

Ch. 1 Nature and Purpose of Accounting

❖ **Introduction:**

Every business involves exchange of goods or services. That means a businessman or business concern deals with other parties in exchange of goods or services. Such dealings, in business, are called business transactions. The business transactions include purchase of goods or services, sale of goods or services, payments, receipts etc. In a business concern, the transactions are numerous. All the details of these varied transactions cannot be remembered by the businessman.

So there was a need to record all business transaction in a systematic way and this job of recording of transactions have been later on called as “Book-keeping”.

❖ **Meaning of Book Keeping:**

Book keeping is a process of recording business transactions in the books of accounts in a systematic manner.

Booking Keeping is the process of analysing, classifying and recording transactions in a systematic manner to provide information about the financial affairs of the business concern.

Book-Keeping may be defined as the science and the art of the recording monetary, business transactions in a set of books.

‘Book’ means ‘Book of Accounts’ and ‘keeping’ means ‘maintaining’ the books of accounts. Thus, the writing of business transactions in the books of accounts for future use is a simple meaning of Book-Keeping.

❖ **Book Keeping is a Science or an Art :**

Book Keeping is a science as well as an art. Book-keeping has some rules and principles as (like) science. Book keeping is a systematic body of knowledge governed by certain rules. Therefore, it is called as science. However, it is not a physical, natural or pure science like chemistry, Biology or Mathematics, but a social science evolved by man and society. Therefore answers provided by book keeping are not always fixed or rigid, but largely dependent upon the needs of the business and the society.

An art means an action of doing a thing with some skill and experience. Therefore, Book-keeping is an art. An accountant (Book-keeper) can represent any typical transactions in an easy way with his art. In book-keeping some transactions can be represented in alternate (different) ways.

❖ **Importance of Book-Keeping :**

Following points explain the Importance of Book Keeping.

1. **Aid to Memory:** Human memory has certain limitations. A businessman cannot remember all the business transactions. Book-keeping helps the businessman in this regard also. Due to Book-keeping, it is not necessary to remember the transactions.
2. **Facilitates planning:** Proprietors have to plan their business operations for years to come. Book-keeping generates valuable information about production, sales, expenses and incomes, which helps planning.

3. **Decision making:** Management has to take valuable decisions about business. Book-keeping makes available necessary information, which facilitates decision-making.
4. **Controlling:** With the help of available financial information and figures the executives of the business can control the business.
5. **Comparison:** A businessman can do yearly comparative study to understand the business position over the years. He can also do the comparative study with other business units.
6. **Evidence in litigations:** Court considers the record provided by businessman as an evidence in case of any disputes.
7. **Sale of business:** In case the business is sold out, the purchase consideration can be decided on the basis of the accounts maintained.

❖ **Utility of Book Keeping :**

To Owner: It helps to find out profit, losses, Assets, liabilities in the business at any time.

To Management: It helps the management in planning, decision making, controlling and managing the overall business activities.

To Government: Book keeping helps various department of government to decide how much taxes are collected from business.

To Investors: Investors can decide whether to invest or not to invest their funds in the business on the basis of information provided by the Book-keeping & Accountancy.

To Customers: Customers can judge the financial capacity of the business and can remain assured about smooth supply of goods.

To Lenders: Lenders can study the creditworthiness of the business firm with the help of books of accounts which assures continuous supply of funds.

To Purchaser: Book-Keeping helps the purchaser to find out the true value of the business.

To Trade Union: Book Keeping helps the trade union to know that wages, salaries or bonus given to employees are fair or not. A Trade union is able to demand high wage (Wage hike) on the basis of book-keeping.

To Partner: In case of partnership firm, partners are able to get information about admission, retirement or death of a partner from book-keeping.

❖ **Meaning of Accountancy/Accounting:**

Accountancy/Accounting is a wider concept than Book-keeping. Book-keeping is the recording branch of Accountancy. Accountancy includes Book-keeping & classifying, summarising & interpreting of the business transactions. It makes easy to take decisions relating to business. Accountancy starts where book-keeping ends.

Accountancy is concerned with the processes of recording, sorting & summarising data resulting from Business operations & events. Accountancy also refers to systematic analysis of the recorded data.

❖ **Distinction between Book-keeping & Accountancy**

	Book-keeping	Accountancy
1	Meaning	
	Book-keeping is a process of recording business transactions in the books of accounts in a systematic manner	Accountancy is concerned with the processes of recording, sorting & summarising data resulting from Business operations & events. Accountancy also refers to systematic analysis of the recorded data.
2	Stage	
	Book-keeping is the first stage and it comes immediately after transaction.	Accountancy comes after recording and classification. Accountancy is the next stage after Book-keeping.
3	Objectives	
	Book-keeping aims at keeping the record and provides primary information.	Accountancy aims at finding the profits or losses and gives financial position.
4	Level of work	
	In book-keeping, the level of work is less. It is done by junior staff.	In accountancy, the level of work is high. It is done by senior staff.
5	Results	
	Book-keeping basically results in Journal and Ledger.	The results of Accountancy is Profit and Loss A/c and Balance sheet.
6	Period	
	Book-keeping gives day to day details.	Accountancy gives details of entire year.
7	Scope	
	Book-keeping has a limited scope.	Accountancy has a wider scope.

❖ **Basis of Accountancy / Accounting:**

- 1 **Cash Basis:** Under this system only cash transactions are recorded. Under cash basis an income is recorded only when cash is actually received and expenses are recorded when cash is actually paid. The business records every cash that comes in business and every cash that goes from business.
- 2 **Accrual Basis:** An income is recorded when it is earned (whether cash received or not) and expenses are recorded when they become payable. Both cash as well as credit transactions are recorded. This is also called Mercantile Basis of Accounting.

❖ **Branches of Accounting**

In order to satisfy the needs of different people interested in the accounting information, different branches of accounting have been developed. The changing business scenario has given birth to the specialized branches of accounting which are:

- 1 **Financial Accounting:** Financial Accounting is concerned with recording of financial transactions, summarizing and interpreting them and communicating the results. It is original form of accounting that ascertains profits earned or loss suffered during a specific period (generally a year) and ascertains the financial position on the date when the accounting period ends.
- 2 **Cost Accounting:** It is the process of accounting and controlling the cost of product, operation or function. The purpose of this branch of accounting is to ascertain the cost, to control the cost and to communicate information for decision.
- 3 **Management Accounting:** It is an accounting for the management i.e. accounting which provides necessary information to the top level management for discharging its functions. Management accounting covers various areas such as cost accounting, budgetary control, inventory control, statistical methods, internal auditing etc. The purpose of this branch of accounting is to supply all information that management may need in taking decisions and to evaluate the impact of its decisions and actions.

❖ **ACCOUNTING PRINCIPLES**

Meaning of Accounting Principles

The literal (dictionary) meaning of the term Principle is that it is a basic fundamental truth or treaty, which is uniformly accepted and followed by everyone & everywhere. Development of accounting principle took place from time to time based on experience, usage and necessity. ***Accounting principles are those rules of action or conduct, which are accepted universally by all accountants in recording transactions in the books of accounts.*** (Accounting principles are those rules which are to be adopted by Accountants) These principles are usually developed by professional accounting bodies.

Accounting principles can be broadly classified into two main categories

- a) Accounting Concepts
- b) Accounting Conventions

Meaning of Accounting Concept

Accounting is the language of business. In the absence of systematic approach, accountants may use their own language and it may not be understood in the same sense by all concerned parties. With a view to make accounting language a standard language, certain accounting concepts have been developed over a course of period. *Accounting concepts are general guidelines for sound accounting practices.*

Accounting concepts are assumptions and conditions on which the whole accounting structure stands. They are the predetermined condition which a book - keeper must keep in mind, while recording transactions in the books of accounts.

Entity concept / Entity / Business Entity:

Entity means something that has real separate existence. In other words, entity refers to status or personality. The business has separate existence from its owner or proprietor. For instance **Mr. A** has been conducting business under the title **Ganesh Medicals** for last so many years. Here in this case **Mr. A** and **Ganesh Medicals** are different from each other.

Money Measurement concept / Money measurement:

There is a need to express transactions in common unit of measurement, Every transaction is recorded in terms of money. In India all the accountants use only Indian currency i.e. 'Rupee' (₹) Because of this concept only monetary items are recorded. In accounting, everything is recorded in terms of money. Events or transactions, which can not be expressed in terms of money, are not recorded in the books of accounts, even if they are very important or useful for the business.

Cost concept:

This concept does not recognise the realisable value, the replacement value or the real worth of an asset. Thus, as per cost concept.

- a) An asset is ordinarily recorded at the price paid to acquired (got/purchased) it i.e. At its cost, and
- b) This cost is the basis for all subsequent accounting for the asset.

Going concern concept:

It is the basic assumption that business will continue for a quite long time, it will go on and on and will not be closed down or stopped for a quite long time. Business is not to be closed at its early stage but should give a long life. This principle helps may investors to invest, many suppliers to give credit, many workers or employees to give services.

Realisation concept:

Income is recorded only when it is realized i.e. either it is received or earned. Revenues are recorded only when sale are effected or the services are rendered. Sales revenues are considered as recognized when sales are effected during the accounting period irrespective of the fact whether cash is received or not.

Accrual Concept:

It implies recording of revenues (Incomes) and expenses of a particular accounting period, whether they are received or paid in cash or not. Income is recorded when it accrues (earned) and expenses are recorded when they accrue (become payable) All expenses and revenues related to the accounting period are to be considered irrespective of the fact, the revenues (Incomes) are received in cash or not or expenses are paid in

cash or not. Outstanding expenses & outstanding incomes are entered in the books of Account due to accrual concept.

Dual Aspect:

Every business transaction has two effects and involves exchange of benefits. Benefit received and benefit given both the aspects should be recorded in the books. The system which records such dual aspects in the books is known as Double Entry System.

This principle also considered as the concept of debit & credit. The account where the benefit comes in is debited and the account where benefit goes out is credited.

Matching Concept / Matching Principle:

This concept is very important for determination of profit or loss correctly. According to this concept, the profit of the business is calculated by matching total revenue earned during the year with total expenses incurred during the same period. The difference between the two represents profit or loss. *Excess of revenue over expenses is profit while Excess of expenses over revenue is a loss.*

Meaning of Accounting Conventions

Dictionary meaning of convention is behaviour and attitudes that most people in a society considered to be normal and right. Accordingly, accounting conventions refer to rules which have common acceptance and agreement in accountancy. In other words, customs or traditions which guide or direct the preparation of accounts are called accounting conventions. In this sense, accounting conventions and accounting concept are synonymous. In short, *accounting conventions means customs or traditions which are followed years together to prepare accounts of the business concern.*

Different Accounting Conventions are as follows:**1 Convention of Disclosure / Disclosure / full Disclosure:**

The accounts must disclose all material (important) information. The accounting reports should disclose full and fair information to the related parties. The financial position and performance should be disclosed very honestly to all the users. The financial position means the Balance Sheet of the business and financial performance means business results in terms of profits or losses and income and expenses in profit and loss account.

All the information disclosed should be relevant, reliable, comparable and understood by all the concerned authorities.

2 Convention of Materiality / Materiality:

Material means important. The accountant should attach importance to material (important) details and ignore insignificant (unimportant) details. If this is not done accounts will be overburdened with minute (small) details. As per the American Accounting Association, "an item should be regarded as material, if there is a reason to believe that knowledge of it would influence the decision of informed investor."

Therefore, keeping the convention of materiality in view, unimportant items are either left out or merged with other items or shown as foot notes.

3 Convention of consistency / consistency concept:

Any policy adopted for accounting should be continuous or consistent throughout the business and it need not be changed generally unless and until circumstances demand. However it does not stop any improvement of new techniques. But that should be disclosed with a note.

4 Convention of Conservatism:

It refers to the policy of 'playing safe'. *As per this convention all prospective (possible & expected) losses are taken into consideration but not all prospective (possible & expected) profits. In other words anticipate no profit but provide for all possible losses.*

❖ **Accounting Standards****Meaning of Accounting Standards**

Accounting Standards are written policy documents issued by the expert accounting body or by Government or other regulatory body.

Standards of Accounting is recommended by the Institute of Chartered Accountants of India (I.C.A.I.) and prescribed by the Central Government in consultation with the National Advisory committee of Accounting Standards (N.A.C.A.S.)

Accounting Standards are written policy documents issued by the expert accounting body or by Government or other regulatory body covering following various aspects.

- 1) Recognition 2) Measurement 3) Treatment 4) Presentation

Objectives of Accounting Standards

To standardize the diverse accounting policies and practices with a view to eliminate the non-comparability of financial statements and add the reliability to the financial statements.

Some Accounting Standards (AS):

The Council of the Institute of Chartered Accountants of India has so far issued thirty two accounting standards. Some of these accounting standards are explained below-

- 1 AS-1 Disclosure of Accounting Policies (1-4-1991)**
According to this standard the accounting policies followed in the preparation and presentation of financial statements should form a part of the financial statements and normally be disclosed in one place.
- 2 AS-2 Valuation of Inventories (1-4-1991)**
According to this standard inventories in general should be valued at lower of historical cost and net realisable cost.
- 3 AS-3 Cash flow statements (1-4-2000)**
According to this standard a cash flow statement is prepared and presented for the period for which the profit and loss account is prepared.

4 AS-6 Depreciation Accounting (1-4-1995)

According to this standard the depreciation amount of an asset should be allocated on a systematic basis for each accounting period during the useful life of an asset.

5 AS-8 Accounting for Research and Development (1-4-1991)

According to this standard the amount of research and development costs should be charged as an expense of the period in which they are actually incurred.

6 AS-9 Revenue Recognition (1-4-1991)

This standard deals with the basis required for recognition of revenue items in the Profit and Loss Account of an enterprise. It lays down conditions to recognize revenues that arise from the various transactions of an enterprise.

❖ International Financial Reporting Standard (IFRS)**Introduction to IFRS**

With the globalization of Indian economy it is needed that Indian accounting should be compatible to the International accounting practices. But different Countries adopt different accounting treatments, disclosures and patterns for the same economic event which may create confusion among the users while interpreting the financial statements. With this view in mind, most of the countries of the world are coming to a conclusion that they can adopt to International Financial Reporting Standards (IFRS) which would bring uniformity in the accounting Practices followed.

Meaning:

IFRS is a single set of high quality, understandable and enforceable global accounting standards. It is a principle based on set of standards which are drafted in a simple manner and are easy to understand and apply.

IFRS comprises of

1. International Accounting Standards (IAS) issued before 2001
2. International Financial Reporting Standards (IFRS) issued after 2001
3. Standing interpretation Committee (SIC) issued before 2001

In addition to the above there is a “Framework” for the preparation and presentation of financial statements which describes the principles underlying IFRS.