Indian Accounting Association

Subject: Financial Accounting

Unit-I

Financial Accounting: Concepts

Name of the Contributor:

Soumita Mukherjee

Affiliation:

Assistant Professor of Commerce

Fakir Chand College, Diamond Harbour, West Bengal

Email: soumita.mukherjee88@gmail.com

Unit-I Financial Accounting: Concepts

LEARNING OUTCOMES

- Understand the concept of accounting in details.
- Can distinguish between accountancy, accounting and book-keeping.
- Explain the different accounting concepts and conventions.
- Understand the concept of voucher.
- Have an idea about Accounting Standards in details in India.

1.1 Accounting- Meaning and Definition

Accounting is defined as identifying, measuring, recording and communicating financial information. It is an art and science as well. Accounting is an information system which provides relevant financial information through financial statements. The task of an accountant ranges from measuring economic changes of an entity, recording transactions, analyzing, interpreting the financial information and communicating that information to the users of such information. Accounting deals with numbers and measurable quantities.

Accounting is known as language of business.

The *Committee on Terminology set up by the American Institute of Certified Public Accountants* formulated the following definition of accounting in the year 1961 as-

"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".

In India, the origin of accounting can be traced back to the ancient times. In '*Arthashastra'* by Kautilya around 4th century there was a chapter on keeping accounts of business. The modern method of accounting is said to be originated from Venice, Florence and other towns of Italy. The text book which described double entry system of book-keeping was written by *Luca Pacioli* named *Summa de Arithmetica, Geometria, Proportioniet Proportionalita* in the year 1494 and was published in Venice. Pacioli is not the father of double entry system, but this system was widely used in Europe. Gradually when joint stock companies emerged, the entity concept of accounting mentions that owner and business are two separate entities. Hence, the requirement for keeping proper records and maintaining books of accounts was felt. Thus double entry system gained importance.

Accounting is applied for financial transactions only. An incident, happening or occurring which don't have a financial element is termed as 'event'. Example- Purchase goods for cash Rs 500, Employed Mr. C as an office assistant.

Former is a transaction having financial element, whereas the later one is just an event stating a happening where there is no financial element.

Functions of Accounting

The functions of accounting stated by Moontiz, are-

- Managing resources held by specific entities
- Reflection of claims against and interest in those entities
- Measuring changes in claims against and interest in, of those entities
- Assigning changes to specifiable period of time
- Expressing those in terms of money as common denominator

Characteristics of Accounting

- It is a source of information.
- Some of the qualitative characteristics of accounting information are *relevance, quantitative measure, economic feasibility, reliability, unbiased, verifiability, understandability, timeliness.*

Objectives of Accounting

Providing reliable information regarding the following aspects-

- Changes in financial position of an enterprise.
- Earnings of an enterprise, the sources of earning and its trend.

- Economic resources and obligations of an enterprise i.e. claim against and interest in.
- Changes in net financial resources.
- Any additional relevant information that must be disclosed in financial statements for users of accounting information.

Advantages of Accounting

The following are the advantages of accounting-

- To provide useful information for decision making
- Helpful for external users of accounting information who primarily depends on financial statements for their decision making
- It provides information useful for investors and creditors for predicting, comparing and evaluating the expected cash flows in terms of amount, timing and the probable uncertainty.
- Provides information that helps in judging management's ability of an enterprise in achieving the goal.
- Provides financial information that is helpful in comparing and evaluating the earning power of the enterprise.

Limitations of Accounting

Inspite of various advantages of accounting there are certain disadvantages or limitations of accounting also. They are-

a. Accounting is historical in nature
b. Profit and loss account matches current revenue with historical cost or expense
c. Inflation factor is ignored
d. Profit and loss account does not show the changes in net assets
e. Financial statements prepared based on accounting information are not comparable since accounting principles are not static.

1.2 Book Keeping Vs Accounting Vs Accountancy

Book keeping and accounting are often used synonymously but there exists a distinction between the two. Book keeping is just recording the transactions but accounting goes beyond that. Accounting includes summarizing, classifying, interpreting, communicating also.

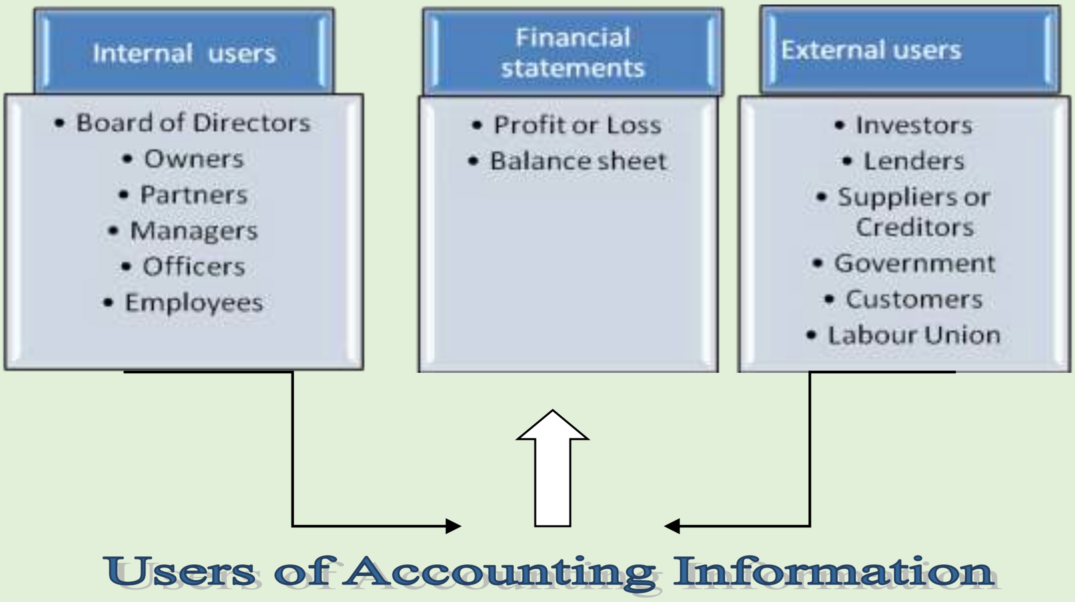
Accountancy and Accounting is also often used synonymously by many, while there is a distinction between the two. Accountancy is the area or field of knowledge consisting of principles and techniques which are applied in accounting to achieve organizational goals. Hence accountancy is the area of knowledge, accounting is the process.

Sl No	Book keeping	Accounting
1.	It is the recording part	It is the summarizing part
2.	It is the basis of accounting	It is business language
3.	Book keepers do book keeping	Accountants do accounting
4.	Special skill and knowledge is not required	Special skill and knowledge is required
5.	Financial statements cannot be prepared	Financial statements can be prepared
6.	Managerial decision cannot be taken	Managerial decision can be taken
7.	Do not have any branch	Has several branches

1.3 Users of Accounting Information

There are two sets of users of accounting information. They are a) Internal users and b) External users. Accounting information are useful for the stakeholders of an enterprise i.e. those who are either directly or indirectly related to the enterprise.

The internal and external users of accounting information are-



1.4 Important Accounting Terminology

- *Debtors*- persons who owe money to the business.
- *Creditors*- persons to whom the business owes money.
- *Purchase*- goods bought by a business. Immediately paid in cash is cash purchase and the payment deferred to a future date is credit purchase.
- *Sales*- goods sold by a business.
- *Accounts receivables*- amount owed by credit customers for sale of goods and services.
- *Accounts payable*- amount owed to suppliers for purchase of goods or services in credit.
- *Stock*- unsold goods lying with business on a given date. Stock at the beginning and end of accounting period is known as opening and closing stock respectively.
- *Goods*- commodities in which a trader deals are called goods or merchandise.
- *Revenue*- inflow of cash or assets resulting from sale of goods or services in course of business.
- *Expenses*- cost of goods and services incurred to earn revenue.
- *Losses*- decrease in value of an asset without any flow of revenue.
- *Expenditure*- amount incurred for acquiring an asset.
- *Income*- excess of revenue over expense.

- *Gain*- benefit in monetary terms resulting from a transaction or set of transactions.
- *Assets*- economic resources owned by business and expected to give future benefit. Example- furniture, building etc.
- *Liabilities*- debts owed by a business to external parties. Example- loan, creditors etc.
- *Return outward or purchase return*- goods returned to supplier.
- *Return inward or sales return*- goods returned by customers.
- *Carriage inwards*- conveyance charges paid on goods purchased.
- *Carriage outward*- conveyance charges paid on goods sold.
- *Capital*- is the difference between what business owns and what it owes.
- *Bills payable*- negotiable instrument in writing containing an unconditional order, accepted in favor of creditors.
- *Bills receivable*- negotiable instrument in writing containing an unconditional order, drawn on debtors.
- *Bad debts*- irrecoverable debts are known as bad debts. It is written off to profit and loss account.
- *Drawings*- cash or goods or any asset taken from the business by the owner for personal use.
- *Cartage*- conveyance of goods from dock to warehouse and vice-versa by cart.
- *Trade discount*- discount allowed by wholesaler to retailer from retail selling price, as shown in wholesaler's price list.
- *Cash discount*- discount allowed to buyers, for prompt account settlement.

1.5 Principles of Accounting: Concepts and Conventions

Accounting concepts are simply assumptions based on which transactions are recorded in the books of accounts and thereafter finally financial statements are drafted. Accounting concepts are also called postulates.

Various accounting concepts are:

Entity concept- states that every business is an entity separate from its owner i.e. owner or owners of the business and the business itself are two separate entities. Example- if owner a business owns a car and the car is completely for personal use that car cannot be shown as an asset in balance sheet of the business.
Money measurement concept- only those transactions which can be measured in terms of money are to be recorded in the books of account. Money is the most commonly used measurement unit in India.
Going concern concept- this concept states that when a business is started, it is assumed that the business will not be dissolved in foreseeable future. It is not possible to wait for the dissolution of the business in order to measure the results of the business during its life span.
Accounting period concept- the going concern concept assumes that a business will continue for indefinite period. Following this, the accounting period concept arises. This concept assumes the life span of a business unit should be segregated into equal parts for the sake of convenience in determining the profit or loss. It usually covers one year.
Dual aspect concept- it is the basis of double entry system of accounting which recognizes two aspects of a transaction i.e. debit and credit. When a transaction occurs, there are two-sided effects i.e giving and receiving or changes in wealth and equity.
Matching concept- this concept recognizes only those expenditures as expenses for an accounting period which are incurred for earning revenue or expired in the same period.
Accrual concept- most of the businesses maintain their accounts on accrual basis which recognizes revenue and expenses as they are earned or incurred, irrespective of the date of receipt or payment.
Realization concept- in accrual accounting, revenue should be recognized when it is earned. Earning may not occur at a single point of time.
Cost concept- assets are entered in the books of accounts at the price paid at the time of acquisition.

Accounting conventions are customs followed by accountant for preparation of financial statements. The commonly used accounting conventions are-

Conservatism or prudence- this convention mentions that all possible losses should be recognized and no gains should be anticipated. It says, provide for all expected losses but not for any gains.

Consistency – accounting policies and procedures should be followed consistently, so that figures of one accounting period can be compared with another.	
Materiality – it refers to the relative importance of an item. What is relevant is considered to be material.	
Full disclosure- it requires disclosure of all significant matters/information affecting financial statements and important for the users of accounting information.	

1.6 Voucher- Meaning, Preparation and Presentation

Voucher is a document which gives authorization to make payment and specifies the amount to be debited or credited. It is prepared for all expenditure. It is attached with invoice and has an identification number.

Voucher contains written evidence about – expenditures have been incurred on basis of proper authorization, goods and services have been received and payment has been made for the goods and services received.

Preparing a voucher

A clerk prepares a voucher by filling data taken from invoice like the invoice date, invoice number, amount, creditor's name and address. Then it is sent to the employee for verification of price, quantity and terms as mentioned in purchase order. After this, voucher and supporting documents are sent to the accounting department, who mentions the accounts to be debited or credited on the voucher. Then it is ready for recording and before that it is to be presented to the accounts officer for final approval. After this, it is entered in the books of original entry.

Specimen of a voucher

Pay to……….	Voucher No…. Date….. Due Date…..

Date of Invoice….. Invoice Number….	Gross Amount ……….. Less: Cash Discount

Approval

	Approved by	Date
Prices in agreement with purchase order	………………………	………………
Quantities in agreement with receiving report	…………………….	
Credit terms in agreement with purchase order	…………………….	
Account distribution and recording approved	………………………	
Approved for payment		
		Accounts Officer

Reverse Side of the Voucher

Account Head	Amount	Voucher No. ………………..
		Date ……….
Purchases	…………………………..	
Transportation	…………………….	Date due …….
Repairs	……………………	
Heat, light and power	……………………	Payee
Miscellaneous general expenses	…………………	Amount of invoice
Telephone	…………..	Less: Cash discount
Sales salaries	…………….	Net amount
Office salaries	………………	Paid by cheque no
…………….		Date of Cheque………
…………….		Amount of Cheque………..
Credit vouchers payable (total)	……………..	
Account distribution by	…………………….	Entered in voucher register by

SUMMARY

- *Accounting is defined as identifying, measuring, recording and communicating financial information.*
- *Book keeping is just recording the transactions, Accounting includes summarizing, classifying, interpreting, communicating also, Accountancy is the field of knowledge.*
- *There are two sets of users of accounting information. They are a) Internal users and b) External users.*
- *Accounting concepts are simply assumptions, accounting conventions are customs.*
- *Various accounting concepts are there like entity, going concern, realization, money measurement etc. Some important conventions are conservatism, consistency, full disclosure etc*
- *Various accounting terminologies are there like assets, liabilities, purchase, sale etc.*
- *Voucher is a document which gives authorization to make payment and specifies the amount to be debited or credited.*

TEST YOURSELF:

A. Multiple Choice Questions:

1. Plant and Machinery is an example of which account?
   a) Personal
   b) Real
   c) Nominal
   d) None of the above
2. Provide for all anticipated losses but not for any gain- is which convention?
   a) Consistency
   b) Full Disclosure
   c) Conservatism
   d) All of the above
3. Which document gives authorization to make payment?
   a) Invoice
   b) Bills Receivable
   c) Voucher
   d) Bills payable
4. …………….. is the field of knowledge.
   a) Accounting
   b) Book-keeping
   c) Both (a) & (b)
   d) Accountancy

Answer keys

1. b) 2. c) 3. c) 4. d)

B. Theoretical Questions

1. What is accounting?
2. Distinguish between accounting and book-keeping.
3. Who are the users of accounting information?
4. Explain the various accounting concepts.

Suggested Readings:

- Batty, J. *Principles of Accounting.*
- Grewal, T.S. *Introduction to Accountancy*. S. Chand and Co. New Delhi
- Gupta R. L. and Gupta, V.K. *Principles & Practice of Accounting*. Sultan Chand and Sons, New Delhi.
- Haneef and Mukherjee. Accountancy-I & II, Tata McGraw Hill Co
- Jain S.P. & Narang, K.L. *Accountancy-I*. Kalyani Publishers.
- Jawaharlal Lal. *Financial Accounting*. Himalaya Publishing House.
- Sehgal, Deepak. *Fundamentals of Financial Accounting*. Tax Mann Publication
- Tulasian, Accountancy–I & II: Tata McGraw Hill Co.