UNIT 1 ACCOUNTING: AN OVERVIEW

Structure

1.0 OBJECTIVES

After studying this unit you should be able to appreciate:

- the need for accounting;
- definition of accounting and its objectives;
- describe the advantages and limitations of branches of accounting;
- identify the parties interested in accounting information;
- activities of a management accountant;
- identify the stages involved in accounting process;
- explain the accounting concepts to be observed at the recording and reporting stages; and
- understand and appreciate the Generally Accepted Accounting Principles.

1.1 INTRODUCTION

In business numerous transactions take place every day. It is humanly impossible to remember all of them. With the help of accounting records the businessman is able to ascertain the profit or loss and the financial position of the business at a given period and communicate such information to all interested parties. In this unit you will learn about an overview of accounting and the basic concepts which are to be observed at the recording and reporting stage. You will also learn different stages involved in accounting process and importance of accounting standards to maintain uniformity in the practice of accounting.

1.2 NEED FOR ACCOUNTING

In early days the business organisations and transactions were small and easily manageable by the owners of the business themselves. The businessmen used to remember the transactions by memorizing them. In those days accounting developed as a result of the needs of the business to keep relationship with the outsiders, listing of their assets and liabilities. The advent of industrial revoluation and technological changes have widened the market opportunities. Most of the business concerns in these days are run by company type of organisation. The business concern has constantly enter into transactions with outsiders. A transaction involves transfer of money or money's worth (goods or services) from one person to another. In addition to the transactions with outsiders, there are also events requiring monetary record.
It is not possible for a human being to keep in memory all the transactions. Therefore, it is necessary to record all these transactions properly to get required financial information. With the help of accounting records the businessman would be able to ascertain the profit or loss and the financial position of his business at the end of a given period and would be able to communicate the results of business operations to various interested parties. It is, therefore, necessary to record all the transactions systematically from time to time irrespective of the form of business organisation.
The accounting information is useful both for the management and the outside agencies. The management needs it for the purpose of planning , controlling and decision making. The outsiders like banks, creditors etc. also require it for assessing the financial solvency of the business and the tax authorities use it for determining the amount of tax liability. Infact accounting is necessary not only for business organisations but also for non-business organisations like schools, colleges, hospitals, clubs etc.

1.3 DEFINITION OF ACCOUNTING

Accounting as said earlier, involves the collection, recording, classification and presentation of financial data for the benefit of management and outside agencies such as shareholder, creditors, investors, government and other interested parties.
Accounting has been defined in different ways by different authorities on the subject. The following are some of the important definitions of accounting:

According to the Committee on Terminology of 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".

Eric L. Kohlen (A Dictionary for Accountants) defines accounting as "the procedure of analysing, classifying and recording transactions in accordance with a pre-conceived plan for the benefit of : (a) providing a means by which an enterprise can be conducted in orderly fashion, and (b) establishing a basis for reporting the financial condition of enterprise and the results of its operations."

The former definition denotes that accounting is concerned with the recording of transactions which are measurable in monetary terms in such a way that analysis and interpretation of business activities is possible. According to the latter definition accounting is concerned with the recording of business transactions for better management of the concern and also reporting the true financial position of the concern.

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

Smith and Ashburne define accounting as "the science of recording and classifying business transactions and events, primarily of a financial character, and the art of making significant summaries, analysis and interpretations of those transactions and events and communicating the results to persons who must make decisions or form judgments." Thus this definition emphasises financial reporting and decision making aspects of accounting.

From the above definitions it is clear that accounting is a science of recording transactions of economic nature in a systematic manner and also an art of analysing and interpreting the same.

Based on the above definitions, we can summarise the functions of accounting as:

i) Identifying financial transactions,

ii) Recording of transactions which are financial in character,

iii) Classification of transactions,

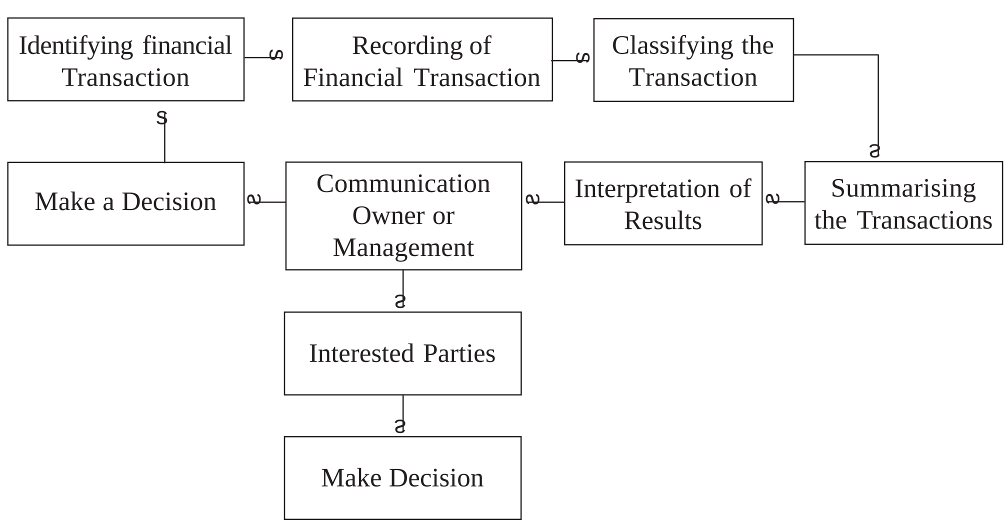
iv) Summarising the transactions which also includes preparation of trail balance, income statements and balance sheet,

v) Interpretation of financial results, and

vi) Communicating the interpreted financial results in a proper form and manner to the proper person.

Look at the following figure and note the functions of accounting which starts from identifying financial transactions to be recorded in the books and ends with communicating to the interested parties who use them for decision making.

Functions of Accounting



1.4 OBJECTIVES OF ACCOUNTING

The basic objectives of accounting is to provide necessary information to the persons interested who will make relevant decisions and form judgement. The persons interested in the business are classified into two types : i) Internal users, and ii) External users. Internal users are those who manage the business. External users are those other than the internal users such as investors, creditors, Government, etc. Information required by the external users are provided through Profit and Loss account and Balance sheet whereas the internal users get required information from the records of the business. Thus the main objectives of accounting are as follows:

1) **To keep systematic records of the business :** Accounting keeps a systematic record of all financial transactions like purchase and sale of goods, cash receipts and cash payments etc. It is also used for recording all assets and liabilities of the business. In the absence of accounting it is impossible to a human being to keep in memory all business transactions.
2) **To ascertain profit or loss of the business :** By keeping a proper record of revenues and expenses of business for a particular period, accounting helps in ascertaining the profit or loss of the business through the preparation of profit and loss account. Profit and Loss account helps the interested parties in assessing the profit or loss made by the business during a particular period. It also helps the management to take remedial action in case the business has not proved remunerative or profitable. A proper record of all incomes and expenses helps in preparing a profit and loss account and in ascertaining net operating results of a business during a particular period.
3) **To ascertain the financial position of business :** The business man is also interested to know the financial position of his business apart from operating results of the business during a particular period. In other words, he wants to know how much he owns and how much owes to others. He would also like to know what happened to his capital, whether it has increased or decreased or remained constant. A systematic record of assets and liabilities facilitates the preparation of a position statement called Balance Sheet which provides necessary information to the above questions. Balance Sheet serves as barometer for ascertaining the financial solvency of the business.
4) **To provide accounting information to interested parties :** Apart from owners there are various parties who are interested in the accounting information. These are bankers, creditors, tax authorities, prospective investors etc. They need such information to assess the profitability and the financial soundness of the business. The accounting information is communicated to them in the form of an annual report.

Parties Interested in Accounting Information

Many people are interested in examining the financial information provided in the financial statements besides a owner or management of the concern. These financial statements help them to know the following :

i) To study the present financial position of business,
ii) To compare its present performance with that of past years, and
iii) To compare its performance with similar enterprises.

The following are the various parties interested in the financial statements:

i) **Owners/Shareholders :** Shareholders are the real owners of the company because they contribute the required capital and take the risk of business. Obviously they are interested to know the result of operations and financial position of the company. The shareholders are also interested to use the accounting information to evaluate the performance of the managers because in company type of organisation management of business is vested in the hands of paid managers.

ii) **Prospective Investors :** The persons who are interested in buying shares of a company or who want to advance money to the company, would like to know how safe and rewarding the investments already made or proposed investments would be.

iii) **Lenders :** Initially the required funds of the business are provided by the owners. When business is going on, it requires more funds. These funds are usually provided by banks and other money lenders. Before lending money they would like to know about the solvency of the enterprise so as to satisfy themselves that their money will be safe and repayments will be made on time.

iv) **Creditors** : The creditors are those who supply goods and services on credit. These creditors like other money lenders are also interested to know the credit worthiness of the business. The accounting information greatly helps them in assessing the ability of the enterprise to what extent credit can be granted.

v) **Managers :** Accounting information is very much useful to managers. It helps them to plan, control and evaluate all business activities. They also need such information for making various decisions relating to the business.

vi) **Government :** The Government may be interested in accounting information of a business on account of taxation, labour and corporate laws. The financial statements are of great importance for assessing the tax liability of the enterprise.

vii) **Employees :** The employees of the enterprise are also interested in knowing the state of affairs of the organisation in which they are working, so as to know how safe their interests are in the organisation. The knowledge of accounting information helps them in conducting negotiations with the management.

viii) **Researchers :** The accounting information is of immense value to the researchers undertaking research in accounting theory and practices.

ix) **Citizen :** An ordinary citizen as a voter and tax payer may be interested to know the accounting information to measure the performance of Government Company or a public utility concern like banks, gas, transport, electricity companies etc.

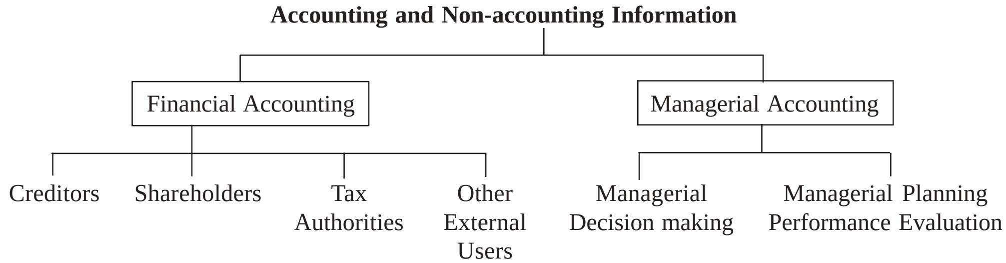
1.5 ACCOUNTING AS PART OF THE INFORMATION SYSTEM

Accounting is part of an organisation's information system, which includes both financial and non-financial data. Accounting is the process of identifying, measuring and communicating economic information to permit judgment and decisions by users of the information. The main objective of accounting is to provide information to the users. Accounting is also required to serve some broad social obligations since the accounting information is used by a large body of people such as customers, employees, investors, creditors and government.

Accounting is commonly divided into (1) Financial Accounting, and (2) Managerial Accounting. Financial accounting refers to the preparation of general purpose reports for use by persons outside an organisation. Such users include shareholders, creditors, financial analysts, labour unions, government regulations etc. External users are interested primarily in reviewing and evaluating the operations and financial status of the business as a whole.

Managerial accounting, on the other hand, refers to providing of information to managers inside the organisation. For example a production manager may want a report on the number of units of product manufactured by various workers in order to evaluate their performance. A sales manager might want a report showing the relative profitability of two products in order to pinpoint selling efforts. The financial reports are available from the libraries or companies themselves where as managerial accounting reports are not widely distributed outside because they often contain confidential information. The following figure shows that accounting is part of an organisation system which includes both Financial and non financial data :

Accounting as part of the information system



Uses of Accounting Information

Accounting provides information for the following three general uses :-

1) **Managerial decision making :** Management is continuously confronted with the need to make decisions. Some of these decisions may have immediate effect while the others have in the long run. Decisions regarding the price of the product, make or buy the product or to dropt it, to expand its area of operations etc., are some of the examples of decisions that face management and accounting provides necessary information to arrive at right conclusions.

2) **Managerial planning, control and internal performance evaluation** : Managerial accounting plays an important role in the planning and control. By assisting management in the decision making process, information is provided for establishing the standard. Accounting also provides actual results to compare with projections.

   Planning can be defined as the process of deciding how to use available resources. The key word in this definition is deciding, because planning is essentially a matter of choosing the set of alternatives which seem most likely to enable the organisation to meet its objectives. Several different kinds of planning processes can be identified, but most important is periodic planning for the activities of the organisation as a whole.

   Control is the complement of planning. It consists of management's efforts to prevent undesirable departures from planned results and to take corrective action in response to it.

   The planning and control process consist of the following steps :

   i) Setting standards as to what actual performance should be.
   ii) Measuring the actual performance.
   iii) Evaluating actual performance by comparing actual performance with the standards. This evaluation aids management in assessing actions already taken and in deciding which course of action should be taken in future.

   The main relationship between planning and control is the planning produces a plan. This becomes a set of instructions to be executed. The results of the action taken on the basis of the plan are then compared with the planned results. The difference of the plan are interpreted to determine what kind of response is appropriate. A corrective response requires a change in the way of plan is carried out, while adaptive response requires replanning. Each of these leads back to an earlier phase of the process and the loop is completed.

   For example where a marketing manger is given a target of sales revenues of Rs. 10 crores, the amount of Rs. 10 crores will serve as a standard for evaluating the performance of the marketing manager. If annual sales revenues vary significantly from Rs. 10 crores, steps will be taken to ascertain the causes for the difference. When the factors leading to the variance are not under the control of the marketing manager, then the marketing manager would not be held responsible for it. On the other hand the cause for variance is under the control of marketing manager then he will be held responsible in evaluating the performance of marketing manager.

3) **External Financial reporting and performance evaluation :** Accounting has always been used to supply information to those who are interested in the affairs of the company. Various laws have been passed under which financial statements should be prepared in such way that required information is supplied to shareholders, creditors, government etc. For example, the investors may be interested in the financial strength of the business, creditors may require information about the liquidity position, government may be interested to collect details about sales, profit, investment, liquidity, dividend policy, prices etc. in deciding social and economic policies. Information is required in accordance with generally accepted accounting principles so that it is useful in taking important decisions.

1.6 BRANCHES OF ACCOUNTING

To meet the requirements of different people interested in accounting information, accounting can be broadly classified into three categories :

1) Financial Accounting,
2) Cost Accounting, and
3) Management Accounting

1.6.1 Financial Accounting

The American Institute of Certified Public Accountants has defined Financial Accounting as "the art of recording, classifying and summarizing in a significant manner in terms of money transactions and events which are in part at least of a financial character, and interpreting the results thereof". Accounting is the language effectively employed to communicate the financial information of a business unit of various parities interested in its progress.

The object of financial accounting is to find out the profitability and to provide information about the financial position of the concern. Two important statements of financial accounting are Income and Expenditure Statement and Balance Sheet. All revenue transactions relating to a particular period are recorded in this statement to decide the profitability of the concern. The balance sheet is prepared at a particular date to determine the financial position of the concern.

Functions of Financial Accounting

Financial accounting provides information regarding the status of the business and results of its operations to management as well as to external parties. The following are some of the important functions of financial accounting :

a) **Recording of Information**

In business, it is not possible to keep in memory all the transactions. These transactions need to be systematically recorded and pass through the journals, ledgers and worksheets before they could take the form of final accounts. Only those transactions are recorded which are measurable in terms of money. The transactions which cannot be expressed in monetary terms does not form part of financial accounting even though such transactions have a significant bearing on the working of a business.

b) **Managerial Decision Making**

Financial accounting is greatly helpful for managers in taking decisions. Without accounting, the managerial functions and decision making programmes may mislead. The performance of daily activities are to be compared with the predetermined standards. The variations of actual operations and their analysis are possible only with the help of financial accounting.

c) **Interpreting Financial Information**

Interpretation of financial information is very important for decision making. The recorded financial data is interpreted in such a manner that the end users such as creditors, investors, bankers etc., can make a meaningful judgment about the financial position and profitability of the business operations.

d) **Communicating Results**

Financial accounting is not only concerned with the recording of facts and figures but it is also connected with the communication of results. In fact accounting is the source of business operation. Therefore, the information accumulated and measured should be periodically communicated to the users. The information is communicated through statements and reports. The financial statements and reports should be reliable and accurate. A variety of reports are needed for internal management depending upon its requirement. In communicating reports to outsiders, standard criteria of full disclosure, materiality, consistency and fairness should be adhered to.

Limitations of Financial Accounting

Financial accounting was able to cope up with the needs of business in the initial stages when business was not so complex. This is because financial accounting is mainly concerned with the preparation of final accounts, i.e., profit and loss account and balance sheet. But the growth and complexities of modern business have made financial accounting highly inadequate. The management needs information for planning, controlling and coordinating business activities.

The limitations of financial accounting are as follows :

1) **Historic nature** : Financial accounting is the record of all those transactions which have taken place in the business during a particular period. As management's decisions relates to future course of action, they are made on the basis of estimates and projections. Financial accounting provides information about the past data and not about the future. It does not suggest the measures about what should be done to improve efficiency of the business. Past data are needed for making future decisions but that does not alone sufficient.

2) **It records only actual costs :** Financial accounting has always been concerned with figures treating them as single, simple and silent items because it records only actual cost figures. The price of goods and assets changes frequently. The current prices may be different from recorded costs. Financial accounts do not record these price fluctuations. Therefore, the recorded information may not give correct information.

3) **It provides quantitative information :** Financial accounting considers only those factors which are quantitatively expressed. Anything which cannot be measured quantitatively will not constitute a part of financial accounting. Today business decisions are influenced by a number of social considerations. Governments polices have a direct bearing on the working of business. Therefore, in addition to social consideration the management has also to take into account, the impact of government policies on the business. But these factors cannot be measured quantitatively so their impact will not reflect in financial statement.

4) **It provides information about the whole concern :** Financial accounting provides information about the concern as a whole. It discloses only net results of the collective activities of a business. Detailed information regarding product-wise, process-wise, department wise, etc. is not recorded in financial accounts. Thus, product wise or job wise cost of production cannot be determined. It is essential to record the transactions activity wise for cost determination and cost control purpose.

5) **Difficulty in price fixation :** The cost of the product can be obtained only when all expenses have been incurred. It is not possible to determine the prices in advance. Price fixation requires detailed information about variable and fixed costs, direct and indirect costs. Financial accounting cannot supply such information and therefore, it is difficult to quote the prices during the periods of inflation or depression in trade.

6) **Appraisal of policies is not possible :** Financial accounting do not provide data for evaluation of business policies and plans. There is no technique for comparing actual performance with the budgeted targets. Financial accounting do not provide any measure to judge the efficiency of a business. The only criteria for determining efficiency is the profit at the end of financial period. Therefore, the only yardstick for measuring the managerial performance is profit and loss account which is not a reliable test for ascertaining efficiency of the management.

7) **It is not helpful in Decision Making :** Financial accounting do not help the management in taking strategic decisions because they do not provide adequate information to compare the probable effect of alternative courses of action such as replacement of labour by machinery, introduction of new product line, expansion of capacity etc. The impact of these decisions and cost involved is to be ascertained in advance. Due to historic nature of accounting data available from financial accounts, it is not of much helpful to the management.

8) **Lack of uniformity in accounting principles :** Accounting policies differ on the use of accounting principles. There is lack of unanimity on the use of accounting principles and procedures. The financial statements prepared by two different persons of the same concern gives different results due to varying personal judgment in applying a particular convention. The methods of valuing inventory, methods of depreciation, allocation of expenses between revenue and capital etc. are the most controversial issues on which unanimity is not possible. The use of different accounting methods reduces the usefulness and reliability of financial accounting.

9) **It is not possible to control costs :** Another limitation of financial accounting is that the cost figures are known only at the end of financial period. When the cost has already been incurred then nothing can be done to control the cost. A constant review of actual costs from time to time is required for cost control and this is not possible in financial accounting.

10) **Possibility of manipulation of accounts :** The over and under valuation of inventory may affect the profit figures. The profit may be shown more or less to get more remuneration, to pay more dividend or to raise the share prices, or to save taxes or not to pay bonus to workers, etc. The possibility of manipulating financial accounts reduces their reliability.

11) **Technological revolution :** With the advancement in science and technology very minute and detailed break-up of all types of data relating to various parts of a business unit have become a must for the management of its day to day functioning. It is clear that financial accounting with its simple structure is not in a position to cater the needs of the management because it supplies only elementary information.

The limitations of financial accounting have given scope for the development of Costing and Management accounting.

1.6.2 Cost Accounting

Cost accounting is one of the important elements of accounting information about the problems of internal managerial control. Financial accounts are unable to meet information needs about the cost structure of a product. The need for cost determination and controls necessitated new set of principles of accounting and thus emerged 'Cost accounting' as a specialised branch of accounting. Cost accounting is the process of accounting for costs. It includes the accounting procedures relating to recording of all income and expenditure and preparation of periodical statements and report with the object of ascertaining and controlling costs. Such cost accounting is a good technique for ascertaining profitability and for decision making. The Institute of Cost and Management, London defines cost accounting as "the application of costing and costing principles, methods and techniques to the science, art and practice of cost control and ascertainment of profitability. It includes presentation of information derived therefrom for the purpose of managerial decision making."

Functions of Cost Accounting

The main functions of cost accounting can be briefed as follows :

a) Cost accounting enables the management to ascertain the cost of product, job, contract, service or unit of production.

b) It helps in price fixation or quotation.

c) It provides information for the preparation of estimates and tenders.

d) It helps in minimizing the cost of manufacture.

e) It helps in determining profitability of each product, process, department etc.

f) It is a useful tool for managerial control and helps in cost reduction and cost control.

g) It increases efficiency and reduces wastages and costs.

h) It provides cost data for comparison in different periods.

Limitations of Cost Accounting

Cost accounting lacks a uniform procedure. It is developed through theories and accounting practices based on reasoning and common sense. There is no common system of cost accounting applicable to all industries. A limitation of cost accounting is its emphasis on cost data and largely based on estimates. Hence, it is considered very narrow in its perspective as it fails to consider the revenue aspect in detail. Moreover, cost accounting can be used only in big organisations.

1.6.3 Management Accounting

Cost accounting helps the internal management by directing their attention on inefficient operations and assisting in a day-to-day control of business activities. The costing data needs to be arranged, re-analysed and processed further for effective role in managerial process. In addition to costing and accounting data, managerial functions need the use of socio-economic and statistical data (e.g., population break-ups, income structure, etc.). Cost and financial accounting do not provide such information and this limitation pave the way for the emergence of management accounting. Management accounting is a systematic approach to planning and control functions of management. It generates information for establishing plans and controls. It provides for a system of setting standards, plans, or targets and reporting variances between planned and actual performances for corrective actions. Thus, Management accounting consists of cost accounting, budgetory control, inventory control, statistical methods, internal auditing and reporting. It also covers financial accounting.

Management accounting is the process of identification, measurement, accumulation, analysis, preparation, interpretation and accumulation of financial information used by management to plan, evaluate, and control within an organisation and to assure appropriate use of and accountability for its resources. Management accounting also comprises the preparation of financial reports for management groups such as shareholders, creditors, regulator agencies and tax authorities.Thus it is the application of professional information to assist the management in the formation of policies and in planning and control of the operations of the business enterprise.

Thus Management accounting helps an organisation to accomplish its goals in the following ways :

1) It provides a way to communicate expectations to managers throughout the organisation.
2) It provides feedback which enables a manager to monitor the day to day operations of the company for which he is responsible. If actuals differ significantly from targeted results, the manager is alerted, can look for causes for deviation and can take corrective actions.
3) It provides a set of prescribed tools and techniques for use in decision making.

Limitations of Management Accounting

Though Management Accounting is a useful tool for planning, directing and controlling functions still it suffers from the following limitations :

1) **Based on Cost and Financial Information:** Management accounting derives information from financial and cost accounting and other records. The accounting statements and records suffer from certain limitations as they are prepared on the basis of certain accounting concepts and conventions. The correctness and effectiveness of managerial decisions will depend upon the quality of data on which these decisions are based. If financial data is not reliable then management accounting will not provide correct analysis. The limitations of financial statements and records may be transmitted to the management accounting system. This may limit its effectiveness and make the information a substandard one.
2) **Persistence of Intuitive Decision Making:** Management accounting provides facts and figures of various situations and assists management in taking decisions scientifically. It includes decision tools such as marginal costing, differential costing and OR techniques like linear programming, decision theory, etc. Despite the facilities provided, the management mostly resorts to simple methods of decision making by intuition. Intuitive decisions limit the usefulness of management accounting.
3) **It has a very Wide Scope:** For taking decision, management requires information from both accounting as well as non-accounting sources and also quantitative as well as qualitative information. This creates many problems and brings a degree of inexactness and subjectivity in the conclusions obtained through it .
4) **Lack of Knowledge:** The use of Management accounting requires the knowledge of a number of related subjects. Lack of knowledge in the related subjects limits the use of management accounting

5) **It is very Costly System:** The installation of Management accounting system needs a very elaborate organisational system. A large number of rules and regulations are also required to make this system workable and effective. This results in heavy investment which only big concerns can afford.

6) **Scope for Personal Bias:** The interpretation of financial information depends upon the capability of interpreter as one has to make a personal judgment. There is every possibility of personal bias in analysis and interpretation. Personal bias will affect the quality of decision making.

7) **It invites Resistance within the Organisation:** The installation of management accounting needs a radical change in the accounting organisation. New rules and regulations are also to be framed. It demands rearrangement of personnel and their activities. This will affect a number of personnel and therefore, there is a possibility of resistance by some of the people of the organisation concerned.

Check Your Progress A

1. What is Accounting ?

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2. List out various Accounting activities in an organisation.

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3. What are the limitations of Accounting ?

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4. Name the parties interested in accounting information.

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5. What is the main purpose of Financial Accounting and Management Accounting ?

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6. State whether each of the following statements is True or False :

   i) Accounting is concerned only with the recording of transactions.
   ii) Accounting is the language of the business.
   iii) Accounting records both financial and non financial transactions.
   iv) Management accounting provide necessary information to outsiders only.
   v) Cost accounting helps in ascertaining and controlling costs.
   vi) The main objective of financial accounting is to ascertain the operating results and financial position of a concern.
   vii) Management accounting provides decision to the management.

1.7 ROLE OF MANAGEMENT ACCOUNTANT

The term Management Accountant has been applied to any one who performs accounting work within a firm and it encompasses persons performing activities which range from :

i) Posting customers' receivable accounts,

ii) Doing financial analysis for decision making, and

iii) Making high-level decisions in a large scale organisation.

There is no particular academic or professional accomplishments have been associated with the term. He plays a significant role in the decision making process of an organisation. The positional status of management accountant in an organisation varies from concern to concern depending upon the pattern of management system in the concern. He plays a significant role in the decision making process of the organisation heading the accounting department. In large organizations he is known as Financial Controller, Financial Advisor, Chief Accounts officer etc. He is responsible for installation, development and efficient functioning of the management accounting system. He plays an important role in collecting, compiling, reporting and interpreting internal accounting information. He prepares the financial and cost control reports to satisfy the requirements of different levels of management. He computes variances by comparing the actuals with the standards and interprets the results of operations to different levels of the organisation and to the owners of the business.

Thus, the management accountant occupies an important position in the organization. He performs a staff function and also has line authority over the accountants. If he participates in planning and execution of policies, he is equal to other functional managers. In most of the organisations, management accountant performs staff functions. He supplies information and gives his views about the data and leaves the final decision making to functional heads. If management accountant provides the facts accurately and are presented in a manner which allows proper analysis and interpretation then he cannot be held responsible for any wrong judgment by the management. On the other hand, if the information provided by the management accountant is biased, inaccurate and is not presented properly then he is responsible to the management for wrong decision making.

Functions of Management Accountant

The functions of the Management Accountant depends upon the position he occupies in the organisation and requirements of the organisation. The functions of the controller, by whatever name he is called, have been laid down by the controllers' Institute of America which are as follows :

1) **Planning and Control :** Management accountant establishes, coordinates and maintains an integrated plan for the control of operations. Such a plan would provide, to the extent required in the business cost standards, profit planning, programmes for capital investing and for financing, sales forecast and the expense budgets, together with necessary procedures to effectuate the plan.

2) **Reporting and Interpreting :** Management accountant measures the performance against given plans and standards. The results of the operations are interpreted to all levels of management and to the owners of the business. This also includes installation of accounting and costing system and recording of actual performance to find out deviation, if any.

3) **Evaluation of Policies and Programmes :** He is responsible to evaluate various policies and programmes. The effectiveness of policies, programmes and

organisation structure to attain the objectives of the organisation to a large extent depends upon the caliber of the management accountant.

4) **Tax administration :** It is also the function of management accountant to report to the government as required under different laws in force and to establish and administer tax policies and procedures. He has also to supervise and coordinate preparation of reports to government agencies.

5) **Protection of assets :** The management accountant has to assure fiscal protection for the assets of the business through adequate internal control and proper insurance coverage.

6) **Appraisal of External Effects :** He has to assess continuously the effect of various economic and social forces and government policies and interpret their effect upon the business towards the attainment of common goals.

The functions as stated above can also prove to be useful under the Indian context. Some of the above functions, in India are performed by Company Secretary, top level management, statistical department etc.

1.8 FINANCIAL ACCOUNTING PROCESS

Accounting may be defined as the process of recording, classifying, summarizing, analysing, and interpreting the financial transactions and communicating the results thereof to the persons interested in such information.

Thus the accounting process consists of the following five stages :

1) Recording the Transactions,
2) Classifying the Transactions,
3) Summarizing the Transactions, and
4) Interpreting the Tesults.

Let us discuss briefly these stages:

1) **Recording the Transactions :** The accounting process begins with the basic function of recording all the transactions in the book of original entry. This book is called 'Journal'. The journal is a daily record of business transactions. All business transactions of financial character are recorded in the journal in a chronological order (date wise) with the help of various vouchers such as cash memos, cash receipts, invoices, etc. The process of recording a transaction in the journal is called journalising. The journal may be further sub-divided into various subsidiary books such as cash journal for recording cash transactions, Purchase Journal for recording purchase of goods, Sales Journal for recoding sale of goods, etc. The number of subsidiary books to be maintained will depend upon the nature and size of the business.

2) **Classifying the Transactions :** The journal is just a chronological record of all business transactions and it does not provide all information regarding a particular item at one place. To overcome this difficulty we maintain another book called 'Ledger'. It consists of systematic analysis of the recorded data with a view to group the transactions of similar nature and posting them to the concerned accounts. It contains different pages of individual account heads under which all financial transactions of similar nature are collected. For example, all transactions related to cash are posted to cash account and transactions related to different persons are entered separately in the account of each person. The objective of classifying the transaction in this manner is to ascertain the combined effect of all transactions of a given period in respect of each account. For this purpose all accounts are balanced periodically.

3) **Summarising the Transactions :** The third step is presenting the classified data in a manner which is understandable and useful to the internal as well as external end users of accounting information. This can be done through the preparation of a year end summary known as 'Final Accounts'. Before proceeding to final accounts one has to prepare a statement called 'Trial Balance' in order to check the arithmetical accuracy of the books of accounts. If the Trial Balance tallies, more or less it means that the transactions have been accurately recorded and posted into the ledgers. Then with the help of the Trial Balance and some other additional information, final accounts are prepared. The objective of preparing final accounts are :

   i) To know the net operating results of the business, and

   ii) To ascertain the financial position of the business at a particular date.

   The operating results of the business can be ascertained by preparing an income statement called Trading and Profit and Loss Account and financial position of the business can be known by preparing a position statement called 'Balance Sheet'. The Trading and Profit and Loss account gives information about the profit or loss made during the year and the Balance Sheet shows the position of assets and liabilities of the business at a particular time.

4) **Interpreting the Results :** The final stage of accounting is analysing and interpreting the results shown by the final accounts. The recorded financial data is analysed and interpreted in a manner that the end users can make a meaningful judgement about the financial position and profitability of the business operations. This involves computation of various accounting ratios to assess the liquidity, solvency and profitability of the business. The balance on various accounts appearing in the Balance Sheet will then be transferred to the new books of account for the next year. Thereafter the process of recording transactions for the next year starts again.

The accounting information after being meaningfully analysed and interpreted has to be communicated in the proper form and manner to the proper person. This is done through preparation and distribution of accounting reports which includes besides the final accounts, in the form of ratios, graphs, diagrams, funds flow statements, etc.

1.9 ACCOUNTING EQUATION

The recording of transactions in the books of accounts is based on accounting equation. Each transaction has double effect on the financial profit of a concern. Accounting equation is a formula expressing equivalence of the two expressions of assets and liabilities. Thus, the total claims will equal to the total assets of the firm. The total claims may be to outsiders and the proprietor. In the beginning the owner of the firm provides funds to the business in the form of 'capital' which is also known as 'owners equity'. Initially the capital contributed by the owner to the business will be in the form of cash and this cash is treated as an asset of the firm. At the same time a liability will be created in the form of owners' equity according to business entity concept (i.e., business and the owner are two separate entities). Thus, the asset is (cash) balanced against liability (capital).

The accounting equation can thus be expressed as follows :

Cash (Asset) = Capital (Liabilities)

Total Assets = Total Liabilities (Capital + Liabilities)

OR

Fixed Assets + Current Assets = Internal Liabilities + External Liabilities

Capital = Assets – Liabilities

OR

Liabilities = Assets – Capital

Thus the above relationship is known as accounting equation and it is also called as Balance Sheet equation. Each transaction will affect the above equation but the relationship will remain the same on account of dual aspect of the transaction. An increase in asset side leads to increase in the liabilities side and vice versa. Thus dual effect will take place either on the same side or on both the sides of accounting equation. Let us take a few transactions and see how accounting equation is always maintained.

1. Mr. X started business with Rs. 1,00,000 cash : The business received a cash of Rs. 1,00,000 which is an asset to business. The capital contributed by Mr. X is a liability to the business because from the business point of view owner and business are separate legal entity.

   The equation now stands as follows:

   Equation : Assets = Capital + Liabilities

   Rs. 1,00,000 (Cash) = Rs. 1,00,000 + Nil

2. The business purchased furniture worth Rs. 15000 and paid cash : The effect of this transaction is that on one hand it increases one asset (furniture) and on other hand it decreases another asset (cash). The equation now will appear as follows;

	Assets						
	Cash	+	Furniture	=	Capital	+	Liabilities
Old equation	1,00,000	+	–	=	1,00,000	+	–
New Transaction	–15,000	+	15,000	=	–	+	–
New Equation	85,000	+	15,000	=	1,00,000	+	–

3. The business purchased goods on credit from Mr. Z for Rs. 10,000: The effect of this transaction is that it increases an asset (stock of good) and creates a liability (creditor). The equation now will be as follows :

	Assets								
	Cash	+	Furniture	+	Stock	=	Capital	+	Liabilities
Old equation	85,000	+	15,000	+	–	=	1,00,000	+	–
New Transaction (Creditor)	–	+	–	+	10,000	=	–	+	10,000
New Equation	85,000	+	15000	+	10,000	=	1,00,000	+	10,000

4. The business sold goods for Rs. 7,000 on credit : In this transaction, assets will be decreased by Rs. 7,000 in the form of stock and assets will be increased by Rs. 7,000 in the form of sundry debtors.

	Assets								Liabilities		
	Cash	+	Furniture	+	Stock	+	Sundry Debtors	=	Capital	+	Creditors
Old equation	85,000	+	15,000	+	10,000	+	–	=	1,00,000	+	10,000
New Transaction	–	+	–	+	(–7000)	+	7,000	=	–	+	–
New Equation	85,000	+	15000	+	3000	+	7000	=	1,00,000	+	10,000

5. Mr. X withdrew Rs. 10,000 for his private expenses : Withdrawing of cash from the business for private expenses, reduces business assets in the form of cash as well as his capital by Rs. 10,000.

	Assets								Liabilities		
	Cash	+	Furniture	+	Stock	+	Sundry Debtors	=	Capital	+	Creditors
Old equation	85,000	+	15000	+	3000	+	7000	=	1,00,000	+	10,000
New Transaction	–10,000	+	–	+	–	+	–	=	–10,000	+	–
New Equation	75,000	+	15000	+	3000	+	7000	=	90,000	+	10,000

Thus, the sum of assets will be equal to the sum of Capital and Liabilities irrespective of the number of transactions. The equation can also be presented in the form of statement of assets and liabilities called Balance Sheet which is always prepared at a particular date. The last equation stated above if presented in the form of Balance Sheet, it will be as follows :

Balance Sheet of Mr. X as at ………….

Capital and Liabilities	*Rs.*	*Assets*	*Rs.*
Capital	90,000	Cash	75,000
Creditors	10,000	Stock	3,000
		Sundry debtors	7,000
		Furniture	15,000
	1,00,000		1,00,000

It should be noted that the total of both the sides of Balance Sheet should be equal irrespective of the number of transactions and the items affected thereby. It is due to the dual effect of business transactions on the assets and liabilities of the business.

1.10 ACCOUNTING CONCEPTS

Accounting is the language of business. Business firms communicate their affairs and financial position to the outsiders through accounting in the form of financial statements. To make the language to convey the same meaning to all interested parties it is necessary that it should be based on certain uniform scientifically laid down standards. The accountants in general, have agreed on certain principles to be followed strictly by them to maintain uniformity and also for comparison purpose. These principles are termed as 'Generally Accepted Accounting Principles'. Accounting principles may be defined as "those rules of action or conduct which are adopted by the accountants universally while recording accounting transactions. They are a body of doctrines commonly associated with the theory and procedures of accounting serving as an explanation of current practice and as a guide for selection of conventions or procedures where alternatives exist." To explain these principles, the writers have used a variety of terms such as concepts, postulates, conventions, underlying principles, basic assumptions, etc. The same rule may be described by one author as a concept, by another as a postulate and still by another as convention. Hence, it is better to call all rules and conventions which guide accounting activity and practice as 'Basic Accounting Concepts. These are the fundamental ideas or basic assumptions underlying the theory and practice of financial accounting and are broad working rules for all accounting activities developed and accepted by the accounting profession. It brings about uniformity in the practice of accounting.

These concepts can be classified into two broad groups which are as follows :

1) Concepts to be observed at the recording stage i.e., while recording the transactions, and
2) Concepts to be observed at the reporting stage i.e., at the time of preparing final accounts.

It must however be remembered that some of them are overlapping and even contradictory.

1.10.1 Concepts to be Observed at the Recording Stage

The concept which guide us in identifying, measuring and recording the transactions are :

1) Business Entity Concept
2) Money Measurement Concept
3) Objective Evidence Concept
4) Historical Record Concept
5) Cost Concept
6) Dual Aspect Concept

Let us explain them one by one and learn the accounting implications of each concept.

1) **Business Entity Concept**

According to this concept business is treated as a separate entity from its owners. All transactions of the business are recorded in the books of the firm. Business transactions and business property are different from personal transactions and personal property. If business affairs are mixed with private affairs, the true picture of the business is not available. The owner of the firm is treated as a creditor to the extent of his capital. From the accounting point of view the owner is different and the business is different. Therefore, under this concept the capital contributed by the owner of the firm is the liability to the firm and the owner is regarded as the creditor of the firm. However, personal expenditure of the owner is met from business funds it shall be recorded in the business books as drawings by the owner and not as business expenditure.

The business entity concept is applicable to all form of business organisation. This distinction can be easily maintained in the case of a limited company because the company has a separate legal entity of its own. But such distinction becomes difficult in case of a sole proprietorship or partnership, because in the eyes of law sole proprietor or partners are not considered separate entities. They are personally liable for all business transactions. But for accounting purpose they are treated as separate entities. This enables them to ascertain the profit or loss of the business more conveniently and accurately.

2) **Money Measurement Concept**

Usually business deals in a variety of items having different physical units such as kilograms, quintals, tons, metres, liters, etc. If the sales and purchase of different items are recorded in the physical terms, it will pose problems. But if these are recorded in common denomination their total become homogeneous and meaningful. Therefore, we need a common unit of measurement. Money does this function. It is adopted a common measuring unit for the purpose of accounting. All recording, therefore, is done in terms of the standard currency of the country where business is set up. For example, in India, it is done in terms of Rupees. In USA it is done in terms of US dollars and so on.

Another implication of money measurement concept is that only those transactions and events are recorded in the books of accounts which can be expressed in terms of money such as purchases, sales, salaries etc. Other happenings (non-monetary) like labour management relations, sales policy, labour unrest, effectiveness of competition, a team of dedicated and trusted employees etc., which are vital importance to the business concern do not find place in accounting. This is because their effect is not measurable and quantifiable in terms of money.

Another limitation of this concept is that it is based on the assumption that the money value is constant which is not true. The value of money changes over a period of time. The value of rupee today is much less than what it was in 1971. This is due to a fall in money value. Thus this concept ignores the qualitative aspect of things and the impact of inflationary changes is not adjustable in this principle. That is why accounting data does not reflect the true and fair view of the affairs of business.

Now-a-days it is considered desirable to provide additional data showing the effect of changes in the price level on the reported income and the assets and liabilities of the business.

3) **Objective Evidence Concept**

The term objectivity refers to being free from bias or free from subjectivity. Accounting measurements are to be unbiased and verifiable independently. For this purpose all accounting transactions should be evidenced and supported by documents such as invoices, receipts, cash memos etc. These supporting documents (Vouchers) form the basis for making entries in the books of account and for their verification by auditors. As per the items like depreciation and the provision for doubtful debts where no documentary evidence is available, the policy statements made by the management are treated as the necessary evidence.

4) **Historical Record Concept**

Recording the transactions in the books of account will be done only after identifying the transactions and measuring them in terms of money. According to the historic record concept we record only those transactions which have actually taken place in the business during a particular period of time and not those transactions which may take place in future. It is because accounting record presupposes that the transactions are to be identified and objectively evidenced. This is possible only in the case of past (actually happened) transactions. The future transactions can hardly be identified and measured accurately. You also know that all transactions are to be recorded in chronological (date wise) order. This leads to the preparation of a historical record of all transactions. It also implies that we simply record the facts and nothing else.

One limitation of this concept is that the impact of future uncertainties has no place in accounting. Management needs information for future planning not only of the past but also for future. You know that we will also make a provision for some expected losses such as doubtful debts at the time of ascertaining profit or loss of the business which is contrary to the historic record concept. But it is not a routine item. This is done in accordance with another concept called conservation concept which you will study later.

5) **Cost Concept**

The price paid (or agreed to be paid in case of a credit transaction) at the time of purchase is called cost. Under this concept fixed assets are recorded in the books of account at the price at which they are acquired. This cost is the basis for all subsequent accounting for the asset. For example, when an asset is acquired for Rs. 1,00,000, it is recorded in the books of account at Rs. 1,00,000 even though the market value may be different later. But the asset is shown in the books at cost price.

You know that with passage of time the value of an asset decreases. Hence, it may systematically be reduced from year to year by charging depreciation and the assets be shown in the balance sheet at the depreciated value. The depreciation is usually charged at a fixed percentage on cost. It bears no relationship with the changes in its market value. This makes it difficult to assess the true financial position of the concern and it is, therefore, considered an important limitation of the cost concept.

Another limitation of the cost concept is that if the business pays nothing for an item it acquired, then this will not appear in the accounting records as an asset. Thus, all such events are ignored which affect the business but have no cost. Examples are : a favourable location, a good reputation with its customers, market standing etc. The value of an asset may change but the cost remains the same in the books of account. As such the book value of an asset as recorded do not reflect their real value.
It should, however, be noted that the cost concept is applicable to the fixed assets and not to the current assets.

In spite of the above limitations the cost concept is preferred because firstly, it is difficult and time consuming to ascertain the market values and secondly, there will be too much of subjectivity in assessing current values. However, this limitation can be overcome with the help of inflation accounting.

6) **Dual Aspect Concept**

This is a basic concept of accounting. According to this concept every business transaction has a two-fold effect. In commercial context it is a famous dictum that "every receiver is also a giver and every giver is also a receiver". For example, if you purchase a machine for Rs. 8,000, you receive machine on the one hand and give Rs. 8,000 on the other. Thus, this transaction has a two-fold effect i.e.,(i) increase in one asset, and (ii) decrease in another asset. Similarly, if you buy goods worth Rs. 500 on credit, it will increase an asset (stock of goods) on the one hand and increase a liability(creditors) on the other. Thus, every business transaction involves two aspects (i) the receiving aspect, and (ii) the giving aspect. In case of the first example you find that the receiving aspect is machinery and the giving aspect is cash. In the second example the receiving aspect is goods and the giving aspect is the creditor. If complete record of transactions is to be made, it would be necessary to record both the aspects in books of account. This principle is the core of double entry book-keeping and if this is strictly followed, it is called "Double Entry System of Book-keeping'.

Let us understand another accounting implication of the dual aspect concept. To start with, the initial funds (capital) required by the business are contributed by the owner. If necessary, additional funds are provided by the outsiders (creditors). As per the dual aspect concept all these receipts create corresponding obligations for their repayment, In other words, a contribution to the business, either in cash or kind, not only increases its resources (assets), but also its obligations (liabilities/equities) correspondingly. Thus, at any given point of time, the total assets and the total liabilities must be equal.

This equality is called 'balance sheet equation' or 'accounting equation'. It is stated as under :

Liabilities (Equities) = Assets
Capital +Outside Liabilities = Assets

The term 'assets' denotes the resources (property) owned by the business while the term 'equities' denotes the claims of various parties against the business assets. Equities are of two types : (i) Owners' equity, and (ii) outsiders' equity. Owners' equity called capital is the claim of owners against the assets of the business outsiders' equity called liabilities is the claim of outside parties like creditors, bank, etc. against the assets of the business. Thus, all assets of the business are claimed either by the owners or by the outsiders. Hence, the total assets of a business will always be equal to its liabilities.

When various business transactions take place, they effect the assets and liabilities in such a way that this equity is maintained. You will study later in detail under '1.9 Accounting Equation' of this unit how the equity is maintained.

1.10.2 Concept to be Observed at the Reporting Stage

The following concepts have to be kept in mind while preparing the final accounts:

1. Going concern concept
2. Accounting period concept
3. Matching concept
4. Conservatism concept
5. Consistency concept
6. Full disclosure concept
7. Materiality concept

Let us discuss the above concepts one by one.

1) **Going Concern Concept**

According to this concept it is assumed that every business would continue for a long period. Keeping this in view, the investors lend money and the creditors supply goods and services to the concern. For all practical purpose the business is normally treated as a going concern unless there is a strong evidence to the contrary. The current disposal value is irrelevant for a continuing business. Recording of transactions in accounting is judged whether the benefits from expenses are immediate (short period, say less than one year) or a long term. If the benefits from expenses are immediate it is treated as a revenue or if the benefits are for long term, it is to be treated as capital depending upon the nature of expenses. Short term benefits expenses like rent, repairs etc. are limited to one year therefore such expenses are fully debited to profit and loss account of that year. On the other hand, if the benefit of expenditure is available for a longer period, it must be spread over a number of years. Therefore, only a portion of such expenditure will be debited to profit and loss account. The balance of expenditure is shown as an asset in the Balance Sheet. Similarly fixed assets are recorded at original cost and are depreciated in a proper manner and while preparing the balance sheet, market price of fixed asset are not considered. For example, a firm purchased a delivery van for Rs. 1,00,000 and its expected life is 10 years. The accountant has to spread the cost of the van for 10 years and charges Rs. 10,000 being 1/10th of its cost to the profit and loss account every year in the form of depreciation and show the balance in the balance sheet as an asset. While preparing final accounts, a record will also be made for outstanding expenses and prepaid expenses on the assumption that the business will continue for an indefinite period and the assets will be used for its expected life.

This concept will not apply in case of a concern when it has gone into liquidation or it has become insolvent. In such as case the assets are valued at their current values and the liabilities at the value at which they are to be met.

2) Accounting Period Concept

You know that the going concern concept assumes that life of the business is indefinite and the preparation of income and positional statements after a long period would not be helpful in taking appropriate steps at the right time. Therefore, it is necessary to prepare the financial statements periodically to find out the profit or loss and financial position of the business. It also helps the interested parties to make periodical assessment of its performance. Therefore, accountants choose some shorter period to measure the results and one year has been generally accepted as the accounting period. However, accounts can also be prepared even for a shorter period for internal management purposes. But one year accounting period is recognised by law and taxation is assessed annually. Acconting period may be a calender year i.e., January 1 to December 31 or any other period of twelve months, say April 1 to March 31 or Diwali to Diwali or Dasara to Dasara. The final accounts are prepared at the end of each accounting period and the financial reports thus, prepared facilitate to make good decision, corrective measures, business expansion etc. and also enable the end users to make an assessment of the progress of the enterprise.

3) Matching Concept

Matching concept is based on the accounting period concept. The matching concept is also called Matching of costs against revenue concepts. To ascertain the profit made by the business during a particular period, the expenses incurred in an accounting year should be matched with the revenue earned during that year. The term ‘matching’ means appropriate association of related revenues and expenses. For this purpose, first we have to recognize the revenues during an accounting period and the costs incurred in securing those revenues. Then the sum of costs should be deducted from the sum of revenues to get the net result of that period. The question when the payment was received or made is irrelevant. In other words, all revenues earned during an accounting period, whether received or not and all costs incurred, whether paid or not have to be taken into account while preparing the final accounts. Similarly, any amount received or paid during the accounting period which actually relates to the previous accounting period or the following accounting period must be eliminated from the current accounting period’s revenues and costs. Therefore, adjustments are to be made for all outstanding expenses, accrued incomes, prepared expenses and unearned incomes, etc., while preparing the final accounts at the end of the accounting period. By application of this concept, the owner of the business easily know about the operating results of his business and can make effort to increase earning capacity.

4) Conservation Concept

This concept is also known as Prudent Concept. It ensures that uncertainties and risks inherent in business transactions should be given a proper consideration. Conservatism refers to the policy of choosing the procedure that leads to understatement of assets or revenues, and over statement of liabilities or costs. The consequence of an error of understatement is likely to be less serious than that of an error of over statement. On account of this reason, accountants generally follow the rule ‘anticipate no profit but provide for all possible losses. In other words, profits are taken into account only when they are actually realized but in case of losses, even the losses which may arise due to a remote possibility should also be taken into account. That is the reason why the closing stock is valued at cost price or market price whichever is less. Similarly, provision for doubtful debts and provision for discounts on debtors are also made. This reflects a generally pessimistic attitude of the accountant, but it is regarded as the best way of dealing with uncertainty and protecting creditors against an unwarranted distribution of the firm’s assets as dividends.

This concept is subject to criticism that it is against the convention of full disclosure. It encourages creation of secret reserves and financial statements do not reflect a true and fair view of the affairs of the business.

5) **Consistency Concept**

The principle of consistency means that the same accounting principles should be used for preparing financial statement for different periods. It means that there should not be a change in accounting methods from year to year. Comparisons are possible only when a consistent policy of accounting is followed. If there are frequent changes in the accounting treatment there is little scope for reliability. For example, if stock is valued at 'cost or market price whichever is less, this principle should be followed year to year. Similarly if deprecation on fixed assets is provided on straight line basis, it should be followed consistently year after year. Consistency eliminates personal bias and helps in achieving comparable results. If this principle of consisting is not followed, the accounting information about an enterprise cannot be usefully compared with similar information about other enterprises and so also within the same enterprise for some other period. Consistency principle enhances the utility of the financial statements.

However, consistency does not prohibit change. When a change is desirable, the change and its affect should be clearly stated in financial accounts.

6) **Full Disclosure Concept**

This concept states that the financial statements are to be prepared honestly and all significant information should be incorporated there in because these statements are the basic means of communicating financial information to all interested parties. Therefore, these statements should be prepared in such a way that all material information is clearly disclosed to the persons interested in its affairs . The purpose of this concept is that any body who wants to study the financial statements should not be prejudiced by concealing any facts. It is, therefore, necessary that the disclosure should be fair and adequate to make impartial judgement.

This concept assumes greater importance in respect of Joint Stock Company type of organisations where ownership is divorced from management. The Joint Stock Companies Act, 1956 requires that Profit and Loss Account and Balance Sheet of a company must give a true and fair view of the state of affairs of the company and also provided prescribed form in which these statements are to be prepared so that significant information may not be left out.

7) **Materiality Concept**

This concept is closely related to the full disclosure concept. Full disclosure does not mean that everything should be disclosed. It only means that relevant and material information must be disclosed. American Accounting Association defines the term materiality as "An item should be regarded as material if there is reason to believe that knowledge of it would influence the decisions of informed investor". Materiality primarily relates to the relevance and reliability of information. All material information should be disclosed through the financial statements accompanied by necessary notes. For example commission paid to sole selling agents, and a change in the method of rate of depreciation, if any, must be duly reported in the financial statements.

Further strict adherence to accounting principles is not required for items of little importance or non-material nature. For example, erasers, pencils, stapler, pins, scales etc., are used for a long period, but they are not treated as assets. They are treated as expenses. This does not affect the amounts of profit or loss materially. Similarly, while showing the amounts of various items in financial statements, they can be rounded off to the nearest rupee or hundreds. There may not be any material effect. For example if an amount of Rs. 145,923.28 is shown as Rs. 1,45,923 or Rs. 1,45,900 it does not make much difference for assessment of the performance of the enterprise.

The materiality and immateriality convention varies according to the company, the circumstances of the transaction and economic significance. An item considered to be material for one business, may be immaterial for another. Similarly, an item of material in one year may not be material in the subsequent years. However, there are no specific rules for ascertaining material or non-material items. They are rather in the category of conventions or rules developed from experience to fulfil the essential and useful needs and purposes in establishing reliable financial and operating information control for business entities. What is required is just a matter of personal judgment.

Check Your Progress B

1) What do you understand by money measurement concept ?

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2) Explain dual aspect concept.

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3) List the concepts to be observed at the reporting stage.

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4) What are the stages in accounting process ?

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6) State whether each of the following statements is True or False :

   i) In accounting all business transactions are recorded which are having a dual effect.

   ii) It is the basis of a going concern concept that the assets are always valued at cost price.

   iii) Accounting principles are the rules which are adopted by accountants universally while recording transactions.

   iv) A controller is entrusted with the responsibilities of raising funds.

   v) Money measurement concept ignores qualitative aspect of things.

1.11 ACCOUNTING STANDARDS

Accounting standards are generally accepted accounting principles which provides the basis for accounting policies and for preparation of financial statements.
The object of these standards is to provide a uniformity in financial reporting and to ensure consistency and comparability of the information provided by the business firms. Therefore, the standards set for must be easily understandable as well as acceptable by all and significantly reduce manipulation of information in the books of accounts.

Thus, accounting standards provide useful information to the users to interpret published reports. It provides information about the basis on which accounts have been provided and the rules followed while preparing financial statements.

Importance of Accounting Standards

1) It helps the investors in assessing the return and possible risk involved in evaluating the various investment proposals in different enterprises.
2) It raises the standards of audit while reporting the financial statements to the management.
3) It helps the government and other interested parties in formulating economic policies, tax planning, market analysis, investment decisions etc.
4) It helps the Chartered Accountants to deal with their client, in preparing financial statements on a true and fair basis. They can refuse the reports of their clients which are found to be incorrect or misleading.
5) It helps the interested parities to understand the information properly and make meaningful comparisons and interpretations for decision-making purposes.
6) It facilitates inter firm comparison of the financial position and operating results of similar enterprises.
7) It will reduce the scope of manipulation of accounts to suit the requirement of management.
8) It would facilitate the development of international trade and commerce as financial statements are clearly understandable.

Compliance with the accounting standards has been made mandatory. Section 211(3A) of the Companies Act, 1956 requires that every financial statement i.e., profit and loss account and balance sheet shall comply with the accounting standards. For the purpose of this section the accounting standards issued by the Institute of Chartered Accountants of India (ICAI) shall be deemed to be the accounting standards. According section 211 (2B), If the financial statements of any company do not comply with requirements of the accounting standards, it should state the reasons for such deviations from the accounting standards together its financial effect, if any, arising due to such deviation. Therefore, it is advisable for the companies as far as possible to comply with the accounting standards in view of its mandatory nature. In case the mandatory accounting standards are not complied with, it is in contravention of provisions of the Companies Act and the financial statements prepared and presented will not reflect a true and fair view of the state of affairs of the company. These accounting standards also apply in respect of financial statements audited for tax purpose under section 44 AB of Income Tax Act 1961.

These accounting standards are applicable to all commercial, industrial or business activities of any enterprise but not to those enterprises which are not commercial, industrial or business in nature.

1.12 ACCOUNTING ASSUMPTIONS AND POLICIES AS PER ACCOUNTING STANDARDS OF INDIA

Accounting measurements are not always uniform. Some financial quantities can be measured in two or more different ways. The management with the help of company's accountant decides which measurement alternatives are to be used. These choices are known as 'accounting policies'. These accounting polices differ from company to company. Therefore, it is advisable to each company to state in the notes of its financial statements which accounting policy it has followed. The company should not change its policy frequently and when there is a change in the policy, the company should justify the reason for such a change.

The management is not completely free in choosing any accounting policies because selection of policy must fit within the limits set by the measurement guidelines known as 'generally accepted accounting principles' as well as to comply statutory requirements. For example, The Central Board of Direct Taxes requires the following information to be disclosed in respect of change in accounting polices :

1) A change in accounting policy shall be made only if the adoption of different accounting policy is required by statute or if it is considered that the change would result in more appropriate in preparation or presentation of the financial statements of an assessee.
2) Any change in accounting policy which has material effect shall be disclosed in the financial statements of the period in which such change is made. Where the effect of such change is not ascertainable or such change has no material effect on the financial statements for the previous year but has material effect in years subsequent to the previous year, the fact shall be stated in the previous year in which such change is adopted.

Materiality of an item depends on its amount and nature. An item should also be considered material if the knowledge of it would influence the decisions of the investors. Materiality varies from one business to another business. Similarly, an item which is material in one year may not be material in the next year. While preparing financial statements it is, therefore, necessary to give emphasis only on those matters which are significant and thereby ignoring insignificant matters.

In order to bring uniformity for the presentation of accounting results, the Institute of Chartered Accountants of India, established an Accounting Standard Board (ASB) in April, 1977. The Board consists of representatives from industry and government. The main function of ASB is to formulate accounting standards to be followed while preparing and interpreting the financial results. While framing the accounting standards, the ASB will pay due attention to the International Accounting Standards and try to integrate them to the possible extent. It also takes into account the prevailing laws, customs and business environment prevailing in India. To improve quality and bring parity with the presentation of financial statements in India, the ASB has formulated the following accounting standards:

No.	Title
AS 1	Disclosure of Accounting Policies
AS 2	Valuation of Inventories
AS 3	Cash Flow Statements
AS 4	Contingencies and Events occurring after Balance Sheet Date
AS 5	Net Profit or Loss, Prior Period Items and Changes in Accounting Policies
AS 6	Depreciation Accounting
AS 7	Accounting for Construction Contracts

AS 8 Accounting for Research and Development
AS 9 Revenue Recognition
AS 10 Accounting for Fixed Assets
AS 11 Accounting for the Effect of Changes in Foreign Exchange Rates
AS 12 Accounting for Government Grants
AS 13 Accounting for Investments
AS 14 Accounting for Amalgamations
AS 15 Accounting for Retirements Benefits in the Financial Statements of Employers
AS 16 Borrowing Costs
AS 17 Segment Reporting
AS 18 Related Party Disclosures
AS 19 Leases
AS 20 Consolidated Financial Statement
AS 21 Earnings per Share
AS 22 Accounting for Taxes on Income
AS 23 Accounting for Investments in Consolidated Financial Statements
AS 24 Discounting Operations
AS 25 Interim Financial Reporting
AS 26 Intangible Assets
AS 27 Financial Reporting of Interest in Joint Ventures

Check Your Progress C

1) Why accounting practices should be standardised ?

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2) State whether each of the following statements is True or False:

   i) A management accountant is not the custodian of properties and financial interests of a business enterprise.

   ii) 'Statement of Standard Accounting Practice' were formulated by an Accounting Standard Board in India.

   iii) The generally accepted accounting principles prescribe a uniform accounting practice.

   iv) The materiality concept refers to the state of ignoring small items and values from accounts.

   vi) The avoidance of insignificant things will not affect accounting results.

1.13 LET US SUM UP

In business a number of transactions take place every day. It is not possible to remember all of them. Hence there is a need to record them. The recording of business transactions in a systematic manner is the main function of accounting. It enables to ascertain the profit and loss and the financial position of the business. It also provides necessary financial information to all interested parties.

Accounting is the process of identifying, measuring, recording, classifying and summarizing the transactions and analysing, interpreting and communicating the results thereof. Accounting provides information for three general uses such as i) managerial decision-making, ii) managerial planning control, and internal performance evaluation, and iii) financial reporting and external performance evaluation. To meet the requirements of different people interested in accounting information, accounting is classified as financial accounting, cost accounting and management accounting. Financial accounting refers to the preparation of reports for general purpose whereas management accounting provides information to inside the organisation. Cost accounting provides information about the problems of internal managerial control.

Management accountant plays a significant role in the decision making process and it depends upon his position and requirements of the organisation. The accounting process is divided into four stages: (i) recording the transactions, (ii) classifying the transactions, (iii) summarizing the transactions, and (iv) interpreting the results. The recording of transactions in the books of accounts is based on accounting equation. Accounting equation is a formula expressing equivalence of the two expressions of assets and liabilities. The relationship will remain the same on account of dual aspect of the transaction.

The accountants over a period of time, have developed certain guidelines for all accounting work. These are called basic concepts of accounting. Certain concepts are to be observed at the time of recording the transactions, while others are relevant at the summarizing and reporting stages. The concepts to be observed at the recording stage are : business entity, money measurement, objective evidence, historical record, cost and the dual aspect concept. Concepts to be observed at the reporting stage are : going concern concept, accounting period concept, matching concept, conservatism concept, consistency concept, full disclosure concept and materiality concept. Lack of uniformity in accounting practice makes it difficult to compare the financial reports of different companies. The multiplicity of accounting practices makes it possible for management to conceal material information. To avoid this problem accounting standards are developed by various professional bodies. The object of accounting standards is to provide uniformity in financial reporting and to ensure consistency and comparability of the information provided by the business firms. The management is not absolutely free in choosing any accounting policy. The accounting policy selected must fit within the limits set by generally accepted accounting principles and also comply to the statutory requirements. The Accounting Standard Board (ASB) of India, has developed so far 27 standards to improve quality and parity with the preparation of financial statements.

1.14 KEY WORDS

Accounting Period : A period of twelve months for which the accounts are usually kept.

Balance Sheet : A statement of assets and liabilities as at the end of an accounting period.

Books of Accounts : Books in the form of bound registers or loose sheets wherein transactions are recorded.

Business Unit : A unit formed for the purpose of carrying on some kind of business activity.

Financial Position : Position of assets and liabilities of a business at a given point of time.

Financial Statement : Summary of accounting information such as profit and loss account and Balance Sheet prepared at the end of accounting period.

Profit and Loss Account: An account showing profit or loss of the business during an accounting period.

Transaction : Transfer of money or money's worth between the two business units.

Management Accountant : A staff-functionary who uses accounting information for management planning and control.

Staff Function : It is performed in an advisory capacity without line or decision-making.

Accounting Conventions : Methods or procedures used in accounting

Accounting Equation : Assets = Owners' equity + Liabilities

Accounting Principles : The methods or procedures used in accounting for events reported in the financial statements.

Accounting Standards : Accounting Principles.

Cost Accounting : Classifying, Summarizing, recording, reporting and allocating current or predicted costs.

Double Entry : The system of recording transactions that maintains the equality of the accounting equation.

Generally Accepted Accounting Principles (GAAP) : The conventions, rules and procedures necessary to define accepted accounting practice at a particular time; includes both broad guidelines and relatively detailed practices and procedures.

Internal Reporting : Reporting for management's use in planning and control.

Materiality : The concept that accounting should disclose separately only those events that are relatively important for the business or for understanding its statement.

External Reporting : Production of financial statements for the use of external interest groups like shareholders, investors, creditors, government etc.

1.15 ANSWERS TO CHECK YOUR PROGRESS

A) 6 (i) False (ii) True (iii) False (iv) False (v) True (vi) True (vii) True

B) 5 (i) True (ii) True (iii) True (iv) False (v) True

C) 2 (i) False (ii) True (iii) True (iv) False (v) True

1.16 TERMINAL QUESTIONS

1) What are the objectives of Accounting ? Name the different parties interested in accounting information and state why they want it.
2) Briefly explain the accounting concepts which guide the accountant at the recording stage.
3) What do you understand by Dual Aspect Concept ? Explain the accounting implications.
4) Explain the role of Management Accountant in a modern business organisation.
5) What are the accounting concepts to be observed at the reporting stage ? Explain any two in detail.

6) Discuss in brief the basic accounting concepts and fundamental accounting assumptions.

7) Why do accounting practices be standardized ? What progress has been made in India regarding standardization of accounting ?

8) Is it possible to give a true and fair view of a company's position using accounting information ? Explain.

9) Explain the following :

   i) Accounting equation

   ii) Convention of materiality

   iii) Accounting standards

   iv) Accounting process

   v) Branches of accounting

   vi) Accounting a source of financial information.

1.17 SOME USEFUL BOOKS

Harold Bierman Jr. and Allan R. Drebin, 1978. *Financial Accounting : An Introduction*, W. B. Sounders Company, Philadelphion, London (Chapter 1-3).

Maheswari, S. N., 2002, *An Introduction to Accounting*, Vikas Publishing House : New Delhi (Chapter 1 and 2)

Patil, V.A.,and J. S. Korlahalli, 1986. *Principles and Practice of Accounting,* R. Chand and Co., New Delhi (Chapter 1-3)

Gupta, R. L. and M. Radhaswamy, 1986. *Advanced Accountancy,* Sultan Chand and Sons : New Delhi (Chapter I and II)

Anthony, Robert, N. and James Reece, 1987. *Accounting Principles*, All India Traveler Book Seller, New Delhi (Chapter 1-3)

Meigs, Walter, B. and Robert F. Meirgs, 1987. Accounting : The Basis for Business Decisions, MC Graw Hill : New York (Chapter I)

Sidney Davidson, Michael W. Maher, Clyde P. Stickney, Roman L Weil, 1985. Managerial Accounting, An Introduction to Concepts, Methods, and Uses, Holt-Saunders International Editors, Japan. (Chapter I)