire fixed asset which is consumed during one accounting period only. Since fixed assets are utilized over a period of more than one accounting year, the cost of these assets is allocated over the effective or expected life of the assets. The term expired cost or expense is used to denote the cost of any resource consumed (current assets or fixed assets) during the accounting year and in the context of fixed assets, such expired cost is known as depreciation. Unexpired costs of such resources (cost of fixed assets which have not expired as yet) are carried forward to be matched against the revenues of subsequent periods.

Expired cost is not to be determined in case of tangible assets only. For example, certain expenditures on issue of shares etc. are incurred in a particular accounting period, while as they are expected to yield their benefit in several years. In such cases, it is not appropriate to match the entire such costs against the revenue of that year. The costs proportionate to the unexpired utility of such expenditures are carried forward to be matched against the revenue of subsequent years. Similarly, the practice of providing for bad debts with regard to the credit sales made in a particular year is again done in the backdrop of matching concept. Application of matching concept in practice is, however, beset with an important difficulty and that is how accurately the estimates with regard to expired costs are made. In spite of this difficulty, matching principle is indispensible for having a true and fair view of the profitability and financial position of the business enterprise.

Accounting Conventions

As stated earlier, accounting conventions are customs and traditions that guide in the preparation of financial statements. Some popular conventions followed in the accounting practice are explained below:

Convention of Conservatism

To some extent, conservatism connotes pessimism. In the world of uncertainty, every body wants to play safe, so do business enterprises. In the business world, the working rule is, “anticipate no profits but provide for all possible losses”. Also known as convention of prudence, conservatism principle emphasizes that anticipated profits should be ignored until they are certain, while as anticipated losses should be taken into account instantly. The implication of this convention, for example, is that closing stock is valued at cost price or market price which ever is lower. In case market price is higher than the cost, the excess is profit but is ignored as stock is valued at cost. In case market price is lower than the cost, the difference is loss and is accounted for as stock is valued at market price. Following are some other examples of the application of convention of conservatism:

- Making provision for bad and doubtful debts in anticipation.
- Providing for discount to debtors and ignoring possible discount from creditors.
- Amortization of intangible assets like goodwill which has otherwise indefinite life.
- Accounting for claims intimated but not yet accepted as an item of expense in the accounts of insurance companies.
- Charging of small capital items like office stationery to revenue.

The essence of the conservatism principle can thus be summed up, “don’t count on the eggs which are not hatched, but provide for an umbrella for the rainy day.” The convention of conservatism should, however, be applied cautiously. If the principle is stretched unnecessarily, it will result in the understatement of profit in one year and overstatement in the other. Moreover, over-application of this convention results in the creation of secret reserves which is in direct conflict with another important convention, the ‘convention of full disclosure’. Besides, conservatism principle allows anticipation of losses in the form of provisions which is a violation of the basic historical accounting or cost concept that emphasizes that an event should be recorded only when occurred. Keeping in view these limitations, there has slightly been a shift in the accounting thought and practice and other conventions like convention of materiality, convention of objectivity and convention of full disclosure have started taking precedence on the convention of conservatism.

Convention of Consistency

Convention of consistency emphasizes that there should be consistency and uniformity in the application of accounting policies, procedures and practices from one period to another. This is so because when accounting procedures and practices are adhered to consistently from year after year, the results disclosed by the financial statements become more useful, meaningful and comparable. Since there are alternatives available in a number of accounting operations and whatever alternative procedure is adopted in relation to a particular accounting operation, the procedure should be adopted consistently over a period of time. For instance, in case of depreciation, straight line method, written down value method, sinking fund method etc. are permitted in accounting. Similarly, for inventory valuation, FIFO method, LIFO method or average cost method can be adopted. Each alternative method of these accounting operations has its own merits and demerits. But whatever method has been chosen, it should be consistently adopted year after year. Shifting from one method to another not only creates the scope for personal bias and judgment but also destroys the comparability of financial results.

Consistency principle not only facilitates time series analysis but also enables cross sectional analysis. Time series analysis is the analysis of the results of the same enterprises over a period of time. Such analysis also known as 'vertical analysis' enables the management to analyze the performance of the same business unit and make necessary decisions. Such type of consistency is also known as vertical consistency. Consistency should also be ensured horizontally, that is accounting operations should have consistency across the segments, departments or units of the same enterprise. Cross sectional analysis is possible when all the firms or enterprise within the particular industry use the same set of accounting principles and methods in the preparation of their accounting statements. When sectional analysis is possible because all enterprises in the industry adopt same accounting concepts and conventions, the consistency is known as the 'cross sectional' or 'multi-dimensional consistency'. One of the main objectives of developing and adhering to GAAP at the national level and IAS and IFRS at the international level is to ensure consistency at the industry level, national level and international level.

It may be noted that the consistency principle should not be mistaken as an impediment to positive and desirable changes in the accounting procedures and practices. Deviations to consistency should be made in case the change is required to comply with the law or a new accounting standard, or it results in the use of improved accounting procedures and thereby helps in providing more meaningful and reliable accounting information to the decision makers. However, the fact of such change and its impact on the financial results of the business enterprise should be disclosed and such disclosure should form part of the financial statements.

Convention of Materiality

Materiality convention emphasizes that accounting should focus on material facts and resources should not be wasted in recording and analyzing immaterial and insignificant facts. Generally, materiality of an item or event depends upon the amount involved and the convention requires that only those facts should be disclosed in the financial statements which are materially significant. Materiality, therefore puts a restriction on what should be recorded and reported in accounting.

Some facts may not be material, therefore, theoretically correct procedure of recording or disclosing them cannot be justified keeping in view the practical considerations and the usefulness of the information. For example, figures in the financial statements are rounded off to the nearest hundred or thousand depending upon the size of the enterprise and its financial statements. Such rounding off on the one hand enhances the tidiness of the financial statements, while on the other, it does not materially affect the quality and reliability of the information available in the financial statements. Another example is treating items of petty but long lasting nature as an expense rather than assets. Purchase of stationery items, some of which may last for years together, are not capitalized but treated as consumed on the date of acquisition itself and as such shown as items of revenue nature. It may, however, be noted that an item or event material for one enterprise may be immaterial for another. Similarly, an item material for one year many not be so in the subsequent years. Amount involved is not, therefore, the only determining factor of materiality. It is rather determined on a number of factors including usage, custom, time, situation and perspective.

Convention of Full Disclosure

Financial statements should act as a means of conveying and not concealing the state of affairs of business. These statements must disclose all the relevant information so that they are useful to the users. The principle of full disclosure is highly important in case of corporate form of business as there is a divorce between management and ownership. It is in this backdrop that the Companies Act makes ample provisions for the disclosure of essential information in the company accounts. So much so that the formats and contents of company balance sheet and profit and loss account are prescribed by law.

The term 'disclosure' does not, however, imply that all the information that anyone could conveniently desire is to be included in the accounting statements. The term only implies that there is to be a sufficient disclosure of information which is of material interest to various stakeholders including owners, potential investors, creditors, bankers etc. As a result of principle of full disclosure, the practice of appending notes to the financial statements has developed lately. Because of the wide recognition of this principle, there is now an accounting standard which requires the disclosure of all significant accounting policies adopted in the preparation of financial statements and the effect of change of such policies, if any, on the financial statements. The accounting principles of 'going concern', 'consistency' and 'accrual' are considered fundamental assumptions in the preparation of financial statements. In case any one or more of these assumptions are not followed, the fact should be disclosed.

Accounting Assumptions and Accounting Policies

Strictly speaking, accounting assumptions and accounting policies are basically accounting principles. Like other principles, accounting assumptions and accounting policies also guide accounting procedures and practices. In case of accounting assumptions, they are the fundamental hypothesis or premises upon which the entire edifice of accounting practices and procedures is based. There is no exception to these assumptions and all business entities are required to follow them all. There are only three universally recognized accounting assumptions. These three accounting assumptions have the recognition of the Institute of Chartered Accountants of India, the statutory body responsible for developing and issuing

accounting standards in India, and the International Accounting Standards Committee of IASB which issues the International Accounting Standards. These three assumptions are:

(i) Going Concern Assumption

(ii) Consistency Assumption

(iii) Accrual Assumption

These three assumptions have been explained in detail in the preceding pages under the heading 'accounting concepts'. However, for the convenience of students, these are briefly described once again.

(i) Going Concern: As per this assumption, the business enterprise will exist in the foreseeable future and its activities will continue for a fairly long period of time. It is presumed that the business will not be liquidated or closed down in the foreseeable future nor will it materially curtail the scale of its operations.

(ii) Consistency: Consistency assumes that there is consistency and uniformity in the application of accounting policies, procedures and practices from one accounting period to another.

(iii) Accrual: According to accrual assumption, revenues and costs are recognized when they are realized (earned) and incurred respectively. This is irrespective of the fact whether actual cash is received and paid or not.

The above fundamental assumptions are to be compulsorily followed (except in certain specific cases) by all business entities in the preparation and presentation of financial statements. In case, for some extraordinary reason, these fundamental assumptions are not followed, the fact that these assumptions have not been followed must be explicitly disclosed. However, no specific disclosure is needed as long as these are followed because they are supposed to have been followed without fail.

As far as accounting policies are concerned, there is a choice of alternatives in such policies vis-à-vis certain accounting operations and the enterprise is at liberty to adopt the policies that suit it most. However, a particular accounting policy once adopt must be

consistently followed. In certain compelling circumstance, a deviation or change can nevertheless be made but the reason for such change and its impact on the financial statement results must be disclosed clearly. Following are some of the accounting areas where a choice of accounting policies is available:

- Methods of charging depreciation
- Methods of valuation of inventory
- Amortization of preliminary expenses
- Methods of providing for bad and doubtful depts.
- Treatment of research and development expenses
- Methods of providing for discount to debtors

Distinction between Accounting Assumptions and Accounting Policies:

Accounting assumptions and accounting policies are essentially the principles that guide the accounting procedures and provide the framework to the accounting practices. They not only ensure objectivity and reliability of financial statements but also make possible vertical or time series analysis and cross-sectional or third dimensional analysis of financial results of enterprises. Despite the fact, that accounting assumptions and accounting policies play complementary roles in systematizing the knowledge and practice of accounting, the two differ on a number of factors including the following:

Accounting Assumptions		Accounting Policies
There are only three widely recognized accounting assumptions going concern, consistency and accrual.	1.	There is no such exhaustive list of accounting policies which are applicable in all business entities.
Accounting assumptions are the fundamentals that provide a framework accounting practices.	2.	Accounting policies have no such broader role. They are rather specific to certain accounting

valuation,		operations like; inventory provision of depreciation etc.
Accounting assumptions are logically to conceived and rationally developed.	3.	Accounting policies are confined certain areas of accounting operations and are a matter of practice and choice.
There is no choice available choice to the business entities as far as their accounting assumptions are concerned. instance, using down method	4.	Accounting policies provide to the business entities as far as adoption is concerned. For depreciation can be provided straight line method, written value method, sinking fund etc.
Business entities cannot shift from one set of accounting assumptions to another over a period of time. They continue to serve the basic premises, come what may.	5.	Business entities can, in extreme circumstances, shift from the previously adopted accounting policies.
The fact that the accounting assumptions make a	6.	Financial statements need to

have been followed need not be disclosed. However, if these assumptions are not followed, the facts needs to be disclosed clearly. In other words, assumptions are presumed to have been followed in all cases.

mention of the significant accounting policies adopted. Moreover, in case the enterprise has made a change in a particular accounting policy, the fact needs to be disclosed along with the impact it has on the results of the financial statements, if any.