**Part A**

**Financial Accounting**

**Unit 1: Introduction**

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| **This Unit Includes the Following Topics:**1. Meaning and objectives of Financial Accounting, Meaning of different types of accounting, users of accounting information and their information needs
2. Accounting Concepts and Conventions
3. Accounting Standard (Basic concepts & issues)
4. Accounting in ERP environment
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**Unit 1: Introduction**

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| **Unit Learning Objectives:** After studying this unit, students will be able to:* Understand the meaning of financial accounting and its relationship with the other branches of accounting.
* Understand the objectives of financial accounting.
* Know the underlying accounting concepts and conventions.
* Have a basic understanding of accounting standards and related issues.
* Have preliminary knowledge on accounting in an ERP environment.
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**Topic a. Meaning and objectives of Financial Accounting, Meaning of different types of accounting, users of accounting information and their information needs**

* **Introduction to Financial Accounting**

A business is an economic activity undertaken with the objective of earning profits and to maximize the wealth of the owners. A business cannot run in isolation. Largely, the business activities are carried out by people coming together with a purpose to serve a common cause. This team is often referred to as an organization, which could be in different forms such as sole proprietorship, partnership, body corporate etc. The rules of business are based on general principles of trade, social values, and statutory framework encompassing national or international boundaries. While these variables could be different for different businesses, different countries etc., the basic purpose is to add value to a product or service in order to satisfy customer demand.

The business activities require resources (which are limited & have multiple uses) primarily in terms of material, labour, machineries, factories and other services. The success of business depends on how efficiently and effectively these resources are managed. Therefore, there is a need to ensure the businessman tracks the use of these resources. The resources are not free and thus one must be careful to keep an eye on cost of acquiring them as well. As the basic purpose of business is to make profit, one must keep an ongoing track of the activities undertaken in course of business. Two basic questions would have to be answered:

(a) What is the result of business operations? This will be answered by finding out whether it has made profit or loss.

(b) What is the position of the resources acquired and used for business purpose? How are these resources financed? Where the funds come from?

The answers to these questions are to be found continuously and the best way to find them is to record all the business activities. However, recording of business activities has to be done in a scientific manner so that they reveal correct outcome. The science of book-keeping and accounting provides an effective solution in this respect. It is basically a branch of social science.

* **Definition of Accounting**

According to the American Institute of Certified Public Accountants (Year 1961), 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 result thereof”.

According to the American Accounting Association (Year 1966), accounting is “the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of accounting”.

* **Objectives of Accounting**

**(i) Systematic Recording of Transactions**

To ensure reliability and precision for the accounting measurements, it is necessary to keep a systematic record of all financial transactions of a business enterprise which is ensured by bookkeeping. These financial records are classified, summarized and reported in the form of accounting measurements to the users of accounting information i.e., stakeholders.

**(ii) Ascertainment of Results of above Transactions**

‘Profit/loss’ is the core accounting measurement. It is measured by preparing Profit and Loss Account for a particular period. Various other accounting measurements such as different types of revenue expenses and revenue incomes are considered for preparing this Profit and Loss Account. Difference between these revenue incomes and revenue expenses is known as result of business transactions identified as profit/loss. As this measure is used very frequently by stockholders for rational decision making, it has become the objective of accounting to provide such information. For example, Income Tax Act requires that every business should have an accounting system that can measure taxable income of business and also explain nature and source of every item reported in Income Tax Return.

**(iii) Ascertainment of Financial Position of Business**

‘Financial position’ is another core accounting measurement. Financial position is identified by preparing a statement of ownership i.e., Assets and Owings i.e., liabilities of the business as on a certain date. This statement is popularly known as Balance Sheet. Various other accounting measurements such as different types of assets and different types of liabilities as existed at a particular date are considered for preparing the balance sheet. This statement may be used by various stakeholders for financing and investment decision.

**(iv) Providing Information to the Users for Rational Decision-making**

The primary objective of accounting is to provide useful information for decision-making to stakeholders such as owners, management, creditors, investors, etc. Various outcomes of business activities such as costs, prices, sales volume, value under ownership, return of investment, etc. are measured in the accounting process. All these accounting measurements are used by stakeholders (owners, investors, creditors/bankers, etc.) in course of business operation. Hence, accounting is identified as ‘language of business’.

* **Functions of Accounting**

The functions of accounting are as follows:

1. Identification of monetary transactions and events;
2. Measurement of the identified transactions and events;
3. Recording of such transactions;
4. Classifying and summarizing of the recorded transactions;
5. Obtaining the results of operations and determination of financial state of affairs;
6. Analysing and interpreting the results and position to help in decision-making;
7. Communicating such information to the users (both internal and external).
* **Book Keeping**

As defined by Carter, ‘Book-keeping is a science and art of correctly recording in books of accounts all those business transactions that result in transfer of money or money’s worth’.

It is an activity concerned with recording and classifying financial data related to business operation in order of its occurrence. Its primary objective is to maintain systematic recording of transactions on a regular basis. It is a concept narrower than accounting.

* **Accountancy**

Accountancy is the discipline that incorporates certain principles or rules of accounting. It refers to the entire body of the theory and practice of accounting. It is a concept wider than accounting.

Thus, while Book-keeping is a subset of accounting, Accounting, in turn, is a part of Accountancy.

**Figure 1.1.1 Relation between Book Keeping, Accounting and Accountancy**

* **Various Branches of Accounting**

Though the journey of accounting began in form of financial accounting, over the years accounting has been evolved into many new branches, such as,

1. **Cost Accounting**
2. **Management Accounting**
3. Human Resource Accounting
4. Tax Accounting
5. Forensic Accounting
6. Social Accounting

In addition to the above major classes of accounting, there certain objective-led accounting, such as,

1. Project Accounting
2. Not-for-profit Accounting
3. International Accounting
4. Government Accounting
* **Cost Accounting**

CIMA Official Terminology defines cost accounting as the process of gathering of cost information and its attachment to cost objects, the establishment of budgets, standard costs and actual costs of operations, processes, activities or products; and the analysis of variances, profitability or the social use of funds.

Thus, cost accounting encompasses the following;

(i) One of the main purposes of cost accounting is gathering of cost information related to cost objects. This cost information is then suitably presented to the management which aides them in their decision-making process.

(ii) Nuances of cost accounting includes the process of cost accumulation through which the cost of operations, processes or activities or products is calculated.

(iii) Computation profitability which pivots around fixation of selling price is an important aspect of cost accounting.

* **Management Accounting**

Managerial accounting involves the presentation of financial information for internal purposes to be used by management in making key business decisions.

According to the Institute of Management Accountants (IMA): "Management accounting is a profession that involves partnering in management decision making, devising planning and performance management systems, and providing expertise in financial reporting and control to assist management in the formulation and implementation of an organization's strategy".

Management accountants (also called managerial accountants) look at the events that happen in and around a business while considering the needs of the business. From this, data and estimates emerge. Cost accounting is the process of translating these estimates and data into knowledge that will ultimately be used to guide decision-making.

* **Difference Between Financial, Cost and Management Accounting**

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| **Basis** | **Financial Accounting** | **Cost Accounting** | **Management Accounting** |
| Objectives | Record transactions and determine financial profit or loss and financial position. | Ascertainment, allocation, accumulation and accounting for cost. | To assist management in decision-making and policy formulation.  |
| Nature | Concerned with historical data. | Concerned with both past and present records.  | Deals with projection of data for future (futuristic in nature) |
| Data Type | Qualitative aspects are not recorded.  | Only quantitative aspect is recorded. | Uses both quantitative and qualitative aspects.  |

* **Users of Accounting Information and Their Information Needs**

There are primarily two types of users of accounting information;

**A.** **Internal users (primary users)** – If a user of the information is part of the business itself then he/she is considered as one of the internal or primary users of accounting information. For example, management, owners, employees, etc.

**B.** **External users (secondary users)** – If a user of the information is an external party and is not related to the business then he/she is considered as one of the external or secondary users of accounting information. For example, potential investors, lenders, vendors, customers, legal and tax authorities, etc.

The different users and information need of these users are discussed below:

**1. Management** – Organization’s internal management includes all junior and senior business managers.

They use it for

1. Budgeting, forecasting, analysis & take important financial decisions.
2. Investment decisions, identification of warning and opportunity signals.
3. Taking informed & evaluated decisions.
4. Compliance with all statutory, regulatory, and any other external body.

**2. Owners or Partners or Shareholders –**

They use it for -

1. Tracking their investment and monitoring their return on investment.
2. Observing their capital invested and evaluating its upward or downward move.
3. Keeping an eye on the overall well-being of the business.

**3. Employees** – Full-time & part-time workers. They are essentially on the company’s payroll.

They use it for -

1. Checking the overall financial health of the company as it affects their remuneration and job security.
2. Decision making in case of shares-based payment such as ESOPs offered by the employers.
3. Examining if the employer is depositing all required funds to the appropriate authorities such as the provident fund, ESI premium etc.

**4. Investors -**

They use it for

1. Checking how the management is utilizing the equity invested in the business.
2. Decisions related to an increase in investment or to divest from the business.
3. Analyzing their present investment in the business or the overall financial health in case of a potential investor.

**5. Lenders** – Banks and Non-banking financial companies which provide loans in the form of cash or credit are termed as lenders.

They use it for -

1. Evaluation of short-term and long-term financial stability of a business.
2. An insight into the liquidity, profitability, etc. with the help of ratio analysis
3. Assessment of the creditworthiness with the help of financial ratios and scrutiny of the three main financial statements in accounting.

**6. Regulatory and Tax Authorities** – Regulatory bodies such as the stock exchange & authorities include the govt. along with various statutory and tax departments.

They use it for

1. To keep a check and ensure that the firm is following all required accounting principles, standards, rules & regulations.
2. The ultimate intent is to protect business integrity & safeguard investors.
3. Tax department as one of the users of accounting information assures accurate tax calculation by the companies.

**7. Customers** – Are buyers of goods or services and may exist at any stage of a business cycle. They may be producers, manufacturers, retailers, etc.

They use it for -

1. Checking the continuous inflow of stock and the pace of overall production.
2. Assessing the financial position of its suppliers which is essential to maintain a stable source of supply.
3. Efforts to maintain and improve the quality of products and services.

**8. Suppliers** – Are the sellers of goods and services.

They use it for -

1. Inspecting the credibility of their customers by evaluating their repayment ability.
2. Setting up a credit limit & payment terms with their customers.

**9. Public** – The general public is also among users of accounting information. They are keen to know the financial health of a business to get a fair idea of the firm’s niche market, business environment, and economic atmosphere of the country.

**Topic b. Accounting Concepts and Conventions**

* **Accounting Principles – Accounting Concepts and Accounting Conventions**

Accounting principles refer to those rules of action that are universally adopted by the accountants for recording accounting transactions. They provide the guidelines for recording and reporting transactions and as such provide explanations to the current accounting practices.

Accounting principles can be further classified into (A) Accounting Concepts and (B) Accounting Conventions.

**A.** **Accounting Concepts:** Accounting concepts refer to the assumptions and conditions that define the parameters and constraints within which the accounting operates. They lay down the foundation for accounting principles, and ensure recording of financial facts on sound bases and logical considerations. The common accounting concepts include:

1. Entity concept
2. Going concern concept
3. Periodicity concept
4. Money measurement concept
5. Accrual concept
6. Dual aspect concept
7. Matching concept
8. Realisation concept
9. Cost concept

**B.** **Accounting Conventions:** Accounting conventions are customs and traditions associated with the practical application of accounting principles. These are widely accepted, and are the common practices which are used as guidelines when transactions are recorded. These have evolved over time out of different accounting practices. These conventions are also known as doctrine. The different accounting conventions include the following:

1. Convention of Conservatism
2. Convention of Consistency
3. Convention of Materiality
4. Convention of Full disclosure.

These accounting concepts and conventions are discussed in the following section.

**A. Accounting Concepts**

1. **Business entity concept:** This concept assumes that, for accounting purposes, the business enterprise and its owners are two separate independent entities. Thus, the business and personal transactions of its owner are separate. For example, when the owner invests money in the business, it is recorded as liability of the business to the owner. Similarly, when the owner takes away from the business cash/goods for his/her personal use, it is not treated as business expense.
2. **Going concern concept:** Accounting assumes that business will continue to operate for a longer period of time in future. In other words, it is assumed that neither there is any intention nor necessity to curtail the business operations of entity. It is on this basis that financial statements of a business entity are prepared and referring to which investors agree upon their decision to invest in the business.
3. **Periodicity or Accounting Period Concept:** Accounting period concepts assumes that the infinite life of an organisation can be split into smaller periods of equal duration (viz. a quarter, half-year or year). Due to this concept, the operating results are ascertained for a specific period, the financial position is reflected (through the balance sheet) at regular intervals.
4. **Money Measurement Concept:** A business transaction will always be recoded if it can be expressed in terms of money. The advantage of this concept is that different types of transactions could be recorded as homogenous entries with money as common denominator. A business may own Rs.3 Lacs cash, 1500 kg of raw material, 10 vehicles, 3 computers etc. Unless each of these is expressed in terms of money, we cannot find out the assets owned by the business. When expressed in the common measure of money, transactions could be added or subtracted to find out the combined effect. In the above example, we could add values of different assets to find the total assets owned.
5. **The Accrual Concept:** The accrual concept is based on recognition of both cash and credit transactions. In case of a cash transaction, owner’s equity is instantly affected as cash either is received or paid. In a credit transaction, however, a mere obligation towards or by the business is created. When credit transactions exist (which is generally the case), revenues are not the same as cash receipts and expenses are not same as cash paid during the period.
6. **Dual Aspect Concept:** Dual aspect is the foundation or basic principle of accounting. It provides the very basis of recording business transactions in the books of accounts. This concept assumes that every transaction has a dual effect, i.e., it affects two accounts in their respective opposite sides. Therefore, the transaction should be recorded at two places. It means, both the aspects of the transaction must be recorded in the books of accounts. For example, goods purchased for cash has two aspects which are (i) Giving of cash (ii) Receiving of goods. These two aspects are to be recorded. Thus, the duality concept is commonly expressed in terms of fundamental accounting equation:

Assets = Liabilities + Capital

1. **Matching Concept:** This concept states that the revenues and expenses must be recorded at the same time at which they are incurred. In general, the revenues earned should be with the expenses incurred during the accounting period. For the application of this concept several adjustments are made for prepaid expenses, accrued incomes, etc. The operating result of an accounting period can be measured only when incomes are compared with the related expenses incurred.
2. **Realisation Concept:** This concept states that revenue from any business transaction should be included in the accounting records only when it is realised. The term realisation means creation of legal right to receive money. Selling goods is realisation, receiving order is not. Accordingly, revenue is said to have been realised when cash has been received or right to receive cash on the sale of goods or services or both has been created.
3. **Cost Concept:** Accounting cost concept states that all assets are recorded in the books of accounts at their purchase price, which includes cost of acquisition, transportation and installation and not at its market price. It means that fixed assets like building, plant and machinery, furniture, etc are recorded in the books of accounts at a price paid for them. For example, a machine was purchased by XYZ Limited for Rs.500000, for manufacturing shoes. An amount of Rs.1,000 were spent on transporting the machine to the factory site. In addition, Rs.2000 were spent on its installation. The total amount at which the machine will be recorded in the books of accounts would be the sum of all these items i.e., Rs.503000. This cost is also known as historical cost. The effect of cost concept is that if the business entity does not pay anything for acquiring an asset this item would not appear in the books of accounts.

**B. Accounting Conventions**

1. **Convention of Conservatism:** This convention is based on the principle that “Anticipate no profit, but provide for all possible losses”. It provides guidance for recording transactions in the books of accounts. It is based on the policy of playing safe in regard to showing profit. The main objective of this convention is to show minimum profit. Profit should not be overstated. If profit shows more than actual, it may lead to distribution of dividend out of capital. This is not a fair policy and it will lead to the reduction in the capital of the enterprise.
2. **Convention of Consistency:** The convention of consistency means that same accounting principles should be used for preparing financial statements year after year. A meaningful conclusion can be drawn from financial statements of the same enterprise when there is comparison between them over a period of time. But this can be possible only when accounting policies and practices followed by the enterprise are uniform and consistent over a period of time. If different accounting procedures and practices are used for preparing financial statements of different years, then the result will not be comparable.
3. **Convention of Materiality:** The convention of materiality states that, to make financial statements meaningful, only material fact i.e., important and relevant information should be supplied to the users of accounting information. The question that arises here is what is a material fact. The materiality of a fact depends on its nature and the amount involved. Material fact means the information of which will influence the decision of its user.
4. **Convention of Full Disclosure:** Convention of full disclosure requires that all material and relevant facts concerning financial statements should be fully disclosed. Full disclosure means that there should be full, fair and adequate disclosure of accounting information. Adequate means sufficient set of information to be disclosed. Fair indicates an equitable treatment of users. Full refers to complete and detailed presentation of information. Thus, the convention of full disclosure suggests that every financial statement should fully disclose all relevant information.

Accounting principles - concepts and conventions – lie at the core of accounting profession as they bring about the much sought-after uniformity in the process of recording transactions. Such uniformity makes it possible to reliably compare the financial performance, financial position, and cash flows across entities and also across the reporting periods. They contribute a lot in standardising the financial reporting process.

**Topic c. Accounting Standards (Basic Concepts and Issues)**

Accounting Standards are written policy documents which discuss the aspects of recognition, measurement and treatment of specific accounting transactions, along with the presentation and disclosure thereof in the financial statements of an entity. These are usually issued by specified professional accounting bodies, or by the government, or other regulatory bodies. In India, accounting standards are governed by The Institute of Chartered Accountants of India (ICAI). In the US, the American Institute of Certified Public Accountants (AICPA) is responsible to lay down the standards. These standards basically deal with accounting treatment of business transactions and disclosing the same in financial statements.

In India, the Accounting Standards for non-corporate entities including Small and Medium sized Enterprises, are issued by the Accounting Standards Board (ASB) of Institute of Chartered Accountants of India (ICAI), to establish uniform standards for preparation of financial statements, in accordance with the Indian GAAP (Generally Accepted Accounting Practices), for better understanding of the users. However, in the case of corporate entities, the Accounting Standards notified by the MCA are applicable. These standards are mandatory on and from the dates specified either in the respective document or as may be notified by the ICAI/ MCA.

It may be noted that MCA also issues the Accounting Standards for companies, based on recommendations made by the ICAI. Accordingly, MCA notifies such Accounting Standards vide Companies (Accounting Standards) Rules and amendments thereto, applicable for companies including Small and Medium Sized Companies to whom Indian Accounting Standards (Ind AS) are not applicable.

**Accounting Standards and Indian Accounting Standards**

Accounting Standards were indigenously developed by Indian Regulators.

Indian Accounting Standards are the converged accounting standards with International Financial Reporting Standards by IFRS Foundation.

**Applicability and Scope of Ind AS**

Ind AS are the Indian version of IFRS which are global standards governing the accounting aspects. These are basically standards that have been harmonised with the IFRS to make reporting by Indian companies more globally accessible. The Ministry of Corporate Affairs (MCA), in 2015, had notified the Companies (Indian Accounting Standards) Rules 2015, which stipulated the adoption and applicability of IND AS in a phased manner beginning from the Accounting period 2016-17. The MCA has since issued seven Amendment Rules, one each in year 2016, 2017, 2018, 2019, 2020, 2021 and 2022 to amend the original 2015 rules. On the other hands companies covered by Companies (Accounting Standards) Rules, 2021 require to follow old accounting standards and not Ind AS.