

1.3 ACCOUNTING

1.3.1 Meaning of Accounting

Accounting, as an information system is the process of identifying, measuring and communicating the economic information of an organization to its users who need the information for decision making. It identifies transactions and events of a specific entity. A transaction is an exchange in which each participant receives or sacrifices value (e.g. purchase of raw material). An event (whether internal or external) is a happening of consequence to an entity (e.g. use of raw material for production). An entity means an economic unit that performs economic activities.

1.3.2 Definition of Accounting

American Institute of Certified Public Accountants (AICPA) which defines accounting as “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”.

1.3.3 Objective of Accounting

Objective of accounting may differ from business to business depending upon their specific requirements. However, the following are the general objectives of accounting.

i) To keeping systematic record: It is very difficult to remember all the business transactions that take place. Accounting serves this purpose of record keeping by promptly recording all the business transactions in the books of account.

ii) To ascertain the results of the operation: Accounting helps in ascertaining result i.e., profit earned or loss suffered in business during a particular period. For this purpose, a business entity prepares either a Trading and Profit and Loss account or an Income and Expenditure account which shows the profit or loss of the business by matching the items of revenue and expenditure of the some period.

iii) To ascertain the financial position of the business: In addition to profit, a businessman must know his financial position i.e., availability of cash, position of assets and liabilities etc. This helps the businessman to know his financial strength. Financial statements are barometers of health of a business entity.

iv) To portray the liquidity position: Financial reporting should provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, cash dividends and other distributions of resources by the enterprise to owners and about other factors that may affect an enterprise's liquidity and solvency.

v) To protect business properties: Accounting provides upto date information about the various assets that the firm possesses and the liabilities the firm owes, so that nobody can claim a payment which is not due to him.

vi) To facilitate rational decision – making: Accounting records and financial statements provide financial information which help the business in making rational decisions about the steps to be taken in respect of various aspects of business.

vii) To satisfy the requirements of law: Entities such as companies, societies, public trusts are compulsorily required to maintain accounts as per the law governing their operations such as the Companies Act, Societies Act, and Public Trust Act etc. Maintenance of accounts is also compulsory under the Sales Tax Act and Income Tax Act.

1.3.4 Importance of Accounting

i) Owners: The owners provide funds or capital for the organization. They possess curiosity in knowing whether the business is being conducted on sound lines or not and whether the capital is being employed properly or not. Owners, being businessmen, always keep an eye on the returns from the investment. Comparing the accounts of various years helps in getting good pieces of information.

ii) Management: The management of the business is greatly interested in knowing the position of the firm. The accounts are the basis, the management can study the merits and demerits of the business activity. Thus, the management is interested in financial accounting to find whether the business carried on is profitable or not. The financial accounting is the “eyes and ears of management and facilitates in drawing future course of action, further expansion etc.”

iii) Creditors: Creditors are the persons who supply goods on credit, or bankers or lenders of money. It is usual that these groups are interested to know the financial soundness before granting credit. The progress and prosperity of the firm, two which credits are extended, are largely watched by creditors from the point of view of security and further credit. Profit and Loss Account and Balance Sheet are nerve centres to know the soundness of the firm.

iv) Employees: Payment of bonus depends upon the size of profit earned by the firm. The more important point is that the workers expect regular income for the bread. The demand for wage rise, bonus, better working conditions etc. depend upon the profitability of the firm and in turn depends upon financial position. For these reasons, this group is interested in accounting.

v) Investors: The prospective investors, who want to invest their money in a firm, of course wish to see the progress and prosperity of the firm, before investing their amount, by going through the financial statements of the firm. This is to safeguard the investment. For this, this group is eager to go through the accounting which enables them to know the safety of investment.

vi) Government: Government keeps a close watch on the firms which yield good amount of profits. The state and central Governments are interested in the financial statements to know the earnings for the purpose of taxation. To compile national accounting is essential.

vii) Consumers: These groups are interested in getting the goods at reduced price. Therefore, they wish to know the establishment of a proper accounting control,

which in turn will reduce to cost of production, in turn less price to be paid by the consumers. Researchers are also interested in accounting for interpretation.

viii) Research Scholars: Accounting information, being a mirror of the financial performance of a business organization, is of immense value to the research scholar who wants to make a study into the financial operations of a particular firm. To make a study into the financial operations of a particular firm, the research scholar needs detailed accounting information relating to purchases, sales, expenses, cost of materials used, current assets, current liabilities, fixed assets, long-term liabilities and share-holders funds which is available in the accounting record maintained by the firm.

Check Your Progress 1

List out five objectives of Accounting.

Notes: (a) Write your answer in the space given below.

(b) Check your answer with the ones given at the end of this Lesson (pp. 13).

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1.3.5 Functions of Accounting

i) Record Keeping Function: The primary function of accounting relates to recording, classification and summary of financial transactions-journalisation, posting, and preparation of final statements. These facilitate to know operating results and financial positions. The purpose of this function is to report regularly to the interested parties by means of financial statements. Thus accounting performs historical function i.e., attention on the past performance of a business; and this facilitates decision making programme for future activities.

ii) Managerial Function: Decision making programme is greatly assisted by accounting. The managerial function and decision making programmes, without accounting, may mislead. The day-to-day operations are compared with some pre-determined standard. The variations of actual operations with pre-determined standards and their analysis is possible only with the help of accounting.

iii) Legal Requirement function: Auditing is compulsory in case of registered firms. Auditing is not possible without accounting. Thus accounting becomes compulsory to comply with legal requirements. Accounting is a base and with its help various returns, documents, statements etc., are prepared.

iv) Language of Business: Accounting is the language of business. Various transactions are communicated through accounting. There are many parties-owners, creditors, government, employees etc., who are interested in knowing the results of the

firm and this can be communicated only through accounting. The accounting shows a real and true position of the firm or the business.

1.3.6 Advantages of Accounting

The following are the advantages of accounting to a business:

- i) It helps in having complete record of business transactions.
- ii) It gives information about the profit or loss made by the business at the close of a year and its financial conditions. The basic function of accounting is to supply meaningful information about the financial activities of the business to the owners and the managers.
- iii) It provides useful information for making economic decisions,
- iv) It facilitates comparative study of current year's profit, sales, expenses etc., with those of the previous years.
- v) It supplies information useful in judging the management's ability to utilise enterprise resources effectively in achieving primary enterprise goals.
- vi) It provides users with factual and interpretive information about transactions and other events which are useful for predicting, comparing and evaluating the enterprise's earning power.
- vii) It helps in complying with certain legal formalities like filing of income-tax and sales-tax returns. If the accounts are properly maintained, the assessment of taxes is greatly facilitated.

1.3.7 Limitations of Accounting

- i) Accounting is historical in nature: It does not reflect the current financial position or worth of a business.
- ii) Transactions of non-monetary nature do not find place in accounting. Accounting is limited to monetary transactions only. It excludes qualitative elements like management, reputation, employee morale, labour strike etc.
- iii) Facts recorded in financial statements are greatly influenced by accounting conventions and personal judgements of the Accountant or Management. Valuation of inventory, provision for doubtful debts and assumption about useful life of an asset may, therefore, differ from one business house to another.
- iv) Accounting principles are not static or unchanging-alternative accounting procedures are often equally acceptable. Therefore, accounting statements do not always present comparable data.
- v) Cost concept is found in accounting. Price changes are not considered. Money value is bound to change often from time to time. This is a strong limitation of accounting.

- vi) Accounting statements do not show the impact of inflation.
- vii) The accounting statements do not reflect those increase in net asset values that are not considered realized.

1.4 Methods of Accounting

Business transactions are recorded in two different ways.

1.4.1 Single Entry

1.4.2 Double Entry

1.4.1. Single Entry: It is incomplete system of recording business transactions. The business organization maintains only cash book and personal accounts of debtors and creditors. So the complete recording of transactions cannot be made and trail balance cannot be prepared.

1.4.2 Double Entry: In this system every business transaction is having a two fold effect of benefits giving and benefit receiving aspects. The recording is made on the basis of both these aspects. Double Entry is an accounting system that records the effects of transactions and other events in at least two accounts with equal debits and credits.

1.4.3 Steps involved in Double entry system

(a) **Preparation of Journal:** Journal is called the book of original entry. It records the effect of all transactions for the first time. Here the job of recording takes place.

(b) **Preparation of Ledger:** Ledger is the collection of all accounts used by a business. Here the grouping of accounts is performed. Journal is posted to ledger.

(c) **Trial Balance preparation:** Summarizing. It is a summary of ledger balances prepared in the form of a list.

(d) **Preparation of Final Account:** At the end of the accounting period to know the achievements of the organization and its financial state of affairs, the final accounts are prepared.

1.4.4 Advantages of Double Entry System

i) **Scientific system:** This system is the only scientific system of recording business transactions in a set of accounting records. It helps to attain the objectives of accounting.

ii) **Complete record of transactions:** This system maintains a complete record of all business transactions.

iii) **A check on the accuracy of accounts:** By use of this system the accuracy of accounting book can be established through the device called a Trail balance.

iv) **Ascertainment of profit or loss:** The profit earned or loss suffered during a period can be ascertained together with details by the preparation of Profit and Loss Account.

v) **Knowledge of the financial position of the business:** The financial position of the firm can be ascertained at the end of each period, through the preparation of balance sheet.

vi) **Full details for purposes of control:** This system permits accounts to be prepared or kept in as much detail as necessary and, therefore, affords significant information for purposes of control etc.

vii) **Comparative study is possible:** Results of one year may be compared with those of the previous year and reasons for the change may be ascertained.

viii) **Helps management in decision making:** The management may be also to obtain good information for its work, specially for making decisions.

ix) **No scope for fraud:** The firm is saved from frauds and misappropriations since full information about all assets and liabilities will be available.

1.5 Meaning of Debit and Credit

The term 'debit' is supposed to have derived from 'debit' and the term 'credit' from 'creditable'. For convenience 'Dr' is used for debit and 'Cr' is used for credit. Recording of transactions require a thorough understanding of the rules of debit and credit relating to accounts. Both debit and credit may represent either increase or decrease, depending upon the nature of account.

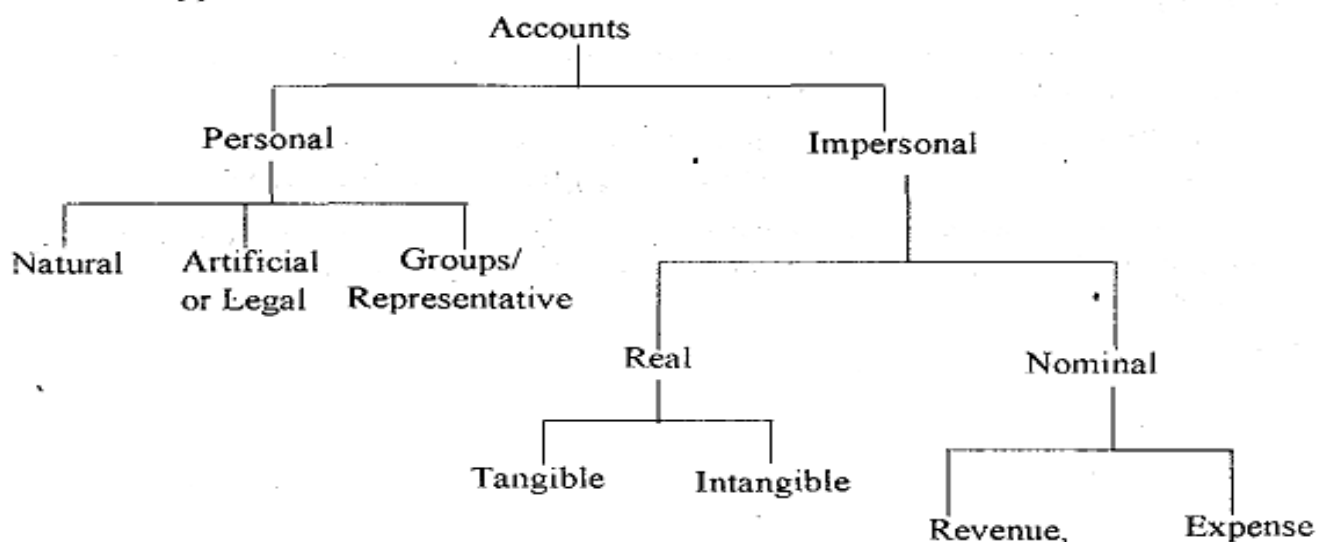
1.6 Types of Accounting

Types of Accounts

The object of book-keeping is to keep a complete record of all the transactions that place in the business. To achieve this object, business transactions have been classified into three categories:

- (i) Transactions relating to persons.
- (ii) Transactions relating to properties and assets
- (iii) Transactions relating to incomes and expenses.

The accounts falling under the first heading are known as 'personal Accounts'. The accounts falling under the second heading are known as 'Real Accounts', The accounts falling under the third heading are called 'Nominal Accounts'. The accounts can also be classified as personal and impersonal. The following chart will show the various types of accounts:



1.6.1 Personal Accounts: Accounts recording transactions with a person or group of persons are known as personal accounts. These accounts are necessary, in particular, to record credit transactions. Personal accounts are of the following types:

(a) **Natural persons:** An account recording transactions with an individual human being is termed as a natural persons' personal account. eg., Kamal's account, Mala's account, Sharma's accounts. Both males and females are included in it

(b) **Artificial or legal persons:** An account recording financial transactions with an artificial person created by law or otherwise is termed as an artificial person, personal account, e.g. Firms' accounts, limited companies' accounts, educational institutions' accounts, Co-operative society account.

(c) **Groups/Representative personal Accounts:** An account indirectly representing a person or persons is known as representative personal account. When accounts are of a similar nature and their number is large, it is better to group them under one head and open a representative personal accounts. e.g., prepaid insurance, outstanding salaries, rent, wages etc.

When a person starts a business, he is known as proprietor. This proprietor is represented by capital account for all that he invests in business and by drawings accounts for all that which he withdraws from business. So, capital accounts and drawings account are also personal accounts.

The rule for personal accounts is: **Debit the receiver**
Credit the giver

1.6.2 Real Accounts

Accounts relating to properties or assets are known as 'Real Accounts', A separate account is maintained for each asset e.g., Cash Machinery, Building, etc., Real accounts can be further classified into tangible and intangible.

(a) **Tangible Real Accounts:** These accounts represent assets and properties which can be seen, touched, felt, measured, purchased and sold. e.g. Machinery account Cash account, Furniture account, stock account etc.

(b) **Intangible Real Accounts:** These accounts represent assets and properties which cannot be seen, touched or felt but they can be measured in terms of money. e.g., Goodwill accounts, patents account, Trademarks account, Copyrights account, etc.

The rule for Real accounts is: **Debit what comes in**
Credit what goes out

1.6.3 Nominal Accounts

Accounts relating to income, revenue, gain expenses and losses are termed as nominal accounts. These accounts are also known as fictitious accounts as they do not represent any tangible asset. A separate account is maintained for each head or

expense or loss and gain or income. Wages account, Rent account Commission account, Interest received account are some examples of nominal account

The rule for Nominal accounts is: **Debit all expenses and losses**
Credit all incomes and gains

1.7 DISTINCTION BETWEEN BOOK-KEEPING AND ACCOUNTING

The difference between book-keeping and accounting can be summarized in a tabular form as under:

Basis of difference	Book-keeping	Accounting
Transactions	Recording of transactions in books of original entry.	To examine these recorded transactions in order to find out their accuracy.
Posting	To make posting in ledger	To examine this posting in order to ascertain its accuracy.
Total and Balance	To make total of the amount in journal and accounts of ledger. To ascertain balance in all the accounts.	To prepare trial balance with the help of balances of ledger accounts.
Income Statement and Balance Sheet	Preparation of trading, Profit & loss account and balance sheet is not book keeping	Preparation of trading, profits and loss account and balance sheet is included in it.
Rectification of errors	These are not included in book-keeping	These are included in accounting.
Special skill and knowledge	It does not require any special skill and knowledge as in advanced countries this work is done by machines.	It requires special skill and knowledge.
Liability	A book-keeper is not liable for accountancy work.	An accountant is liable for the work of book-keeper.

1.8 BRANCHES OF ACCOUNTING

The changing business scenario over the centuries gave rise to specialized branches of accounting which could cater to the changing requirements. The branches of accounting are;

- i) Financial accounting;
- ii) Cost accounting; and
- iii) Management accounting.

Now, let us understand these terms.

1.8.1 Financial Accounting

The accounting system concerned only with the financial state of affairs and financial results of operations is known as Financial Accounting. It is the original form of accounting. It is mainly concerned with the preparation of financial statements for the use of outsiders like creditors, debenture holders, investors and financial institutions. The financial statements i.e., the profit and loss account and the balance sheet, show them the manner in which operations of the business have been conducted during a specified period.

1.8.2 Cost Accounting

In view of the limitations of financial accounting in respect of information relating to the cost of individual products, cost accounting was developed. It is that branch of accounting which is concerned with the accumulation and assignment of historical costs to units of product and department, primarily for the purpose of valuation of stock and measurement of profits. Cost accounting seeks to ascertain the cost of unit produced and sold or the services rendered by the business unit with a view to exercising control over these costs to assess profitability and efficiency of the enterprise. It generally relates to the future and involves an estimation of future costs to be incurred. The process of cost accounting based on the data provided by the financial accounting.

1.8.3 Management Accounting

It is an accounting for the management i.e., accounting which provides necessary information to the management for discharging its functions. According to the Anglo-American Council on productivity, "Management accounting is the presentation of accounting information in such a way as to assist management in the creation of policy and the day-to-day operation of an undertaking." It covers all arrangements and combinations or adjustments of the orthodox information to provide the Chief Executive with the information from which he can control the business e.g. Information about funds, costs, profits etc. Management accounting is not only confined to the area of cost accounting but also covers other areas (such as capital expenditure decisions, capital structure decisions, and dividend decisions) as well.

LESSON – 2 PRINCIPLES OF ACCOUNTING

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2.0 AIMS AND OBJECTIVES

1. To understand the meaning and definition of Accounting.
2. To study the basic accounting principles.
3. To know the bases of accounting.
4. To understand the accounting terminology and equation.

2.1 INTRODUCTION

The word 'Principle' has been differently viewed by different schools of thought. The American Institute of Certified Public Accountants (AICPA) has viewed the word 'principle' as a general law of rule adopted or professed as a guide to action; a settled ground or basis of conduct of practice"

Accounting principles refer, to certain rules, procedures and conventions which represent a consensus view by those indulging in good accounting practices and procedures. Canadian Institute of Chartered Accountants defined accounting principle as "the body of doctrines commonly associated with the theory and procedure of accounting, serving as an explanation of current practices as a guide for the selection of conventions or procedures where alternatives exist. Rules governing the formation of accounting axioms and the principles derived from them have arisen from common experiences, historical precedent, statements by individuals and professional bodies and regulations of Governmental agencies". To be more reliable, accounting statements are prepared in conformity with these principles. If not, chaotic conditions would result. But in reality as all the businesses are not alike, each one has its own method of accounting. However, to be more acceptable, the accounting principles should satisfy the following three basic qualities, viz., relevance, objectivity and feasibility. The accounting principle is considered to be relevant and useful to the extent that it increases the utility of the records to its readers. It is said to be objective to the extent that it is supported by the facts and free from personal bias. It is considered to be feasible to the extent that it is practicable with the least complication or cost. Though accounting principles are denoted by various terms such as concepts, conventions, doctrines, tenets, assumptions, axioms, postulates, etc., it can be classified into two groups, viz., accounting concepts and accounting conventions.

2.2 ACCOUNTING CONCEPTS AND CONVENTIONS

2.2.1 Accounting concepts:

The term 'concept' is used to denote accounting postulates, i.e., basic assumptions or conditions upon the edifice of which the accounting super-structure is based. The following are the common accounting concepts adopted by many business concerns.

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|----------------------------|--------------------------------|
| 1. Business Entity Concept | 2. Money Measurement Concept |
| 3. Going Concern Concept | 4. Dual Aspect Concept |
| 5. Periodicity Concept | 6. Historical Cost Concept |
| 7. Matching Concept | 8. Realisation Concept |
| 9. Accrual Concept | 10. Objective Evidence Concept |

i) Business Entity Concept: A business unit is an organization of persons established to accomplish an economic goal. Business entity concept implies that the business unit is separate and distinct from the persons who provide the required capital to it. This concept can be expressed through an accounting equation, viz., $\text{Assets} = \text{Liabilities} + \text{Capital}$. The equation clearly shows that the business itself owns the assets and in turn owes to various claimants. It is worth mentioning here that the business entity concept as applied in accounting for sole trading units is different from the legal concept. The expenses, income, assets and liabilities not related to the sole proprietorship business are excluded from accounting. However, a sole proprietor is personally liable and required to utilize non-business assets or private assets also to settle the business creditors as per law. Thus, in the case of sole proprietorship, business and non-business assets and liabilities are treated alike in the eyes of law. In the case of a partnership, firm, for paying the business liabilities the business assets are used first and if any surplus remains thereafter, it can be used for paying off the private liabilities of each partner. Similarly, the private assets are first used to pay off the private liabilities of partners and if any surplus remains, it is treated as part of the firm's property and is used for paying the firm's liabilities. In the case of a company, its existence does not depend on the life span of any shareholder.

ii) Money Measurement Concept: In accounting all events and transactions are recode in terms of money. Money is considered as a common denominator, by means of which various facts, events and transactions about a business can be expressed in terms of numbers. In other words, facts, events and transactions which cannot be expressed in monetary terms are not recorded in accounting. Hence, the accounting does not give a complete picture of all the transactions of a business unit. This concept does not also take care of the effects of inflation because it assumes a stable value for measuring.

iii) Going Concern Concept: Under this concept, the transactions are recorded assuming that the business will exist for a longer period of time, i.e., a business unit is considered to be a going concern and not a liquidated one. Keeping this in view, the suppliers and other companies enter into business transactions with the business unit. This assumption supports the concept of valuing the assets at historical cost or replacement cost. This concept also supports the treatment of prepaid expenses as assets, although they may be practically unsaleable.

iv) Dual Aspect Concept: According to this basic concept of accounting, every transaction has a two-fold aspect, viz., 1. giving certain benefits and 2. Receiving certain benefits. The basic principle of double entry system is that every debit has a corresponding and equal amount of credit. This is the underlying assumption of this concept. The accounting equation viz., $\text{Assets} = \text{Capital} + \text{Liabilities}$ or $\text{Capital} = \text{Assets} - \text{Liabilities}$, will further clarify this concept, i.e., at any point of time the total assets of the business unit are equal to its total liabilities. Liabilities here relate both to the outsiders and the owners. Liabilities to the owners are considered as capital.

v) Periodicity Concept: Under this concept, the life of the business is segmented into different periods and accordingly, the result of each period is ascertained. Though the business is assumed to be continuing in future (as per going

concern concept), the measurement of income and studying the financial position of the business for a shorter and definite period will help in taking corrective steps at the appropriate time. Each segmented period is called "accounting period" and the same is normally a year. The businessman has to analyse and evaluate the results ascertained periodically. At the end of an accounting period, an Income Statement is prepared to ascertain the profit or loss made during that accounting period and Balance Sheet is prepared which depicts the financial position of the business as on the last day of that period. During the course of preparation of these statements capital revenue items are to be necessarily distinguished.

vi) Historical Cost Concept: According to this concept, the transactions are recorded in the books of account with the respective amounts involved. For example, if an asset is purchased, it is entered in the accounting record at the price paid to acquire the same and that cost is considered to be the base for all future accounting. It means that the asset is recorded at cost at the time of purchase but it may be methodically reduced in its value by way of charging depreciation. However, in the light of inflationary conditions, the application of this concept is considered highly irrelevant for judging the financial position of the business.

vii) Matching Concept: The essence of the matching concept lies in the view that all costs which are associated to a particular period should be compared with the revenues associated to the same period to obtain the net income of the business. Under this concept, the accounting period concept is relevant and it is this concept (matching concept) which necessitated the provisions of different adjustments for recording outstanding expenses, prepaid expenses, outstanding incomes, incomes received in advance, etc., during the course of preparing the financial statements at the end of the accounting period.

viii) Realisation Concept: This concept assumes or recognizes revenue when a sale is made. Sale is considered to be complete when the ownership and property are transferred from the seller to the buyer and the consideration is paid in full. However, there are two exceptions to this concept, viz., 1. Hire purchase system where the ownership is transferred to the buyer when the last instalment is paid and 2. Contract accounts, in which the contractor is liable to pay only when the whole contract is completed, the profit is calculated on the basis of work certified each year.

ix) Accrual Concept: According to this concept the revenue is recognized on its realization and not on its actual receipt. Similarly the costs are recognized when they are incurred and not when payment is made. This assumption makes it necessary to give certain adjustments in the preparation of income statement regarding revenues and costs. But under cash accounting system, the revenues and costs are recognized only when they are actually received or paid. Hence, the combination of both cash and accrual system is preferable to get rid of the limitations of each system.

x) Objective Evidence Concept: This concept ensures that all accounting must be based on objective evidence, i.e., every transaction recorded in the books of account must have a verifiable document in support of its existence. Only then, the transactions can be verified by the auditors and declared as true or otherwise. The verifiable evidence for the transactions should be free from the personal bias, i.e., it

should be objective in nature and not subjective. However, in reality the subjectivity cannot be avoided in the aspects like provision for bad and doubtful debts, provision for depreciation, valuation of inventory, etc., and the accountants are required to disclose the regulations followed.

2.2.2 Accounting Conventions

The following conventions are to be followed to have a clear and meaningful information and data in accounting:

i) Consistency: The convention of consistency refers to the state of accounting rules, concepts, principles, practices and conventions being observed and applied constantly, i.e., from one year to another there should not be any change. If consistency is there, the results and performance of one period can be compared easily and meaningfully with the other. It also prevents personal bias as the persons involved have to follow the consistent rules, principles, concepts and conventions. This convention, however, does not completely ignore changes. It admits changes wherever indispensable and adds to the improved and modern techniques of accounting.

ii) Disclosure: The convention of disclosure stresses the importance of providing accurate, full and reliable information and data in the financial statements which is of material interest to the users and readers of such statements. This convention is given due legal emphasis by the Companies Act, 1956 by prescribing formats for the preparation of financial statements. However, the term disclosure does not mean all information that one desires to get should be included in accounting statements. It is enough if sufficient information, which is of material interest to the users, is included.

iii) Conservatism: In the prevailing present day uncertainties, the convention of conservatism has its own importance. This convention follows the policy of caution or playing safe. It takes into account all possible losses but not the possible profits or gains. A view opposed to this convention is that there is the possibility of creation of secret reserves when conservatism is excessively applied, which is directly opposed to the convention of full disclosure. Thus, the convention of conservatism should be applied very cautiously.

2.3 BASES OF ACCOUNTING

There are three bases of accounting in common usage. Any one of the following bases may be used to finalise accounts.

1. Cash basis
2. Accrual or Mercantile basis
3. Mixed or Hybrid basis.

2.3.1 Accounting on 'Cash basis

Under cash basis accounting, entries are recorded only when cash is received or paid. No entry is passed when a payment or receipt becomes due. Income under cash basis of accounting, therefore, represents excess of receipts over payments during an accounting period. Government system of accounting is mostly on cash basis.

Certain professional people record their income on cash basis, but while recording expenses they take into account the outstanding expenses also. In such a case, the financial statements prepared by them for determination of their income is termed as Receipts and Expenditure Account.

2.3.2 Accrual Basis of Accounting or Mercantile System

Under accrual basis of accounting, accounting entries are made on the basis of amounts having become due for payment or receipt. Incomes are credited to the period in which they are earned whether cash is received or not. Similarly, expenses and losses are detailed to the period in which, they are incurred, whether cash is paid or not. The profit or loss of any accounting period is the difference between incomes earned and expenses incurred, irrespective of cash payment or receipt. All outstanding expenses and prepaid expenses, accrued incomes and incomes received in advance are adjusted while finalising the accounts. Under the Companies Act 1956, all companies are required to maintain the books of accounts according to accrual basis of accounting.

2.3.3 Mixed or Hybrid Basis of Accounting

When certain items of revenue or expenditure are recorded in the books of account on cash basis and certain items on mercantile basis, the basis of accounting so employed is called 'hybrid basis of accounting'. For example, a company may follow mercantile system of accounting in respect of its export business. However, government subsidies and duty drawbacks on exports to be received from government are recorded only when they are actually received i.e., on cash basis. Such a method could be adopted because of uncertainty with respect of quantum, amount and time of receipt of such incentives and drawbacks. Such a method of accounting followed by the company is called the hybrid basis of accounting. In practice, the profit or loss shown under this basis will not be realistic. Conservative people who prefer recognising income when received but cautious to provide for all expenses, whether paid or not prefer this system. It is not widely practised due to the inconsistency.

2.4 ACCOUNTING TERMINOLOGY

It is necessary to understand some basic accounting terms which are daily in business world. These terms are called accounting terminology.

2.4.1 Transaction

"An event the recognition of which gives rise to an entry in accounting records. It is an event which results in change in the balance sheet equation. That is, which changes the value of assets and equity. In a simple statement, transaction means the exchange of money or moneys worth from one account to another account. Events like purchase and sale of goods, receipt and payment of cash for services or on personal accounts, loss or profit in dealings etc., are the transactions". Cash transaction is one where cash receipt or payment is involved in the exchange.

Credit transaction, on the other hand, will not have cash' either received or paid, for something given or received respectively, but gives rise to debtor and

creditor relationship. Non-cash transaction is one where the question of receipt or payment of cash does not at all arise, e.g. Depreciation, return of goods etc.,

2.4.2 Debtor

A person who owes money to the firm mostly on account of credit sales of goods is called a debtor. For example, when goods are sold to a person on credit that person pays the price in future, he is called a debtor because he owes the amount to the firm.

2.4.3 Creditor

A person to whom money is owing by the firm is called creditor. For example, Madan is a creditor of the firm when goods are purchased on credit from him

2.4.4 Capital

It means the amount (in terms of money or assets having money value) which the proprietor has invested in the firm or can claim from the firm. It is also known as owner's equity or net worth. Owner's equity means owner's claim against the assets. It will always be equal to assets less liabilities, say:

$$\text{Capital} = \text{Assets} - \text{Liabilities.}$$

2.4.5 Liability

It means the amount which the firm owes to outsiders that is, excepting the proprietors. In the words of Finny and Miller, "Liabilities are debts; they are amounts owed to creditors; thus the claims of those who are not owners are called liabilities". In simple terms, debts repayable to outsiders by the business are known as liabilities.

2.4.6 Asset

Any physical thing or right owned that has a money value is an asset. In other words, an asset is that expenditure which results in acquiring of some property or benefits of a lasting nature.

2.4.7 Goods

It is a general term used for the articles in which the business deals; that is, only those articles which are bought for resale for profit are known as Goods.

2.4.8 Revenue

It means the amount which, as a result of operations, is added to the capital. It is defined as the inflow of assets which result in an increase in the owner's equity. It includes all incomes like sales receipts, interest, commission, brokerage etc., However, receipts of capital nature like additional capital, sale of assets etc., are not a part of revenue.

2.4.9 Expense

The terms 'expense' refers to the amount incurred in the process of earning revenue. If the benefit of an expenditure is limited to one year, it is treated as an expense (also known as revenue expenditure) such as payment of salaries and rent.

2.4.10 Expenditure

Expenditure takes place when an asset or service is acquired. The purchase of goods is expenditure, where as cost of goods sold is an expense. Similarly, if an asset is acquired during the year, it is expenditure, if it is consumed during the same year, it is also an expense of the year.

2.4.11 Purchases

Buying of goods by the trader for selling them to his customers is known as purchases. As the trade is buying and selling of commodities purchase is the main function of a trade. Here, the trader gets possession of the goods which are not for own use but for resale. Purchases can be of two types, viz, cash purchases and credit purchases. If cash is paid immediately for the purchase, it is cash purchases, If the payment is postponed, it is credit purchases.

2.4.12 Sales

When the goods purchased are sold out, it is known as sales. Here, the possession and the ownership right over the goods are transferred to the buyer. It is known as 'Business Turnover' or sales proceeds. It can be of two types, viz., cash sales and credit sales. If the sale is for immediate cash payment, it is cash sales. If payment for sales is postponed, it is credit sales.

2.4.13 Stock

The goods purchased are for selling, if the goods are not sold out fully, a part of the total goods purchased is kept with the trader until it is sold out, it is said to be a stock. If there is stock at the end of the accounting year, it is said to be a closing stock. This closing stock at the year end will be the opening stock for the subsequent year.

2.4.14 Drawings

It is the amount of money or the value of goods which the proprietor takes for his domestic or personal use. It is usually subtracted from capital.

2.4.15 Losses

Loss really means something against which the firm receives no benefit. It represents money given up without any return. It may be noted that expense leads to revenue but losses do not. (e.g.) loss due to fire, theft and damages payable to others,

2.4.16 Account

It is a statement of the various dealings which occur between a customer and the firm. It can also be expressed as a clear and concise record of the transaction relating to a person or a firm or a property (or assets) or a liability or an expense or an income.

2.4.17 Invoice

While making a sale, the seller prepares a statement giving the particulars such as the quantity, price per unit, the total amount payable, any deductions made and shows the net amount payable by the buyer. Such a statement is called an invoice.

2.4.18 Voucher

A voucher is a written document in support of a transaction. It is a proof that a particular transaction has taken place for the value stated in the voucher. Voucher is necessary to audit the accounts.

2.5.19 Proprietor

The person who makes the investment and bears all the risks connected with the business is known as proprietor.

2.4.20 Discount

When customers are allowed any type of deduction in the prices of goods by the businessman that is called discount. When some discount is allowed in prices of goods on the basis of sales of the items, that is termed as trade discount, but when debtors are allowed some discount in prices of the goods for quick payment, that is termed as cash discount.

2.4.21 Solvent

A person who has assets with realizable values which exceeds his liabilities is insolvent.

2.4.22 Insolvent

A person whose liabilities are more than the realizable values of his assets is called an insolvent.

2.5 ACCOUNTING EQUATION

As indicated earlier, every business transaction has two aspects. One aspect is debited other aspect is credited. Both the aspects have to be recorded in accounts appropriately. American Accountants have derived the rules of debit and credit through a 'novel' medium, i.e., accounting equation. The equation is as follows:

$$\text{Assets} = \text{Equities}$$

The equation is based on the principle that accounting deals with property and rights to property and the sum of the properties owned is equal to the sum of the rights to the properties. The properties owned by a business are called assets and the rights to properties are known as liabilities or equities of the business. Equities can be subdivided into equity of the owners which is known as capital and equity of creditors who represent the debts of the business know as liabilities. These equities may also be called internal equity and external equity. Internal equity represents the owner's equity in the assets and external represents the outsider's interest in the asset. Based on the bifurcation of equity, the accounting equation can be restated as follows:

$$\text{Assets} = \text{Liabilities} + \text{Capital}$$

(Or)

$$\text{Capital} = \text{Assets} - \text{Liabilities}$$

(Or)

$$\text{Liabilities} = \text{Assets} - \text{Capital}$$