

Introduction to Accounting

1.1. ACCOUNTING

1.1.1. Meaning and Definition of Accounting

Accounting is used as the language of business. Accounting involves the procedure of recording the financial transactions in the books of accounts which are helpful to its users for analysing and interpreting the financial soundness of business. The process of 'Financial Accounting' involves the presentation as well as the interpretation of the financial results of a company's conduct with a view to make an assessment of its financial performance. Financial Accounting provides the requisite information necessary for taking investment decisions.

According to American Institute of Certified Public Accountants (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".

According to American Accounting Association (AAA), Accounting is, "The process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information".

According to Bierman and Derbin, "Accounting may be defined as the identifying, measuring, recording and communicating of financial information".

According to R. N. Anthony, "Accounting system is a means of collecting, summarizing, analyzing, and reporting in monetary terms the information of the business".

1.1.2. Objectives of Accounting

Objectives of accounting have been summarised in the following points:

- 1) **To Keep Systematic Records:** During the conduct of business, a number of financial transactions take place. As it is not possible to memorise all the transactions, there is a need to record them. Maintenance of a proper and systematic record of all the business transactions is the main objective of 'Financial Accounting'.

- 2) **To Determine Profit and Loss:** Preparation of 'Profit and Loss Account' or 'Income and Expenditure Statement' by a business entity helps to achieve next objective of 'Financial Accounting', i.e., to determine the figure of profit earned or loss incurred during an accounting year.
- 3) **To Ascertain Financial Position:** One of the most important objectives of 'Financial Accounting' is to enable the management of a business entity to ascertain the financial position of the business, i.e., where the business stands, what is owned by it and what it owes. In order to achieve this objective, a balance sheet is prepared at the end of a financial year. The balance sheet depicts the statement of assets and liabilities of a business entity as on a particular date.
- 4) **To Communicate the Information:** 'Financial Accounting' is helpful to the management of a company, majorly in the decision-taking process by providing financial data and other vital information/facts to different stakeholders, viz., owners, creditors, employees, investors, regulators, tax/other government authorities, etc. Thus, communicating the information of financial data is equally important, than other objectives of 'Financial Accounting'.

1.1.3. Need and Scope of Accounting

The scope of accounting is wide-ranging, and is evident from the following:

- 1) **Business Forecasting:** A business entity is interested in ascertaining its future level of business on the basis of its past as well as present level of business activities. Such forecasting enables it to chalk out strategies (like expansion, diversification etc.) in advance, relating to future plans with regard to the level of existing activities. **For example,** if a manufacturing unit engaged in the manufacturing of 'Sports Shoes' wants to go ahead for expansion and diversification of its activities into manufacturing of formal shoes, the 'Accounting' may prove to be extremely helpful for taking appropriate forecasting decision.
- 2) **Proper Decision-Making:** A company is frequently required to take important decisions regarding:
 - i) Fixing the price of finished goods on the basis of their cost,

- ii) Investment level in new projects,
- iii) Increase in salary and wages of its employees/labours,
- iv) Distribution of dividends/bonus, etc.

Such decisions need to be taken very carefully, as any wrong decision may land the company into financial trouble, coming out of which may not be that easy. An efficient and effective 'Accounting System' of the company may be of immense help in taking crucial decisions by the management.

- 3) **Correct Taxation:** A company has to fulfil its obligations with regard to liabilities on account of various government taxes, e.g. service tax, income-tax, sales tax, excise duty, customs, etc. The amount of such taxes is decided on the basis of financial results reflected through financial records. An appropriate 'Accounting System' prevailing in the company facilitates determination of accurate amount of each category of tax.
- 4) **Replacing Memory:** A business entity enters into a number of financial transactions, which are complex and diversified in nature. It is not possible for any business entity to memorise every single transaction. As each transaction is recorded in writing through the 'Accounting System', the need to memorise every single transaction is not required.
- 5) **Analysing the Performance of the Business:** Maintenance of a proper record of every business transaction through Accounting enables one to ascertain the performance of a company in terms of 'Income', 'Expenditure', 'Profitability', etc. in detail. Analysis of various sub-head items can also be carried out and necessary steps may be taken to improve the performance of a company.
- 6) **Analysing the Financial Status of the Business:** Financials (mainly 'Profit and Loss Account' and 'Balance Sheet') of a company prepared on the basis of various records of business transactions depict the status of the business. While the 'Profit and Loss Account' reflects the profit made or loss incurred during a particular financial year, the 'Balance Sheet' reflects the position of assets and liabilities of the company on a specific date.
- 7) **Documentary Evidence:** Records maintained through accounting have the legal sanctity too. They can be produced as a proof in the court of law to verify the necessary business claims. As the records of business transactions are based on documentary evidence and each and every entry is supported by authentic vouchers, they are accepted by the court of law as evidence.
- 8) **Helping in Realisation of Debts:** As part of accounting process, the personal ledger accounts of all the parties, with whom a company deals with, are prepared. These accounts reveal the accurate

amount due from the debtors as well as the amount payable to the creditors. They may be forwarded to the debtors for confirmation of the entries and early payment of the debts. Timely payment to the creditors may also be ensured by the company.

1.1.4. Types of Accounting

Accounting can be classified into the following types:

- 1) **Financial Accounting:** It is that type of accounting, which deals with the past data of the business, which is generally for one year and ends with the preparation of 'Financial Statements' like:
 - i) 'Profit and Loss Account', indicating the profit earned or losses incurred during a particular period, and
 - ii) 'Balance Sheet', indicating the financial position, i.e. assets and liabilities held as on the last day of the accounting period.

The 'Financial Statements' are prepared based on Generally Accepted Accounting Principles (GAAP) articulated by the accounting profession and other statutory provisions and accounting standards. Such statements are more useful for the stakeholders and outside the business entity, viz. taxmen, regulators, and other Government agencies. The essence of financial accounting lies in the fact that it highlights the 'Stewardship' (involved in responsible planning and arrangement) aspect of the accounting (and not the 'Decision-making' aspect of the accounting).

- 2) **Management Accounting:** It is that type of accounting, which is 'Forward Looking' and 'Futuristic' in nature rather than dealing with historical data and generally involves 'Cost Accounting' and 'Budgeting'. Its aim is to provide inside reporting to the manager of a company. While preparing various statements under management accounting, it is not necessary to ensure compliance with the provisions of Generally Accepted Accounting Principles (GAAP) articulated by the accounting profession and other statutory provisions and accounting standards. The essence of 'Management Accounting' lies in the fact that it highlights the 'Control', 'Planning' and 'Decision-making' aspect of the accounting (and not the 'Stewardship' aspect of accounting). The framework of management accounting is specifically designed to serve the requirement of a particular company's management.
- 3) **Cost Accounting:** It is that type of accounting, which deals with costing aspect of the business transactions. All the costs, i.e., present and future, are recorded, classified and reported under 'Cost Accounting'. It is an accounting process used to determine cost of production of a business entity by analysing input and fixed cost of production. It also captures the cost of operations of a business. Cost is measured by using various tools and techniques to:
 - i) Define various constituents of cost, viz. 'Material', 'Labour' and 'Overheads',
 - ii) Determine the basis of cost measurement, and
 - iii) Establish the basis for the use of alternate 'Cost Measurement Techniques'.

- 4) **Tax Accounting:** It is that type of accounting that primarily performs two functions, i.e., tax compliance and tax planning. Both of these functions are related to each other. Tax compliance relates to the computation of the tax liability of a business or firm. Occasionally, lengthy and complex tax forms are required to be completed to implement the tax compliance procedure. Usually, it occurs after the completion of one financial year. On the other hand, tax planning is performed before the completion of a financial year. A tax accountant provides advice to the organisation about the tax effects of different forms of transactions. This function of a tax accountant may appear to be part of managerial accounting, but due to the specialised knowledge of a tax accountant, it is required to be classified separately.
- 5) **Forensic Accounting:** It is that type of accounting which deals with accounting, auditing and investigative techniques used in the event of litigation or disputes. It helps in solving various financial issues in accordance with the prescribed Court of Law. The civil and criminal disputes requiring an assessment of the financial effects of a loss or the detection of a financial fraud are dealt with by a forensic accountant. He is regarded as an expert witness in the courts of law for the civil and criminal disputes relating to finance. Usually, the common litigations such as insurance claims, personal injury claims, suspected fraud and claims of professional negligence in a financial matter require the hiring of a forensic accountant.
- 6) **Project Accounting:** It is that type of accounting that deals with the determination of the financial progress of a project. To facilitate the same, a project accountant prepares financial reports and makes frequent analyses. Usually, it is important in project management. Its main objective is to ensure the financial success of the projects of the business. Moreover, project-oriented businesses, like construction firms, can use it as a source of competitive advantage.
- 7) **Social Accounting:** It is that type of accounting that deals with the process of reporting the effect of the business activities on the ecological and social environment. Social accounting is also referred to as Corporate Social Responsibility Reporting and Sustainability Accounting. Environmental reports along with the annual reports of the companies facilitate the social accountant to achieve his objective. This branch of accounting has not been significantly developed and is at its initial stages. However, today many business organisations are adopting social accounting due to the increasing environmental awareness among the people of the society.

1.1.5. Functions of Accounting

The step-wise functions of accounting are in the following order:

- 1) **Identifying:** Identification of the transactions relating to the business directly from the root documents.
- 2) **Recording:** Once the business transactions are identified, the next step involves proper recording thereof in terms of money.

Such recording of business transactions is carried-out in a book termed as 'Journal', which may be further sub-divided, for convenience sake, into various 'Subsidiary Books'.

- 3) **Classifying:** Various business transactions recorded in 'Journal' (or the subsidiary books) are further classified on the basis of their nature. Such classification of similar items is followed by their posting in another set of books termed as 'Ledger'.

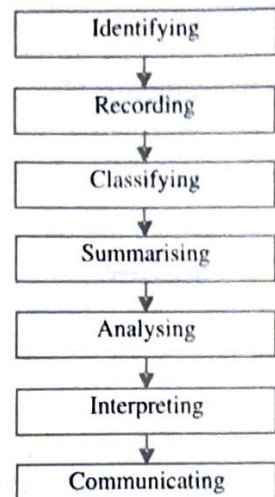


Figure 1.1: Functions of Accounting

'Journal' entries are simply recording of various business transactions without any differentiation, whereas the 'Ledger' posting is done after classifying each entry under appropriate head.

- 4) **Summarising:** The summarised information relating to the business transactions of an organisation is very useful for the stakeholders, both internal to the specific business as well as those who are external to the business. Internal users are generally the management and employees of the organisation, whereas the external users are the creditors, investors, regulators, taxmen, labour unions, trade associations, etc.
- 5) **Analysing:** An in-depth analysis of financial statements, viz. 'Profit and Loss Account' and 'Balance Sheet' of an organisation helps in identifying the financial strengths and weaknesses of the organisation. Such analysis facilitates in overcoming the weaknesses and making utilisation of the strength for the betterment of the organisation.
- 6) **Interpreting:** Interpretation of the financial statements is helpful for the management in decision-making process and formulating future business strategy with regard to growth, expansion and diversification. Other stakeholders are also benefited from such data in taking decisions from their perspective.
- 7) **Communicating:** Communicating the duly summarised and analysed financial data to other stakeholders, enables them to interpret the same in their own way, taking their interests into consideration for taking decision-making at their level.

1.1.6. Advantages of Accounting

The advantages of accounting are as follows:

- 1) **Helps in Management:** The information generated through the process of 'Accountancy' enables the management of a company to perform their job in

an efficient manner by appropriate planning, monitoring and taking decisions to the advantage of the business organisation.

- 2) **Substitute to Memory:** 'Accounting' necessitates recording of all the business transactions in a scientific and classified manner. This eliminates the need to 'memorise all the transactions' entered into by a business organisation.
- 3) **Comparative Study:** The end products of 'Accounting' are financial statements in the form of 'Profit and Loss Account' and 'Balance Sheet', which allows the management of a company to compare the annual result of a year and initiate requisite actions, necessary for the growth of the business.
- 4) **Settlement of Taxation Liability:** Proper maintenance of books of accounts ensures hassle-free assessment of tax liabilities by various Government Departments, especially 'Income Tax', 'Service Tax' and 'Sales Tax' authorities.
- 5) **Evidence in Court:** A systematic record of all the business transactions may be produced as evidence in the court of law. Courts are inclined to accept such records as 'Good Evidence'.
- 6) **Sale of Business:** In case a businessman decides to dispose of his business, maintenance of proper and accurate books of accounts become handy in estimating the cost of the business set-up and finalisation of the 'Purchase Price' by the purchaser.
- 7) **Assistance to an Insolvent Person:** In the event of an individual becoming insolvent, he is required to explain a number of business activities undertaken during the conduct of business by him. This process becomes extremely smooth, if proper books of accounts were maintained by him.

1.1.7. Disadvantages of Accounting

Following are the disadvantages of accounting:

- 1) **Non-Monetary Items Overlooked:** Under the 'Accounting System' all the business transactions, which can be expressed in terms of money, are recorded. Business transactions, which are non-monetary in nature, are completely out of the purview of the existing 'Accounting System'.
- 2) **Original Cost:** The original cost is taken into consideration, while recording the details of fixed assets. The amount spent on them, which logically should be added to their acquisition cost, is not taken into account. As a result, their true value is not reflected in the 'Balance Sheet' of the business entity.
- 3) **Possibility of Manipulation:** The 'Accounting System' envisages profit to be the only parameter to assess the performance of the company's management. This concept is illogical and need not be considered trustworthy, as certain major items

especially those relating to Research and Development, Advertisement, etc. are excluded. Further, the possibility of certain manipulations cannot be ruled out.

- 4) **Bases on Estimates:** Accounting data recorded in the books of accounts are sometimes based on estimation instead of the actual. Such data need not be correct and reliable.
- 5) **Rule of Consistency:** Some of the companies, at times, fail to observe the basic tenets of accounting. The underlying principles are compromised in certain cases. This is especially true in the case of depreciation on fixed assets, as few companies tend to frequently change their policy relating to 'depreciation on fixed assets' from year to year. Inconsistency arising due to following the policy of 'Straight Line Method' (SLM) during one year and 'Written Down Value Method' (WDVM) during the next year results in failure in depicting correct picture of the company's performance.

1.1.8. Interrelationship of Accounting with Other Disciplines

Accounting is related to other disciplines in the following manner:

- 1) **Accounting and Economics:** Economics is both the science and art of making rational decisions in relation to the use of scarce resources required for meeting the unlimited wants of humans, both at the micro and macro levels. On the other hand, Accounting is defined as a system that provides the required information to the users so they can make their opinions and decisions, both at the micro level and macro level. The economic decisions at the micro level are formulated based on the information obtained from the accounting records. In addition to this, the macro-level data of an industry is prepared by summing up the data obtained from a number of firms in the same industry in a systematic manner.
- 2) **Accounting and Statistics:** The jobs of Accountants and statisticians are almost similar as both deal with data and carry out the functions like collection, classification, tabulation, and analysis of data. Both make use of quantitative data for making decisions. An accountant often makes use of statistical methods in the evaluation of accounting data. **For example**, he can use trend analysis to determine the sales trend for the previous ten years and to forecast the sales for the next 5 years.
- 3) **Accounting and Mathematics:** To carry out the accounting calculations, it is important that the accountant should be well acquainted with the general concepts of mathematics like arithmetic and algebra. **For example**, calculation of interest, annuity, etc.

- 4) **Accounting and Law:** Business needs to work as per the laws because almost all financial transactions are regulated through various laws like the Contract Act, Sale of Goods Act, Negotiable Instruments Act, Partnership Act, Companies Act, etc. Therefore, it becomes important for an accountant to have a reasonable working knowledge of mercantile laws so that he can carry out all accounting work efficiently.
- 5) **Accounting and Management:** In any organisation, management plays an important role as it performs important functions like planning, organizing, staffing, directing, and controlling. Managers at different levels are depending on the accounting data for measuring, calculating, and decision-making purposes. To make decisions on different aspects like sales, production, cash, declaration of dividend, issue of rights, bonus to employees, bonus shares to shareholders, etc., the managers obtain data from the accounting department.
- 6) **Accounting and Engineering:** Accounting is related to engineering as both an accountant and an engineer need to work together to deal with the problems of planning and production departments. To carry out the works related to the production department, like the selection of product design, and new product development, the engineers often make use of the figures and values provided by the accountant. Hence, it becomes important for engineers to have knowledge of some simple concepts of accounting so that they can carry out their work efficiently. In the same way, an accountant requires knowledge of machines and software for handling large data. Therefore, to improve the efficiency of the entire organisation, both the accountants and engineers should work together.

According to Carter, Single Entry System is "a method or variety of methods employed for recording some transactions which ignore the two-fold aspect and consequently fails to provide the businessmen with the information necessary for him to be able to ascertain the position".

1.2.2. Features of Single Entry System

Following are the salient features of single entry system:

- 1) Under this system, transactions are recorded unsystematically.
- 2) Normally under this system, cash transactions and personal accounts are maintained whereas, the other aspects like revenue, expenses, gains, losses, assets and liabilities are not properly recorded.
- 3) The records maintained under single entry system are lacking uniformity because the organisations record transactions as per their own convenience and needs. This makes the comparison of records more difficult or even impossible.
- 4) This system is more dependent on original vouchers like sales invoice or purchase invoice etc. to derive the figures that are useful in determining the profit or loss or any other information.
- 5) This system is usually followed in small firms or enterprises.
- 6) This system records only personal account in proper way and the impersonal accounts are, fully or partially, ignored.
- 7) Accounting records under this system are not sufficient for depicting the true financial position of an organisation.

1.2.3. Types of Single Entry System

Single entry system can be classified into the following types:

- 1) **Pure Single Entry System:** The form of single entry system in which the records related to personal accounts of debtors and creditors are maintained, and all transactions related to real and nominal accounts are ignored, is known as 'pure single entry system'. This type of single entry system ignores the dual aspect concept of accounting system.
- 2) **Simple Single Entry System:** The form of single entry system in which records relating to cash transactions and personal accounts of debtors and creditors are maintained, is known as 'simple single entry system'.
- 3) **Quasi Single Entry System:** The form of single entry system in which records relating to personal accounts of debtors and creditors, cash book and some of the subsidiary books are maintained, is known as 'quasi single entry system'. Although, the records maintained under this book goes beyond the maintenance of personal book but, even then

1.2. SINGLE ENTRY SYSTEM

1.2.1. Meaning of Single Entry System

An accounting system is said to be a single entry system, when the accounting records maintained are not strictly following the double entry system. It is also known as the **incomplete records**. However, it is inappropriate to call it is a single entry system because, there is no such system existing in accounting. Sometimes, this term is referred to as a short-cut method to the double entry system but, it is not so. Instead, it is better to refer it as a mechanism of maintaining accounting records in which the recording of some transactions is done by following the double entry system, whereas in other cases either only one sided entry is made or no entry is made. Under this system, information related to cash and personal accounts of debtors and creditors are recorded systematically by complying with the principles of double entry system, while the information related to expenses, revenues, assets and liabilities are recorded in a partial way. Therefore, such mechanism of maintaining records is usually known as **incomplete records**.

the records are not sufficient to be said as the complete because, the cash book and subsidiary books maintained under this form records only the entries that are related to the personal accounts.

1.2.4. Merits of Single Entry System

The merits of single entry system are as follows:

- 1) The cost incurred on maintaining the records through this system is quite low, and therefore it is useful for small traders and firm.
- 2) The maintenance of records under such system does not require having deep knowledge of accounting.
- 3) The recording of unforeseen events can be done conveniently.
- 4) The position of business can be ascertained, even in absence of proper records or if the records maintained by the organisation are damaged due to fire, water, loss of property etc.

1.2.5. Demerits of Single Entry System

The demerits of single entry system are as follows:

- 1) This accounting system does not involve the preparation of trial balance hence the arithmetical accuracy of accounts cannot be checked.
- 2) This accounting system does not involve the preparation of Trading and Profit and Loss Account hence the actual profit or loss of organisation cannot be determined.
- 3) This accounting system does not involve the preparation of Balance Sheet hence the true financial position of organisation cannot be determined.
- 4) The accounting records maintained under this system cannot be audited.
- 5) This accounting system creates various hindrances in operation of internal control system.
- 6) This accounting system creates various hindrances in supervising the internal control system.
- 7) An organisation complying with this system face difficulty in having control over the assets of the business.
- 8) The system is not efficient for identifying the frauds.
- 9) The Courts, Sales Tax and Income Tax Authorities do not recognise these records as the valid documents or proofs.

1.3. DOUBLE ENTRY SYSTEM

1.3.1. Meaning of Double Entry System

The 'Double Entry' system of accounting is based on the fact that every financial transaction has equal and opposite effect in at least two different accounts. It is used to satisfy the equation $\text{Assets} = \text{Liabilities} + \text{Equity}$, whereby each entry is recorded so as to maintain the relationship. Under double entry system

dual aspect of a business transaction is recorded in terms of 'Debit and Credit'. The 'Double Entry System' of book-keeping is the underlying basis of the standard system practised by most of the accountants and the business enterprises to record 'Financial Transactions'. This system, also known as the Venetian method of accounting and was first introduced by an Italian mathematician, **Luca Pacioli**. This new system revolutionised the business and Pacioli was given a place in history as "**The Father of Accounting**".

'Double Entry System' of bookkeeping ensures that a company or individual keeps track of credits and debits and thereby keeps the accounts in balance. The system is called 'Double Entry System' as every financial transaction is recorded in two columns, debit on the left side and credit on the right side, ensuring that the ways in which each transaction affects the company's finances is properly recorded.

To have a better understanding of the concept, other example may be taken:

A shopkeeper (ABC) sells a T.V. set to another shopkeeper (XYZ) for ₹45,000 in cash. The dual aspect of this transaction in the books of 'ABC' and 'XYZ' would be as under:

Dual Aspect for 'ABC'	Dual Aspect for 'XYZ'
Receipt of cash – ₹45,000	Payment of cash ₹45,000
Forgoing of a T.V. set worth ₹45,000	Receipt of T.V. set worth ₹45,000
The two accounts impacted would be 'Sales' and 'Cash'	The two accounts impacted would be 'Cash' and 'Purchase'

1.3.2. Features of Double Entry System

The salient features of the double entry system are as follows:

- 1) Each and every business transaction has dual aspect or two-fold effect.
- 2) One of the dual aspects is 'Receiving Aspect' and the other one is a corresponding 'Giving Aspect'.
- 3) The 'Receiving Aspect' and 'Giving Aspect' are referred to as 'Debit' and 'Credit' respectively.
- 4) In every transaction, two parties are involved – one is the 'Receiver' and the other is the 'Giver'.
- 5) For every 'Debit' there is a corresponding 'Credit'.
- 6) The amount being paid by the 'Giver' is being received by the 'Receiver'.
- 7) The total of 'Debit' side of a business transaction is always equal to the total of the 'credit' side of the same transaction.
- 8) Each and every business transaction influences two accounts equally in the opposite directions.

1.3.3. Difference between Single Entry System and Double Entry System

Basis of Difference	Single Entry System	Double Entry System
1) Types of Accounts	It is concerned with the maintenance of only cash book and personal accounts.	It is concerned with the maintenance of all types of accounts – personal, real or nominal.
2) Accuracy	This system lacks accuracy because it does not maintain the complete records.	This system ensures accuracy because it maintains the complete records.
3) Final Accounts	The accounting records available under this system provide only the estimated value of assets and liabilities therefore, these are not useful for preparation of final accounts.	The accounting records available under this system provide the actual value of assets and liabilities therefore, these are useful for preparation of final accounts.
4) Ascertainment of Profit	Under this system, the profit or loss is ascertained through statement of affairs.	Under this system, the profit or loss is ascertained through trading and profit and loss account.
5) Ascertainment of Financial Position	It is useful for ascertaining the financial position of a firm through statement of affairs.	It is useful for ascertaining the financial position of a firm through Balance Sheet.
6) Difficulty in Tracing any of the Asset or Liability	Under this system, it is very difficult to determine the omitted assets and liabilities during recoding.	Under this system, it is easy to determine the omitted assets and liabilities during recoding, if the balance sheet is not matched.
7) Complete Records	The complete records of all transactions are not maintained under this system.	The complete records of all transactions are maintained under this system.
8) Legal View	The legal authorities such as court, sales tax and income tax authorities are not recognising it as a complete system.	The legal authorities such as court, sales tax and income tax authorities are recognising it as a complete system.

1.4. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

1.4.1. Meaning and Definition of Generally Accepted Accounting Principles

The 'Principle' may be defined as "The fundamental generalisation that is accepted as true and that can be used as a basis for conduct". However, in the present context 'Accounting Principles' means the rules and guidelines that companies are required to follow while

reporting the financial data. Such principles differ from one country to another around the world, and each country usually has its own version of Generally Accepted Accounting Principles (GAAP).

According to American Institute of Certified Public Accountants (AICPA) in their Accounting Terminology Bulletin defines the Principles as "A general law or rule adopted or proposed as a guide to action, a settled ground or basis of conduct or practice".

Accounting principles may be defined as, "Those rules of action or conduct which are adopted by the accountants universally while recording accounting transactions". This is also known as 'Generally Accepted Accounting Principles' (GAAP).

Generally Accepted Accounting Principles may be defined as, "Those rules of action or conduct which are derived from experience and practice and when they prove useful, they become accepted as principles of accounting".

1.4.2. Features of Generally Accepted Accounting Principles

All the accounting principles essentially display the following features:

- 1) **Based on General Rules:** The foundation of accounting principles are "general rules", 'conventions', and 'certain assumptions' recognised by all the stakeholders, viz. accountants, auditors, managers, regulators, and various Government agencies. It is worthwhile to highlight the fact that the accounting principles cannot be considered perfect and there is no way to ensure their correctness.
- 2) **Launched on the Basis of Logic and Experience:** 'Accounting Principles' have no statutory background and, as mentioned earlier, they are based on general 'logic', 'conventions' and 'certain assumptions'. Formulation of accounting principles are dependent upon the practical expectations/requirements of all the stakeholders, viz. creditors, shareholders, regulators, tax-authorities, law enforcement and other Government agencies.
- 3) **Widely Accepted:** One of the most important features of accounting principles is their acknowledgement/recognition by all the stakeholders. It is very common for an organisation to have some deviations from the common accounting practices to suit its requirements, which is accepted by all.

For example, a 'Hire-Purchase' company has an option to use either 'Asset Accrual Method' or 'Total Cash Price Method' for accounting hire-purchase transactions.

1.4.3. Classification of Generally Accepted Accounting Principles

Accounting rests on a small set of fundamental assumptions and principles. These fundamentals are referred to as the 'Generally Accepted Accounting Principles' (GAAP). Understanding the principles gives context and makes accounting practices easier to implement. The underlying objective of 'Accounting Statements' is the true, fair and authentic reflection of the business operations and its results. This objective is achieved through the support of 'Accounting Concepts' and 'Accounting Conventions', which are the two components of the accounting principles.

Accounting principles can be categorised into two parts:

- 1) Accounting Concepts, and
- 2) Accounting Conventions.

1.5. IFRS (INTERNATIONAL FINANCIAL REPORTING STANDARDS)

1.5.1. Introduction

International Financial Reporting Standards (IFRS) were introduced by the **International Accounting Standards Board (IASB)**, which took over the job of harmonisation of accounting standards throughout the world from the International Accounting Standards Committee (IASC) in the year 2001. The standardisation of international accounting practices was necessitated in view of the growing phenomenon of globalisation and with a view to fulfil the day to day need; IASC was brought into existence in the year 1973.

IASB which replaced IASC, is also a 'not for profit' and independent body, the primary objective of which is to develop a set of quality standards pertaining to the financial reporting, which is easy to understand and is acceptable all over the globe for the preparation of financial statements. IFRS is, thus, quite different from the IAS (International Accounting Standards), which were developed by the erstwhile IASC.

IFRS have been developed with a view to provide a common structure and guidelines for the entire world as to how the public companies need to prepare their financial statements with necessary disclosures in a transparent manner. The guidelines framed under IFRS for the preparation of financial statements are general in nature, and as such applicable to all kinds of business and industries; there are no industry-specific rules. Such standards are of immense significance for those business entities which have their businesses spread over a number of countries across the globe or those who have future plan to expand globally. A single set of

widely accepted financial standard facilitates integration and simplification of financial statements prepared by the branches spread over various parts of the world. Other stakeholders also find it convenient to understand the overall performance and financial health of a company and take appropriate decisions.

Table below gives an overview of the IFRS as of September 2005. The table comprises both the main standards (IFRS) and the interpretations of the Standing Interpretation Committee (SIC) and International Financial Reporting Interpretation Committee (IFRIC).

Conceptual Framework	
CF Framework for the Preparation and Presentation of Financial Statements	
IAS 40	Investment property
IAS 41	Agriculture
IFRS 1	First-time Adoption of International Financial Reporting Standards
IFRS 2	Share-based Payment
IFRS 3	Business Combinations
IFRS 4	Insurance Contracts
IFRS 5	Non-current Assets held for Sale and Discontinued Operations
IFRS 6	Exploration for and Evaluation of Mineral Resources
IFRS 7	Financial Instruments: Disclosures
Interpretations	
SIC 7	Introduction of the Euro (IAS 21)
SIC 10	Government Assistance – No Specific Relation to Operating Activities (IAS 20)
SIC 12	Consolidation – Special Purpose Entities (IAS 27)
SIC 13	Jointly Controlled Entities – Non-Monetary Contributions by Venturers (IAS 31)
SIC 15	Operating Leases – Incentives (IAS 17)
SIC 21	Income Taxes – Recovery of Revalued Non-Depreciable Assets (IAS 12)
SIC 25	Income Taxes – Changes in the Tax Status of an Enterprise or its Shareholders IAS (12)
SIC 27	Evaluating the Substance of Transactions involving the Legal Form of a Lease
SIC 29	Disclosure – Service Concession Arrangements
SIC 31	Revenue – Barter Transactions Involving Services
SIC 32	Intangible Assets – Web Site Costs
IFRIC 1	Changes in Existing Decommissioning, Restoration and Similar Liabilities
IFRIC 2	Members' Shares in Co-operative Entities and Similar Instruments
IFRIC 3	Emission Rights (withdrawn by the Board in June 2005)
IFRIC 4	Determining Whether an Arrangement contains a Lease
IFRIC 5	Rights to interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds

1.5.2. Features of IFRS

The salient features of IFRS are as follows:

- 1) **Principle Based Approach:** The rules framed under IFRS are broad based and not very elaborative, prescriptive or inflexible in nature. They are basically founded upon various principles and some of the regulatory outcomes. This approach does not envisage micro-management at any level, and the business entities are free to use

their commercial judgement/discretion within the overall framework of IFRS. It has given a long rope to the management of a business entity for taking decision with regard to:

- i) The accounting methodology to be adopted by them, and
- ii) Assessment of recounting figures, during the preparation of financial statements.

Principle-based approach is diametrically opposite to the rule-based approach inasmuch as the latter lacks flexibility as far as alignment of business objectives and processes with regulatory outcomes are concerned. Such approach (rule-based) entails specific course of action, if certain conditions are fulfilled.

- 2) **Fair Value Accounting:** The accounting based upon the historical cost-based principles suffers from a number of shortcomings. IFRS encourages the fair value accounting principles, which are considered forward-looking and a superior one as compared with the historical cost-based principles (i.e. GAAP). Financial reporting based upon the fair-value of accounting principles is most suitable for the potential investors, who get preference over other stakeholders under the IFRS. The logic behind this is very simple; the investors/potential investors believe in the power of market forces and market-based valuation of assets is acceptable to them for taking decisions with regard to buying or selling of stocks. Under IFRS, a number of items appearing in the financial statements are based upon the principles of fair-value accounting.
- 3) **Comprehensive Income:** The concept of comprehensive income is of recent origin in the evolution process of accounting standards and it occupies an important place in the agenda of IFRS. Comprehensive income provides transparency in showing all revenue expenses, gains, losses, etc. to be recognised during a specific timeframe. Their summary is recorded in a special financial statement, termed as the 'statement of comprehensive income'.
- 4) **Consolidation:** Under the consolidation technique, which is a part of IFRS, the assets and liabilities of a company's subsidiaries are required to be valued at their fair value as on the date of the acquisition. As a sequel to this, the minority interest (also referred to as **non-controlling interest**) is also valued at fair value on the same date. This is a significant departure from the traditional GAAP standards, under which the minority interest is excluded from the fair value adjustments.
- 5) **Transparency:** Transparency is yet another striking feature of IFRS. Transparency in accounting, and especially in the preparation of financial statements, comes from the underlying and strong faith in the market forces; it is presumed that the markets are competent enough, and as such the information communicated to various

stakeholders through the financial statements, are reflected in the stock prices of a company also in an accurate and reliable manner.

This feature of IFRS, which is qualitative in nature, enables stakeholders of a company, particularly the investors, to take necessary decisions on the basis of relevant information.

1.5.3. Objectives of IFRS

IFRS were developed and recommended while considering following objectives in mind:

- 1) To make available in the public interest, a single set of financial reporting standards on the basis of principles, which are of high quality, easy to understand, enforceable and acceptable to the entire global community. These standards, *inter-alia*, require the financial statements and other reports prepared by a company to be of high quality and transparent, which provide comparable information for various stakeholders including the investors, the player in the world's capital markets, and other users, so as to enable them to take necessary decisions;
- 2) To encourage the application of the standards under the IFRS amongst various stakeholders to the maximum possible extent;
- 3) To take into account suitably, the requirements of an array of sizes and types of entities in different economic settings prevailing in the world; and
- 4) As the standards and interpretation thereof were originated from IASB, one of the objectives of IFRS is to facilitate its adoption by various business entities spread over the globe. For this, it is necessary to integrate the national accounting standards of a country with the IFRS.

1.5.4. Needs for IFRS/Significance of IFRS

The aim behind to adopt these standards to make sure the financial centers of the world, that are connected with each other, can use a **global financial reporting** framework that helps to regulate the working of financial markets. There are the reasons to adopt the IFRS are as follows

- 1) **Improved Consistency and Transparency of Financial Reporting:** It provides benefits like, high quality, transparent, understandable, and globally accepted reporting standards for making the financial statements.
- 2) **Benefits the Economy:** It helps in economy growth by the expansion of domestic business to international business.
- 3) **Level of Confidence:** The main advantage of adopting IFRS, which is considered to be a stable, transparent, and fair accounting system across the world, would be that the confidence level of investors – domestic as well as foreign – would be boosted.

- 4) **Risk Evaluation:** If the financial data and other statements are not prepared in terms of international standards, the investors generally assign some premium. Introduction of IFRS would rule out such hurdle to cross-border listings and as such the investors would be the gainers.
- 5) **Merger and Takeover Activity:** As the introduction of IFRS would eliminate the need to redesign the financial statements, the way to cross-border mergers and acquisitions would be facilitated.
- 6) **Investments:** If the IFRS are introduced in a country, and various business entities become IFRS compliant, the comfort level of foreign investors would be enhanced and they would find such destinations more lucrative.
- 7) **Opportunities for Accounting Professionals:** It provides opportunities to the accounting professionals in the world if similar accounting practices are adopted throughout the world.

1.6. INDIAN ACCOUNTING STANDARDS

1.6.1. Meaning of Accounting Standards

Accounting Standards comprise accounting guidelines and rules which are required to be followed while preparing financial statements. Accounting Standards are closely related to **Generally Accepted Accounting Principles (GAAP)**. These standards provide elaborate and clear rules for accounting treatment of various business transactions. This helps in achieving standardisation and homogeneity in internal as well as external record keeping and reporting purpose. These standards are issued by the qualified supervisory authorities, accounting bodies or governments.

The main purpose of Accounting Standards is to provide guidelines to the accounting professionals in the process of identifying, computing, presenting and releasing financial trades. The primary aim of Accounting Standards is to help bringing about universal consistency in reporting. Following Accounting Standards also help to fill the differences in accounting practices and make these reports comparable. At the very same time, it should be made absolutely clear that Accounting Standards are not meant to bring about inflexibility. These standards only offer guidelines with the aim of making financial statements easy to understand.

1.6.2. Accounting Standards Board of India

Accounting Standards Board of India, was established by The Institute of Chartered Accountants of India (ICAI), in April 1977. The Board was constituted to bring about uniformity in Indian accounting procedures.

Accounting Standards Board is primarily responsible for ensuring that its formulated standards are established by the Council of Institute of Chartered Accountants of India.

1.6.3. Objectives & Functions of the Accounting Standards Board of India

Accounting Standards Board of India has following objectives:

- 1) To identify and propose areas which require Accounting Standards to grow.
- 2) Formulation of Accounting Standards to aid the Council of ICAI in the formation of Accounting Standards in India.
- 3) To study International Accounting Standards as well as Reporting Standards to determine their applicability in Indian scenario.
- 4) Review Accounting Standards to keep them relevant to changed scenarios.
- 5) Offer interpretation and guidance on Accounting Standards.
- 6) Workout other related functions to Accounting Standards.

1.6.4. Benefits of Accounting Standards

Accounting Standards have following main advantages:

- 1) **Decreases Deviations:** Accounting Standards helps to decrease the instances of deviation between the treatment of various accounting transactions, which are helpful for making uniform financial statements.
- 2) **Better Reporting:** Accounting Standards helps in providing better picture of financial situation of the concern. It generally provides wider disclosure than required by law.
- 3) **Makes Comparison Easier:** Since Accounting Standards help in homogenising, recording and reporting of financial transactions, it also makes comparison easier between similar occurrences of companies located at same or different countries. However, it should be observed that the reporting may differ due to different legal requirements followed in different countries.

1.6.5. Accounting Standards Issued by ICAI

Following are the Accounting Standards issued by Institute of Chartered Accountants of India:

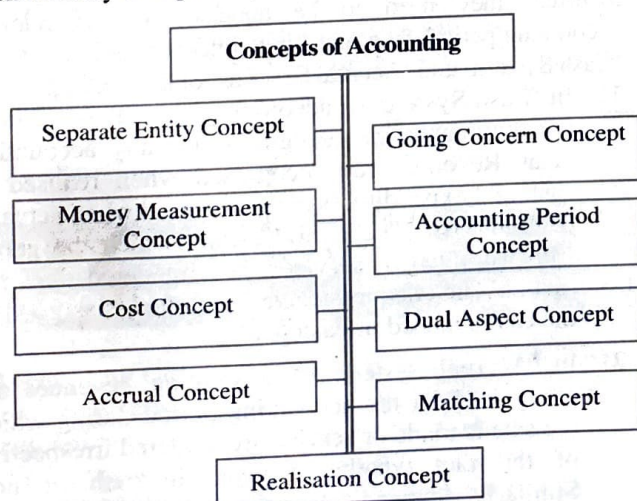
AS No.	Title	Mandatory from Accounting Period Beginning on or After
AS 1	Disclosure of Accounting Policies.	1.4.1991
AS 2	Valuation of Inventories.	1.4.1999
AS 3	Cash Flow Statements.	1.4.2000
(Revised)		
AS 4	Contingencies and Events occurring after Balance Sheet Date.	1.4.1995
(Revised)		
AS 5	Prior Period and Extraordinary Items and Changes in Accounting Policies.	1.4.1996
(Revised)		

AS 6 (Revised)	Depreciation Accounting.	1.4.1995
AS 7	Accounting for Construction Contracts.	1.4.2003
AS 8	Accounting for Research and Development.	1.4.1991
AS 9	Revenue Recognition.	1.4.1991
AS 10	Accounting for Fixed Assets.	1.4.1991
AS 11 (Revised 2003)	Accounting for the Effects of Changes in Foreign Exchange Rates.	1.4.2004
AS 12	Accounting for Government Grants.	1.4.1995
AS 13	Accounting for Investments.	1.4.1995
AS 14	Accounting for Amalgamations.	1.4.1994
AS 15	Accounting for Retirement Benefits in Employer's Financial Statements.	1.4.1995
AS 16	Borrowing Costs.	1.4.2000
AS 17	Segment Reporting.	1.4.2001
AS 18	Related Party Disclosures.	1.4.2001
AS 19	Leases.	1.4.2001
AS 20	Earnings Per Share.	1.4.2001
AS 21	Consolidated Financial Statements.	1.4.2001
AS 22	Accounting for Taxes on Income.	1.4.2001
AS 23	Accounting for Investments in Consolidated Financial Statements.	1.4.2002
AS 24	Discontinuing Operations.	1.4.2004
AS 25	Interim Financial Reporting.	1.4.2002
AS 26	Intangible Assets.	1.4.2003
AS 27	Financial Reporting of Interest in Joint Ventures.	1.4.2002
AS 28	Impairment of Assets.	1.4.2004
AS 29	Provisions, Contingent Liabilities & Contingent Assets.	1.4.2004

1.7. CONCEPTS OF ACCOUNTING

The word 'Concept' may be defined as "a general idea or understanding of thought". It is an idea of what thought is or how it works. "Accounting concepts" are the necessary assumptions, conditions or postulates upon which the accounting is based.

Following are the accounting concepts, which have been broadly accepted by accountants:



1.7.1. Separate Entity Concept

There is a presumption under 'Separate Entity Concept' that as far as accounting is concerned the 'owners of a business organisation' and the 'business organisation itself' are two independent and separate entities. The business transactions undertaken by the owner are altogether separate from the personal transactions undertaken by him. **For example**, the capital invested by the owner in a business is recorded as a liability for the business. Similarly, if any asset (including cash or goods) belonging to the business is taken by the owner for his personal use, it is not considered as business expenditure, instead it is treated as '**withdrawal**' or '**drawing**' by the owner. This is the cornerstone of 'Accounting Concepts'.

1.7.2. Going Concern Concept

Going concern is one of the fundamental assumptions in accounting on the basis of which financial statements are prepared. The assumption is that a business entity will continue to operate in the foreseeable future without the need or intention on the part of management to liquidate the entity and it will realise its assets and settle its obligations in the normal course of the business. In simple words, it means that every business entity has continuity of life and it will not be dissolved in the near future. The assumption of going concern is the basis of all the financial transactions of a business entity like entering into long-term contracts with other parties, obtaining loans from banks/financial institutions, extending loans, investing in long-term securities, purchasing bonds/debentures, etc. This concept also enables a business entity to defer some of their costs like prepaid expenditure, closing stocks, etc. which are required to be charged against future incomes.

1.7.3. Money Measurement Concept

In accounting, every transaction is recorded in terms of money, i.e. rupees and paise in India. Receipt of income, payment of expenses, purchase and sale of assets, etc., are monetary transactions and therefore are recorded in the books of accounts. The assumption under money measurement concept enables to have a common measure, in terms of money, for all the transactions, assets and liabilities, which facilitate the preparation of financial statements. This concept would be better understood with the help of a few **examples**. A company, on a particular day, makes some purchases, viz. 10 office chairs, 50 meters of curtain cloth and 20 rims of A-4 paper, all of which have different measuring units. However, as all the transactions can be measured in terms of money, they can be easily recorded in the books of accounts.

1.7.4. Accounting Period Concept

An accounting period is the interval of time at the end of which the financial statements are prepared to ascertain the financial performance of a company. This is known as accounting period concept. Although the "going concern" concept emphasises the continuing nature of an

organisation, it is necessary to review its performance. The preparation of financial statements (balance sheet and profit & loss account) at periodic intervals (known as accounting period) helps in taking timely corrective action and developing appropriate strategies. The accounting period is generally of twelve months (which may be a calendar year or a financial year), although it may be for three months or six months as well in case of new startup. Preparation of financial statements also serves some other purposes like calculation of profit, tax calculation, submission of reports to regulators and other Government agencies, etc.

1.7.5. Cost Concept

As per this concept, cost of an asset is recorded in the books of accounts at the price paid to acquire it (including overheads like transportation and installation charges, if any) and not at the market price. Fixed assets, e.g., land, building, plants, machinery, furniture, fixtures, etc. are taken in the record at the price paid for acquiring them, which is also termed as 'Historical Cost'. However, the cost of assets recorded at the time of purchase may be systematically reduced through depreciation. The significance of cost concept is that the records kept on the basis of it are considered as consistent, comparable, verifiable and reliable.

This concept may be better described through an **example**. If a piece of land is purchased to set-up a factory for ₹50,000 in the books of accounts this would be recorded at ₹50,000 only. After sometime there may be an increase in the market value of the land, but in the books of account, the cost would continue to be shown at ₹50,000 only. Further, at the end of the financial year the land would be subject to depreciation and the reduced cost would be taken over as the opening balance for the next financial year. This will be repeated year after year and the cost would be shown at a lower level despite appreciation in the market price of the land.

1.7.6. Dual Aspect Concept

This is the fundamental concept of accounting. This concept follows from the Entity Concept. All entities own certain assets. Such assets are acquired through contributions of those who have provided the funds for the purpose. Funds are made available either through the surplus of the entity or loans. Logically such providers of funds are claimants to the assets. At any point of time, the assets will be equal to the claims. It may thus be concluded that each and every transaction, a business entity enters into, has a dual effect. With every increase in the money owed to others, there has to be an equal increase in assets or loss.

This concept supports the accounting equation, i.e.,

$$\text{Assets} = \text{Owner's Funds (Capital and Reserves)} + \text{Liabilities, Or}$$

$$\text{Owner's Funds} = \text{Asset} - \text{Liabilities}$$

This concept may be understood in a better way by an **example**. A business is started by Mr. 'X' with an investment of ₹2,50,000. This transaction has two aspects, viz. 'Capital Account' and 'Asset Account'. While the amount lying in 'Capital Account' (₹2,50,000) is a liability for the business (which it owes to Mr. 'X'), whereas the amount lying in 'Asset Account' (₹2,50,000) is an asset for the business.

1.7.7. Accrual Concept

Under the cash system of accounting, the incomes and expenditures are recorded only if there is actual receipt or payment in cash, irrespective of the accounting period to which they belong. But, under the accrual concept, occurrence of claims and obligations in respect of incomes or expenditures, assets or liabilities, diminution in values, etc., are recorded even though actual receipts or payments of money may not have taken place. This concept depicts that incomes and expenses need to be recognised as and when they are earned and incurred respectively, notwithstanding the fact whether the money is actually received or paid in this regard.

This concept may be understood in a better way by an **example**. If a company dealing in medicines gets supply of medicine worth ₹20,000 on March 29, 2019 (during the year 2018-19) and the payment is made on April 2, 2019 (during the year 2019-20), under the accrual system, the expenditure though incurred during 2019-20 needs to be recognised for the year 2018-19 (the year during which the supply was made).

1.7.8. Matching Concept

The matching concept is an outcome drawn from the accrual concept. It emphasises that the revenue earned and the expenditure incurred must belong to the same accounting period. To ascertain the surplus or deficit made by a business entity during an accounting period, it is necessary that the costs incurred are matched with the revenue earned by the entity during that accounting period. Therefore, once the revenue is realised or expenditure incurred, they need to be allocated to the relevant accounting period. The matching concept is different under 'Cash System' and 'Accrual Systems' of accounting:

- 1) In 'Cash System' of accounting only actual receipts and payments are recognised for any accounting year. Revenues are recognised when realised in cash and expenditures are recognised when actually paid in cash. The period during which the goods were supplied or services were rendered does not matter. The cheque received or issued is as good as the cash realised or cash paid.
- 2) In 'Accrual System' of accounting, revenues are recognised for the accounting period during which the sale is made or service are rendered irrespective of the fact whether realised in cash or not. Similarly, expenditures are recognised for the

accounting period during which they are incurred (on due basis), whether paid in cash or not. This process of recognising and relating expenses with revenues is called **matching concept**.

1.7.9. Realisation Concept

According to this concept, revenue needs to be accounted for only when it is actually realised or it has become certain that the revenue will be realised. However, in order to recognise revenue, actual receipt of cash is not necessary. What is important is that the organisation should be legally entitled to receive the amount for the services rendered or the goods sold. 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. It means that selling of goods is realisation, whereas receiving order is not.

This concept may be understood in a better way by an **example**:

- 1) A telecommunication company sells talk-time through scratch cards. No revenue is recognised when the scratch card is sold, but it is recognised when the subscriber makes a call and consumes the talk-time.
- 2) A monthly magazine receives 1,000 subscriptions of ₹240 to be paid at the beginning of the year. Each month it recognises revenue worth ₹20,000 [$(₹240 \div 12) \times 1,000$].

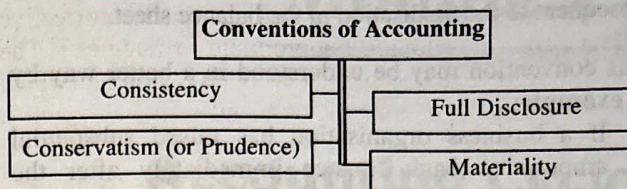
1.7.10. Importance of Accounting Concepts

- 1) The importance of the accounting concept is visible in the fact that its application is involved in every step of recording a financial transaction of the entity.
- 2) Following the generally accepted accounting concepts helps save the accountants' time, effort, and energy, as the framework is already set.
- 3) It improves the quality of financial statements and reports concerning the understandability, reliability, relevance, and comparability of such financial statements and reports.
- 4) Provide financial information to the investors and show the financial status of the entity;
- 5) A clear understanding of how every business transaction has been recorded;
- 6) Uniformly accepted financial report – which assists in better understanding of financial information;

1.8. CONVENTIONS OF ACCOUNTING

'Accounting Conventions' are the guidelines that arise from the practical application of accounting principles. They are not a legally binding practice, rather they are generally accepted practices based on customs, and are designed to help accountants to overcome practical

problems faced by them during the preparation of financial statements. As customs change, so will accounting conventions.



1.8.1. Consistency

The convention of consistency emphasises that the accounting principles/practices followed by an entity should be consistently applied by it over the years so as to achieve compatibility. It facilitates comparison of financial performance of an entity from one accounting period to another.

This convention may be understood in a better way by an **example**:

- 1) There are a number of methods for the valuation of inventories, viz. 'First In First Out' (FIFO), 'Last In First Out' (LIFO), or 'Weighted Average Method'. If an organisation has adopted one method of valuation say 'Weighted Average Method' during one accounting year, the same method needs to be followed during the subsequent accounting years. Any change in the method of inventory valuation would distort the financial results in a substantial manner. In case a change is made, it should be disclosed.
- 2) Similarly, the method of providing depreciation, provision for bad and doubtful debts, change from 'Cash Basis' to 'Accrual Basis' are some of the examples where there are a number of options available to the business entities. But once a method is adopted, the same method should be continued in the forthcoming financial years, so as to maintain consistency. Any change, if at all necessitated, needs to be disclosed properly, as it would result in a difficulty for the stakeholders to compare the financial performances.

1.8.2. Full Disclosure

The term "disclosure" implies that there must be a sufficient exposure of information which is of material interest to all the stakeholders, viz. owners, creditors, lenders, investors, public, etc. The accounts and the financial statements of an entity should disclose full and fair information to the beneficiaries in order to enable them to form a correct opinion on the performance of such entity, which in turn would allow them to take informed and correct decisions.

For example, the Accounting Principles that have been followed for preparation of the Financial Statements should be disclosed along with the Financial Statements for proper understanding and interpretation of the same. Further, any other information relevant to the users of the

financial statements should also be disclosed. Such information may pertain to the period covered by the financial statement or may even those pertain to the period subsequent to the finalisation of the balance sheet.

This convention may be understood in a better way by an **example**:

- 1) If a business organisation has raised substantial amount of bank finance immediately after the balance sheet date but before the finalisation of its balance sheet, it needs to be disclosed appropriately in the financial statements. **For example**, if the balance sheet data is 31st March, 2018, and the business has availed finance on 25th April, 2018, then the amount of bank finance will be disclosed to the period subsequent i.e., 31st March, 2019.
- 2) The figures of the sundry debtors should necessarily be accompanied by the figure of Bad and Doubtful Debts (BDDs) and the provisions made against such BDDs.

1.8.3. Conservatism (or Prudence)

This convention means a cautious approach or policy of having a conservative approach. According to this convention, the anticipated profits need to be ignored but all anticipated losses need to be provided for, in the books of accounts of an entity. In other words, all the prospective losses are taken into consideration, while no doubtful income is taken into consideration in recording of transactions by an entity. This convention also states that the financial statement should be made on verifiable evidence. There are numerous examples of the 'Convention of Conservatism', which are adopted and practiced by many of the business organisations. Some of them are stated in the following points:

- 1) Providing for the Bad and Doubtful Debts (BDD) in the anticipation of some debtors' inability to pay their debts.
- 2) Providing for 'Discount' on debtors.
- 3) Valuation of the 'Stock-in-hand' at the 'Market Price' or 'Cost Price', whichever is lower.
- 4) Creation of 'Investment Fluctuation Reserve'.
- 5) 'Capital Expenditures' of small amount (like crockery purchase) are charged as 'Revenue Expenditure'.

1.8.4. Materiality

The term material refers to the relative importance of an item or event. An item should be regarded as material, if there is a sufficient reason to believe that knowledge of it would influence the decision of informed creditors, lenders, investors, public and other stakeholders.

The accounts and the financial statements should impart importance of all material information so that true and fair view of the state of affairs of the entity is given to its beneficiaries. Hence, keeping the convention of materiality in view, unimportant items are not disclosed separately and are merged with other items.

The concept of materiality is relative. What is material for a small company may not be material for a large company. The cost of small tools may be material for a small vehicle repair workshop, but the same may not be material for large manufacturers of vehicles.

Similarly, the nature of a transaction is also important in deciding the 'Materiality'. A difference of ₹1,000 in cash would be considered 'Material', whereas the difference of the same amount (₹1,000) otherwise would be considered 'Immaterial'.

1.9. EXERCISE

1.9.1. Very Short Answer Type Questions

- 1) Define accounting.
- 2) What is single entry system?
- 3) What do you mean by double entry system?
- 4) What is GAAP?
- 5) What is IFRS?
- 6) What is accounting standard?
- 7) What is convention of conservatism?

1.9.2. Short Answer Type Questions

- 1) Discuss the objectives of accounting.
- 2) State the different types of single entry system.
- 3) How single entry system is different from double entry system?
- 4) What are the features of GAAP?
- 5) Briefly explain the advantages of IFRS.
- 6) Explain the benefits of accounting standards.
- 7) Why is the going concern concept postulate control to accounting practice?

1.9.3. Long Answer Type Questions

- 1) Elaborate the need and types of accounting.
- 2) Explain the relation of accounting with other disciplines.
- 3) Discuss the features and objectives of IFRS.
- 4) Mention the accounting standards issued by ICAI.
- 5) Discuss the concepts and conventions of accounting.