FINANCIAL ACCOUNTING

CONCEPTUAL FRAMEWORK

INTRODUCTION TO ACCOUNTING

- What is Event?

Anything that occurs in general parlance is an Event. It may or may not cause any change in the financial condition of any business unit.

Examples:

1. Using new material in the production,
2. Death of a general manager,
3. Threat by labour union to call a strike,
4. Change in price of the product that the company buy or sell,
5. Improvement of technology by competitor,

and so on.

- Now, what exactly do we mean by Financial Condition?
  If we can identify whether a person is "better off or worse off" than before due to occurrence of an event, then we can say that the financial condition of that person has changed.
- Event that affects the "financial condition" of any party is called an Economic Event.
- For Accounting Purpose, we consider only the "Economic Event" for the following reasons:
  i. It changes the financial condition of an individual.
  ii. It is measurable in terms of money.

- Any Economic Event that will occur between two or more parties (receiver and giver), then this will be termed as "Transaction".

- Broadly, Transaction can be:
  i. Transfer/exchange of something of value among two or more parties (reciprocal transfer) (e.g.: goods purchased for cash – flow of goods from seller to buyer, flow of cash from buyer to seller)
  ii. Non-reciprocal transfer (e.g.: penalty imposed by local authority, payment of income tax, etc.)
- From the two facets of Transaction (Receiver and Giver), Double Entry System originated.

ACCOUNTANCY, ACCOUNTING, ACCOUNT

These three terms cannot be used interchangeably.

- Accountancy is the entire body of theory and practices of Accounting.
- Accounting is the systematic process of recording economic events or transactions and thereby generating information necessary for rational decision-making by users.

- Accounts are the “objects of Accounting”. It is created using different key terms for recording similar transactions. E.g.: Purchase Account – all transactions related to purchase are recorded in that account.

ACCOUNT

- The classification of transactions into different accounts is done on the basis of several “Concepts & Conventions”.
- Classification of Transactions into different accounts is done to record the debit and credit entry.
- What is Debit and Credit?

To answer this, first we need to get familiar with the concepts of “Double Entry System” and “Accounting Equation”.

DOUBLE ENTRY SYSTEM is a system of recording business transactions which recognises that each transaction has a Dual Aspect, i.e., two parts/facets, which indicates that two accounts are always affected by each transaction.

- ACCOUNTING EQUATION is the basis of Double Entry System. Total assets in a business are provided by the creditors/lenders and the owners. Thereby, at any point of time Total Assets will be equal to Total Liabilities. This particular relationship is expressed in terms of Accounting Equation:

  Total Assets = Total Liabilities

  or, Total Assets = Liabilities + Capital

“Liability” means liability to outsiders and “Capital” means liability to owners.

Now coming to where we left our discussion on “Debit & Credit”.

- One account will receive a "debit" entry, meaning the amount will be entered on the *left* side of that account. Another account will receive a "credit" entry, meaning the amount will be entered on the *right* side of that account.

- Whenever an accounting transaction is created, at least two accounts are always impacted, with a debit entry being recorded against one account and a credit entry being recorded against the other account.

- The totals of the debits and credits for any transaction must always equal each other, so that an accounting transaction is always said to be "in balance." If a transaction were not in balance, then it would not be possible to create financial statements.

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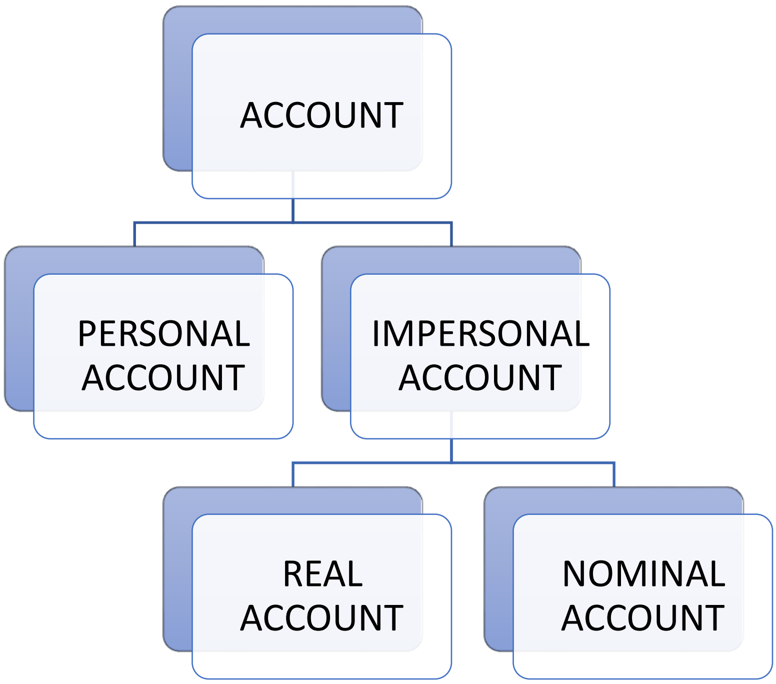
- **The initial challenge with double-entry is to know which account should be debited and which account should be credited.**

  Here comes the need for proper classification of Accounts.

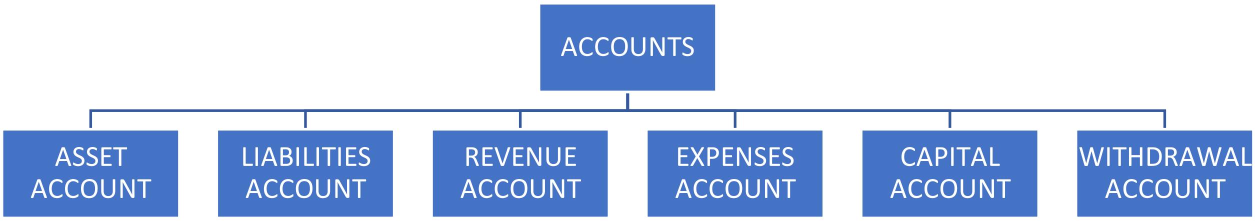
- Number of Accounts can be infinite but we cannot do systematic recording using these innumerable number of accounts. So, Accounts are classified as follows:

TRADITIONAL CLASSIFICATION (Golden Rule)



Types of Account	Short Explanations	Examples	Account to be debited	Account to be credited
Personal Account Or Representative Personal Account (representing a person)	Accounts of Individuals, Firm, Institution, Company, Association, Liabilities, etc. Outstanding wages, for example, is a representative personal account.	A & Co. A/c, Loan A/c, etc.	Receiver	Giver
Real Account	Assets only.	Machinery A/c, Building A/c, Goodwill A/c, Cash A/c, etc.	What comes in.	What goes out.
Nominal Account	Income, Expenses, Gains and Losses.	Wages A/c, Salaries A/c, Discount Allowed A/c, etc.	Expenses or losses.	Incomes or gains.

MODERN CLASSIFICATION



TYPES OF ACCOUNTS	SHORT EXPLAINATION WITH EXAMPLES	ACCOUNT TO BE DEBITED	ACCOUNT TO BE CREDITED
ASSET ACCOUNT	Assets and Properties E.g.: Land, Building, Plant, etc. account.	Increase	Decrease
LIABILITIES ACCOUNT	Lenders, Creditors for goods, Creditors of expense, etc. account.	Decrease	Increase
REVENUE ACCOUNT	Incomes and Gains account.	Decrease	Increase
EXPENSES ACCOUNT	Expenses and Losses account.	Increase	Decrease
CAPITAL ACCOUNT	Account of Proprietor or partner who invested money in the business.	Decrease	Increase
WITHDRAWAL ACCOUNT	Account related to Drawings by Proprietor/purchaser.	Increase	Decrease

ILLUSTRATION: 1

Analyse the following transactions, state the nature of accounts and state which accounts will be debited and which account will be credited:

a) Kabir started his business with cash of Rs.50000
b) Borrowed from Naresh Rs.30000
c) Purchased furniture for Rs.20000 in cash from Modern Furniture House.
d) Purchased goods for cash Rs.15000
e) Purchased goods from Ramesh Rs.30000
f) Sold goods for cash to Rahul Rs.25000
g) Deposited cash into bank Rs.15000 for opening an account.
h) Withdrew cash for personal use Rs.2000
i) Withdrew from bank for office use Rs.5000
j) Paid rent by cheque Rs.5000
k) Paid interest on loan Rs.4000
l) Received cheque from Shyam Rs.5000
m) Deposited Shyam's cheque next day.

BASIC TERMINOLOGIES

1. Debtors: A person who owes amount to the enterprise on account of credit sale of goods or services.

2. Creditors: A person to whom the enterprise owes amount on account of credit purchase of goods and services.

3. Assets: Anything which will enable the firm to get cash or benefit in future is an Asset.

- **i. Fixed Assets –** Assets which are purchased for the purpose of operating the business and not for resale. Example: Land, building, machinery, furniture, etc.
- **ii. Current Assets –** Assets which are kept for short-term with a purpose to convert them into cash or for resale. Example: stock, debtors, bank balance, etc.
- **iii. Tangible Assets –** Assets which have physical existence, i.e., can be seen and touched. E.g.: Land, Building, Machinery, etc.
- **iv. Intangible Assets –** Assets which do not have any physical form, i.e., they cannot be seen and touched. E.g.: Goodwill, Trademarks, Patents, etc.

4. Liabilities (external liability): Amount which the business owes to outsiders but not to the owners.

- i. **Long Term Liability** – Liabilities which are payable after a long term (generally more than a year). E.g.: Long-term loans, debentures, etc.
- ii. **Current Liabilities** – Liabilities which are payable in the near future (generally within a year).

5. Capital (internal liability): Amount invested by the proprietor in the business. For the firm, it is a liability to the owner.

6. Drawings: It is the amount which the proprietor takes from the business for his/her personal/domestic use. It reduces the Capital of the owners.

7. Stock or Inventory:

- It is the tangible property held by an enterprise for the purpose of sale in the ordinary course of business or for using it for the purpose of production of goods meant for sale.
- Stock may be Opening Stock (Stock at the beginning of the accounting Period) or Closing Stock (Stock at the end of the accounting period).
- Stock is classified as Current Asset in the Balance Sheet.
- Stock is valued at “Cost or Market Price” – whichever is less.

CAPITAL & REVENUE CONCEPT

CAPITAL EXPENDITURE	REVENUE EXPENDITURE
It is incurred for acquisition of fixed assets for use in business.	It is incurred for conduct of business.
It increases the earning capacity of business.	It is incurred for earning profits.
Its benefit extends to more than one year.	Its benefit extends to one year only.
It is non-recurring in nature.	It is recurring in nature.
It is debited to Asset account.	It is debited to Expense account.
It is a Real Account.	It is a Nominal Account.
It is shown in the Balance Sheet.	It is shown in Trading account or Profit & Loss account.
Example: • Cost of Plant & Machinery • Cost of Land & Building	Example: • Depreciation of Plant & Machinery • Rent • Repairs and Insurance
Such Expenditures includes: • Expenditure to bring an asset into existence. • Expenditure to purchase a fixed asset. • Expenditure for extension of a fixed asset. • Expenditure to acquire right to carry on business. (preliminary expense, expenditure for obtaining license, etc.) • Legal charges incurred for protecting fixed assets, rights.	Such Expenditure includes: • Expenditure incurred for day-to-day running of the business. (rent, salaries, wages, power, fuel, etc.) • Expenditure incurred for maintenance of fixed assets. • Depreciation • Renewal Fee for carrying on the business.

Some expenses which are "Revenue" in nature but treated as "Capital Expenditure"

a) **Expenses incurred in repairing for the first time on purchase of an old building since such expenses were necessary to bring the building into existence.**
b) **Wages paid to workers to produce a tool to be used by factory itself.**
c) **Expenses incurred in connection with purchase of Land and Building, say, registration fees.**
d) **Interest on Loan raised to acquire an asset.**
e) **Material and stores used to construct fixed assets.**
f) **Transport charges incurred for new plant or machinery are treated as Capital Expenditure and added to the Cost of the Asset.**

STUDENT'S NOTE: The basic idea behind capital & revenue transactions is same. So Capital & Revenue Income, Profit and Loss are note covered under this study material.

RESERVE vs PROVISION

RESERVE	PROVISION
It is an appropriation of profit.	It is a charge on profit.
It is debited to Profit & Loss Appropriation Account.	It is debited to Profit & Loss Account.
It is created to strengthen the financial position and not meant to cover	It is made to meet known liability or contingency.

- **Revenue Reserve** is available for distribution as dividend to the shareholders. E.g.: General Reserve, Dividend Equalisation Reserve, Debenture Redemption Reserve, etc.
- **Capital Reserve** is created out of capital profits and is not available for distribution as dividend to the shareholders. All capital profits should be regarded as capital reserves, **E.g.:** Profit prior to incorporation, Premium on issue of shares or debentures, Profit on sale of fixed assets, etc.
- **General Reserve** is the amount set aside out of profits for no specific purpose. It is available for any future contingency or expansion of business.

BASIS OF ACCOUNTING

CASH BASIS	ACCRUAL BASIS
• It records only cash transactions.	• It records both cash and credit transactions.
• It is not the basis of double-entry system.	• It is the basis of double-entry system.
• Income and Expenses are measured when cash is actually received and paid respectively.	• Income and Expenses are measured when transactions take place.
• Prepayments or Accruals are not recorded.	• Prepayments or Accruals are recorded.
• Final Accounts cannot be prepared.	• Final Accounts can be prepared.
• GAAP do not recognise this basis.	• GAAP recognise this basis.

[**NOTE**: GAAP (Generally Accepted Accounting Principles): It refer to a common set of accounting principles, standards and procedures to be followed at a particular time in a particular country.]

ILLUSTRATION: 2

Mr. P K Srinivasan started his profession as an engineer on 1.1.2017. His income and expenses for the year ended 31.12.2017 are as follows:

Fees received in cash	Rs. 35100
Rent of chamber paid	Rs. 10800
Rent of chamber paid in advance (included above)	Rs. 800
Fees accrued but not yet received	Rs.2000
Salary of compounder paid	Rs. 5400

Salary of compounder outstanding Rs. 500

You are required to ascertain net income from his profession for the year ended 31.12.2017 under:

a) Cash Basis of Accounting
b) Accrual Basis of Accounting

ACCOUNTING CONCEPTS AND CONVENTIONS

"Accounting Concepts" are the theories on how and why certain categories of transactions should be treated in a particular manner.

1) Business Entity Concept:
    - ✓ The business and its owner(s) are two separate entities.
    - ✓ The Books of Accounts are prepared from the point of view of the business. Thus, "Capital" is a liability for the business unit and "Drawings" is an asset.
    - ✓ The Personal Transactions of the Owner are not recorded. For Example: A Car purchased by the owner for personal use is not Recorded in the Books of Account of the Business.
2) Going Concern Concept:
    - ✓ It is assumed that the entity is a going concern, i.e., it will continue to operate for an indefinitely long period in future and transactions are recorded from this point of view.
3) Money Measurement Concept:
    - ✓ In accounting, a record is made only of those transactions or events which can be measured and expressed in terms of money.
    - ✓ Non-monetary transactions (team-work, honesty, skill, etc.) are not recorded in accounting.
4) Accounting Period Concept:
    - ✓ For measuring the financial results of a business periodically, the working life of an undertaking is split into convenient short periods called accounting period.
5) Cost Concept:
    - ✓ An asset acquired by a concern is recorded in the books of accounts at historical cost (i.e., at the price actually paid for acquiring the asset). The market price of the asset is ignored.
6) Dual - Aspect Concept:
    - ✓ For Every Debit, there is a Credit Every transaction should have a two- sided effect to the extent of same amount
    - ✓ For Example: Cash Sales Rs. 10,000
Debit • Cash Account Rs. 10,000
Credit • Sales Account Rs. 10,000
    - ✓ This Concept has resulted in THE ACCOUNTING EQUATION.
7) Realisation Concept:
    - ✓ Profit is earned when goods or services are provided /transferred to customers. Thus it is incorrect to record profit when order is received, or when the customer pays for the goods.

8) Matching Concept:
   - ✓ The matching principle ensures that revenues and all their associated expenses are recorded in the same accounting period.
   - ✓ The matching principle is the basis on which the accrual accounting method of book-keeping is built.
   - ✓ E.g.: Salary paid in 2012-13 relating to 2011-12 Such salary is treated as Expenditure for 2011-12 under Outstanding Salaries Account, not for the year 2012-13

Accounting Conventions: Accounting Conventions are the common practices which are universally followed in recording and presenting accounting information of business. It helps in comparing accounting data of different business or of same units for different periods.

1) Materiality:
   - ✓ Only those transactions, important facts and items are shown which are useful and material for the business. The firm need not record immaterial and insignificant items.
   - ✓ Illustration: Company XYZ Ltd. bought 6 months supplies of stationary worth $600. Question: Should the Company spread the cost of this stationary for 6 months by expensing off $100 per month to the income statement?
     Answer: Based on this concept, as the amount is so small or immaterial, it can be expensed off in the next month instead of tediously expensing it in the next 6 months.
2) Full Disclosure:
   - ✓ Financial Statements and their notes should present all information that is relevant and material to the user's understanding of the statements.
3) Conservatism:
   - ✓ Anticipate No Profits but Provide for all Losses Accountant should always be on side of safety.
   - ✓ For Example: Making Provision for Bad and Doubtful Debts ; Showing Depreciation on Fixed Assets but not appreciation,etc.
4) Consistency:
   - ✓ The accounting practices and methods should remain consistent from one accounting period to another. Whatever accounting practice is followed by the business enterprise, should be followed on a consistent basis from year to year.
   - ✓ For Example:
     2009-10 -> Straight Line Method
     2010-11 -> Written Down Value Method
     2011-12 -> Units of Measure Method