CHAPTER - I

FUNDAMENTALS OF ACCOUNTING

Accounting is referred to as a language of business. According to Kotler, accounting is recording and reporting of business transactions. The American Institute of Certified Public Accountants defines accounting as *"the art of recording, classifying and summarising in a significant manner and in terms of money, transactions and events which are of financial character and interpreting the results there of"*.

Accountancy is the theory and practice of accounting : its responsibilities, standards, conventions and activities. Thus, Accountancy is more comprehensive than accounting by including the later in the former.

FUNCTIONS / STAGES OF ACCOUNTING :

1. **Recording :** The basic function of accounting is recording the monetary aspects of all the transactions of the business in an orderly manner. Recording is done in the book called 'Journal'.
2. **Classifying :** The transactions recorded in the 'Journal' are classified and posted to the main book 'Ledger'. This book contains individual account heads under which all monetary transactions of a similar nature are collected.
3. **Summarising :** The transactions recorded in the 'Ledger' are summarised and a balance in each accounts is ascertained. The list of balances is called 'trial balance'. This becomes the basis of preparing the final accounts.
4. **Interpreting :** The final stage is analysing and interpreting the finacial data contained in the final accounts and balance sheet. This will help in planning for the future.

OBJECTIVES OF ACCOUNTING

The following are the objectives for which accounts are prepared.

1) To report the result of the business to the owners.
2) To provide useful information to both the investors and creditors.
3) To ensure the best utilisation of available resources.
4) To ensure maximum utilisation of available resources.
5) To have an effective control over the resources of the organisation.
6) To facilitate social function and control.
7) To provide information regarding accounting policies.

LIMITATIONS OF ACCOUNTING

1) Monetary Terms only

Accounting records those transactions which can be measured in monetary terms only.

e.g.: Job satisfaction of employees cannot be recorded in accounting.

2) Cost Price only

It records all the transactions in the books at cost only. That is, accounting does not consider the change in price level. Therefore, it is very difficult to compare the performance at various years.

3) Unreliable

Accounting information may not be reliable. Because, accounting information are recorded by following certain basic concepts and conventions. Therefore, financial statements may not reflect the true financial position of the business.

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4) Personal bias

Accounting is influenced by personal judgement of the accountant.

e.g.: Depreciation, Valuation of Stock etc. If there is any bias over these, it will affect the accounting statements.

PERSONS INTERESTED IN ACCOUNTING

One of the objectives of accounting is to communicate the results of the business. The results of the business is communicated to those persons who are interested in accounting information. The following groups (persons) are interested of accounting information.

1) Owners

2) Management

3) Investors

4) Creditors

5) Government

6) Consumers

7) Research Scholars

The above groups may be broadly grouped into two

1) Internal and 2) External

The internal group refers to owners, management and investors. The external group refers to creditors, government, consumers and research scholars.

1) Owners

Owners may be interested to know whether their funds are properly utilised. They may be interested to know the financial position and profitability of the concern.

2) *Management*

Accounting information are needed to evaluate the performance of workers and employees. Effective management is possible with the help of proper accounting.

3) *Investors*

Investors are interested to know the financial soundness of the business. To know this, financial statements are required. Financial statements can be prepared with the help of accounting information.

4) *Creditors*

Creditors want to know the financial position of the concern in which they have invested their money. They depend only on proper accounts.

5) *Government*

Central and State governments are interested in the accounting information for the purpose of Taxation and Statistics.

6) *Consumers*

Consumers are able to know the cost of production and the profit percentage earned by the trader. Accounting is the base for this.

7) *Research Scholars*

The research scholars use the accounting information for the interpretation of financial statements for a specific objectives they have taken.

ACCOUNTING PRINCIPLES

Accounting principles refers to the conduct or procedure adopted while recording the accounting transactions. It ensures uniformity, clarity and understanding.

Accounting principles can be classified into two categories :

(1) Accounting concepts **(2) Accounting conventions.**

(1) ACCOUNTING CONCEPTS

Accounting, concepts refer to the basic assumptions upon which the science of accounting is based. The following are the important accounting concepts.

(i) Business entity concept :

In accounting, business is treated as an entity different from the proprietor. The transactions that takes place affect the business and not the proprietor. This concept help to keep the business affair free from the effects of private affairs of the proprietor.

(ii) Dual aspect concept :

Every business transaction has two aspects - debit & credit. For every debit there is a corresponding and equal credit.

e.g. When the business buys an asset, the asset comes in. This is one aspect. To buy the asset, business pays cash. This is another aspect.

(iii) Going concern concept:

This concept assumes that the business will continue for a long time to come and it is not likely to be liquidated in the near future.

(iv) Accounting period concept :

Though the business is a continuous affair, the life of the business is divided into accounting periods, say, a period of one year.

(v) Revenue match concept :

This concept is based on accounting period concept. Income made by the business during a period can be ascertained only when the revenue earned during the period is compared with the expenditure incurred for earning the revenue.

(vi) The cost concept :

According to this concept, all assets acquired by a concern are shown in the accounting records at cost. i.e.,the price paid to acquire them.

(vii) Money measurement concept:

According to this concept the accounting records should reflect only items which can be measured in terms of money.

e.g. : The skill of the manager, employer - employee relationship etc. cannot be shown in the books of account. This can be added up only through money values.

(viii) Rupee value concept :

This concept assumes that the value of rupee is constant.

(ix) Realisation concept :

According to this, revenue is recognized only when the sale is made. If no sale takes place, no revenue is considered.

(2) ACCOUNTING CONVENTIONS

Accounting conventions are customs or traditions followed while preparing the accounting statements. The important conventions are as follows.

(i) Convention of conservation :

According to this convention the accountants are expected to be conservatives while preparing accounts. They are expected not to take 'anticipated profits' but provide for all 'possible losses'.

(ii) Convention of consistancy :

According to this convention, accounting practices should remain unchanged for long time unless it becomes absolutely essential.

For example, if a particular method of charging depreciation is followed for a particular asset, the method should be consistently followed.

(iii) Convention of full disclosure :

Accounting reports should give full disclosure of the information. Giving foot notes, references and parentheses in the statement is in accordance with this conventions only.

(iv) Convention of Materiality :

Accountants should report only what is material. He should ignore insignificant details while preparing final accounts.

Theory Questions

Part - A

Short Questions:

1. What is Accounting?
2. What is Convention of materiality?
3. Explain Cost concept of accounting?

Choose the best answer :

1. Business is distinct from owner. This concept is called

   a) Seperate entity b) Going concern

   c) Cost d) Money measurement (Ans : a)

2. Accounting is

   a) An art b) a science

   c) both art and science d) None of the above (Ans: a)

3. Accounting Refers to

a) Selling and buying transaction

b) Counting the cash

c) Recording business transaction in terms of money

d) Getting and giving credit (Ans : c)

4. Every business transaction has

a) one aspect b) two aspect

c) three aspect d) four aspect (Ans : b)

5. The business entity concept can be applied to

a) sole proprietor b) partnership farm

c) company d) all the above (Ans : d)

6. According to going concern concept, a business entity is assumed to have

a) long life b) short life

c) no life d) none (Ans : a)

7. Accounting does not record non financial transaction

a) entity concept b) dual aspect concept

c) money measurement concept d) cost concept (Ans : c)

Part - B

1. Mention the objectives of accounting 2

2. What are accounting concepts? 5

3. Explain accounting conventions? 6

4. Mention the persons interested in accounting.