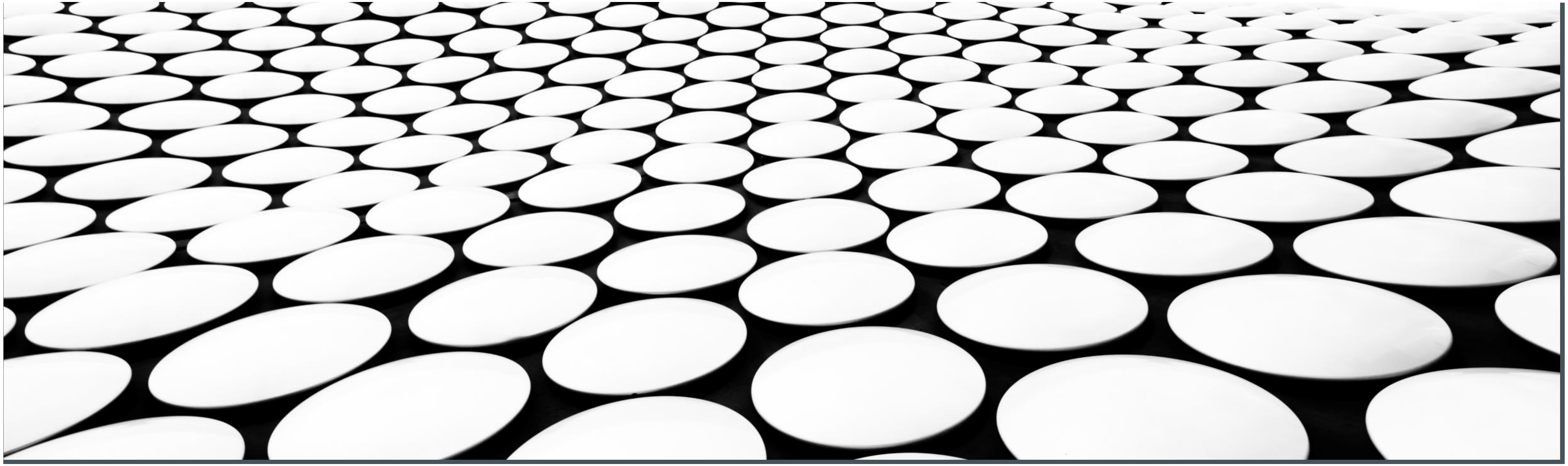
FUNDAMENTALS OF ACCOUNTING – MODULE II
OVERVIEW OF ACCOUNTING CONCEPTS

BY B D CHATTERJEE *FCA, ACMA, ACS, DIP (IFR) ACCA – UNITED KINGDOM*



Accounting Concepts
Accounting Conventions
Accounting Hierarchy

Accounting Concepts

ACCOUNTING CONCEPTS

Accounting concepts are guidelines used to help us determine how to record certain business transactions that have not yet been fully addressed by Accounting Standards. These procedures and principles are not legally binding but are generally accepted by accounting bodies. Basically, they are designed to build consistency and help accountants overcome practical problems that can arise when preparing Financial Statements.

OBJECTIVES OF THE ACCOUNTING CONCEPT

•The primary objective of accounting Concepts is to Maintain a systematic and Efficient way preparation of the financial statements.

•Accounting concepts act as an underlying principle that helps accountants in the preparation and maintenance of business records.

•It aims to understand the business rules and regulations that are required to be followed by all types of business entities, and hence simplifying the detailed and comparable financial information.

ACCOUNTING CONCEPTS

Following are the different accounting concepts that are widely used all around the world :

Business Entity Concept

This concept assumes that the organization and business owners are two independent entities. Hence, the business translation and personal transaction of its owner are different. For example, when the business owner invests his money in the business, it is recorded as a liability of the business to the owner. Similarly, when the owner takes away from the business cash/goods for his/her personal use, it is not treated as a business expense. Thus, the accounting transactions are recorded in the books of accounts from the organization's point of view and not the person owning the business.

Example:

Lets say, Mr. Banerjee started a business. He invested Rs 5,00,000. He purchased Land for Rs 2,00,000, furniture for Rs. 40,000, and plant and machinery for Rs. 10,000 and 2,50,000 remained in hand. These are the assets of the business and not of the business owner. According to the business entity concept, Rs.2,50,000 will be assumed by a business as capital i.e. a liability of the business towards the owner of the business.

Accrual Concept

The accrual principle is an accounting concept that requires transactions to be recorded in the time period in which they occur, regardless of when the actual cash flows for the transaction are received. The idea behind the accrual principle is that financial events are properly recognized by matching revenues against expenses when transactions – such as a sale – occur, rather than when the actual payment for the transaction may be received.

Example:

On March 16, 2023, the firm sold goods for Rs 1,00,000, and the payment was not received until April 19, 2023, the amount was due and payable to the firm on the date goods and services were sold i.e. March 16, 2023. It must be included in the revenue for the year ending March 31, 2023.
Similarly expenses are recognized at the time they have occurred, irrespective of the fact that cash for these services are paid.
In brief, the accrual concept states that revenue is recognized when realized and expenses are recognized when they become due and payable irrespective of the cash receipt or cash payment.

Accounting Cost Concept

This Accounting concept states that all Assets are to be recorded at their Historical Cost value and not on market value/opportunity costs/realizable vale . The cost principle is an accounting principle that records assets at their respective cash amounts at the time the asset was purchased or acquired. The amount of the asset that is recorded may not be increased for improvements in market value or inflation, nor can it be updated to reflect any depreciation..

Example:

A machine was purchased by the firm for Rs. 5,00,000. Additional cost of transportation and installation is spent worth Rs 5,500 and Rs 1,500 respectively. Hence the Total amount of the machine shall be written in the books is Rs 5,07,000. This is the Historical cost of the Machine which is not subject to change.

Going Concern Concept

According to this concept in accounting an enterprise is considered as Going Concern and it is presumed that it will continue it's operations for the forcible future. This simply means that every business has continuity of life. Hence, it will not be dissolved shortly. This is an important assumption of accounting as it provides a base for representing the asset value in the balance sheet.

Example:

A Plant was purchased by the business of Rs 25,00,000 and its span of life is 15 years. According to the Going concern concept, every year some amount of assets purchased by the business will be represented as an expense and the balance amount will be shown as an asset in the books of accounts. Thus, if an amount is incurred on an item that will be used in business for several years ahead, it will not be proper to charge the amount from the revenues of that particular year in which the item was purchased Only a part of the purchase value is shown as an expense in the year of purchase and the remaining balance is shown as an asset in the balance sheet.

Money Measurement Concept

This concept states only events and transactions that are measurable in terms of money are to be recorded in the books. The monetary unit principle states that business transactions should only be recorded if they can be expressed in terms of a currency. In other words, anything that is non-quantifiable should not be recorded a business' financial accounts. Over time, money has been adopted as a measurement unit in accounting

Example:

Office printer sold worth Rs. 4,500, purchase of raw material Rs. 5,000, rent paid Rs.14,000 are expressed in terms of money, hence these transactions can be recorded in the books of accounts. On the other hand lets say Mr. X has exchanged his Mobile phone with Mr. Y, not transaction shall be recorded as there is no monetary terms to define the worth of either of the mobile phones.

Periodicity Concept

Accounting period concepts state that all the transactions recorded in the books of account should be based on the assumption that profit on these transactions is to be ascertained for a specific period. Hence this concept says that the balance sheet and profit and loss account of a business should be prepared at regular intervals. This is important for different purposes like calculation of profit and loss, tax calculation, ascertaining financial position, etc. Also, this concept assumes that business indefinite life is divided into two parts. These parts are termed accounting periods. It can be one month, three months, six months, etc. Usually, one year is considered as one accounting period which may be a calendar year or financial year.

The year that begins on January 1 and ends on January 31 is termed as calendar year whereas the year that begins on April 1 and ends on March 31 is termed as financial year.

Dual Aspect Concept

The dual aspect concept states that every business transaction requires recordation in two different accounts. This concept is the basis of double entry accounting, which is required by all accounting frameworks in order to produce reliable financial statements. As the business is a separate entity each and every transaction of the business has two aspects. For example, goods purchased in exchange for cash have two aspects such as paying cash and receiving goods.

he duality of the transaction is commonly expressed in the terms of the following equation given below:

Assets = Liabilities + Capital

The dual concept implies that every transaction has a similar effect on assets and liabilities in such a way that the value of total assets is always equal to the value of total liabilities.

Realization Concept

The term realization concept states that revenue earned from any business transaction should be included in the accounting records only when it is realized. The term realization implies the creation of a legal right to receive money. Hence, it should be noted that selling goods is considered as realization whereas receiving order is not considered as realization.

In other words, the revenue concept states that revenue is realized when cash is received or the right to receive cash on the sale of goods or services or both have been created.

Matching Concept

The Matching concept states that revenue and expenses incurred to earn the revenue must belong to the same accounting period. Hence, once revenue is realized, the next step is to assign the relevant accounting period. For example, if you pay a commission to a salesperson for the sale that you record in March. The commission should also be recorded in the same month.

Matching Concept

- The Matching concept states that revenue and expenses incurred to earn the revenue must belong to the same accounting period.
- Hence, once revenue is realized, the next step is to assign the relevant accounting period.
- For example, if you pay a commission to a salesperson for the sale that you record in March. The commission should also be recorded in the same month.

Accounting Conventions

ACCOUNTING CONVENTIONS

- Accounting conventions are certain restrictions for the business transactions that are complicated and are unclear.
- Although accounting conventions are not generally or legally binding, these generally accepted principles maintain consistency in financial statements.
- While standardized financial reporting processes, the accounting conventions consider comparison, full disclosure of transaction, relevance, and application in financial statements.

CONSERVATISM

- It tells the accountants to err on the side of caution when providing the estimates for the assets and liabilities, which means that when there are two values of a transaction available, then the always lower one should be referred to.
- It states that a company must always follow the most conservative side of a financial transaction, which can be done by minimizing the profits (by recording uncertain liabilities and expenses and not recognizing uncertain gains)
- In case of casual losses, doubtful debts or any such future events that are uncertain in nature, the error should be done on the side of conservatism. It means that accountants should focus on recording more of estimated expenses and less of assets.
- This concept helps in showing a true view of the financial position and the path of the business in future.

CONSISTENCY

- A company is forced to apply the similar accounting principles across the different accounting cycles. Once this chooses a method it is urged to stick with it in the future also, unless it finds a good reason to perform it in another way. In the absence of these accounting conventions, the ability of investors to compare and assess how the company performs becomes more challenging.
- Consistency principle is important for a business both from accounting and auditing point of view as having a consistent set of accounting principles, procedures helps accountants in recording business transactions in an orderly manner.
- While in the case of auditors, it helps comparing business data much easier as the same accounting methods are followed consistently.
- It also provides the stakeholders and shareholders with a sense of satisfaction that the performance of the business can be tracked using a tried and tested accounting methodology which gives consistent results.
- The accuracy of the provided information can be assured as there is no change when following consistency principle, which enables shareholders and management in making better business decisions.

FULL DISCLOSURE

- Information that is considered potentially significant and relevant is to be completely disclosed, regardless of whether it is detrimental to the company.

- Full disclosure is especially beneficial for creditors and investors. The disclosing of financial information helps in decision making. The information is readily available to investors and creditors in the financial statements or as a note in the end of the financial statements.

- A company can have various stakeholders which include creditors, suppliers, customers, investors, etc. who use the financial information for deciding on the course of action to be taken regarding their stance in the business.

- Since, the external users of financial information lack any kind of information on how business is run, the full disclosure principle makes it easier to determine how a company is functioning.

MATERIALITY

- Similar to full disclosure, this convention also bound organizations to put down their cards on the table, meaning they need to totally disclose all the material facts about the company. The aim behind this materiality convention is that any information that could influence the person's decision by considering the financial statement must be included.

- Materiality concept also allows for the provision of ignoring other accounting principles if doing so doesn't have an impact on the financial statements of the business concerned.

- Therefore, the information present in the financial statements must be complete in terms of all material aspects, so that it is able to present an accurate picture of the business.

- The users of financial statements can be shareholders, auditors and investors, etc.

Example of Materiality Concept

A customer who has defaulted in payment of Rs.100 to a company that has a net assets of 5000 crores is regarded as immaterial for the company. However, if the default amount is Rs. 200 crores, then it will have an impact on the company.

DIFFERENT BRANCHES OF ACCOUNTS

- **Financial Accounting**: Financial Accounting is that branch of accounting which involves identifying, measuring, recording, classifying, summarizing the business transactions, i.e., it involves the steps from Identifying, Recording of transactions to Summarization, and communicating the financial data.
- **Cost Accounting**: Cost Accounting is that branch of accounting which is concerned with the process of ascertaining and controlling the cost of products or services.
- **Management Accounting**: Management accounting refers to that branch of accounting which is concerned with presenting the accounting information in such a way that helps the management in planning and controlling the operations of a business and in decision making.

ADVANTAGES OF ACCOUNTING

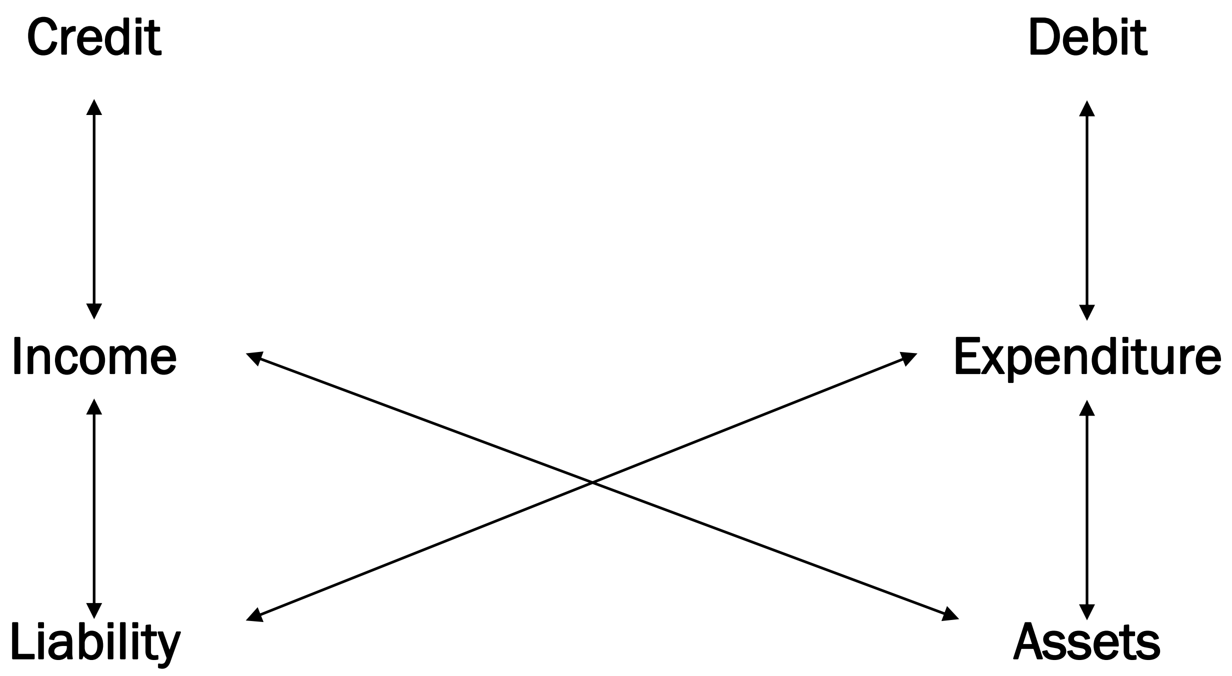
- Generates Information regarding financial performance.
- Maintains Business records.
- Preparation of Financial statements.
- Comparison of results.
- Provides Assistance to management
- Decision Making for future Activities.
- Keeps evidence in legal matters.
- Valuation of Business.
- Settlement of tax liability.
- Replacement of Memory.

DISADVANTAGES OF ACCOUNTING

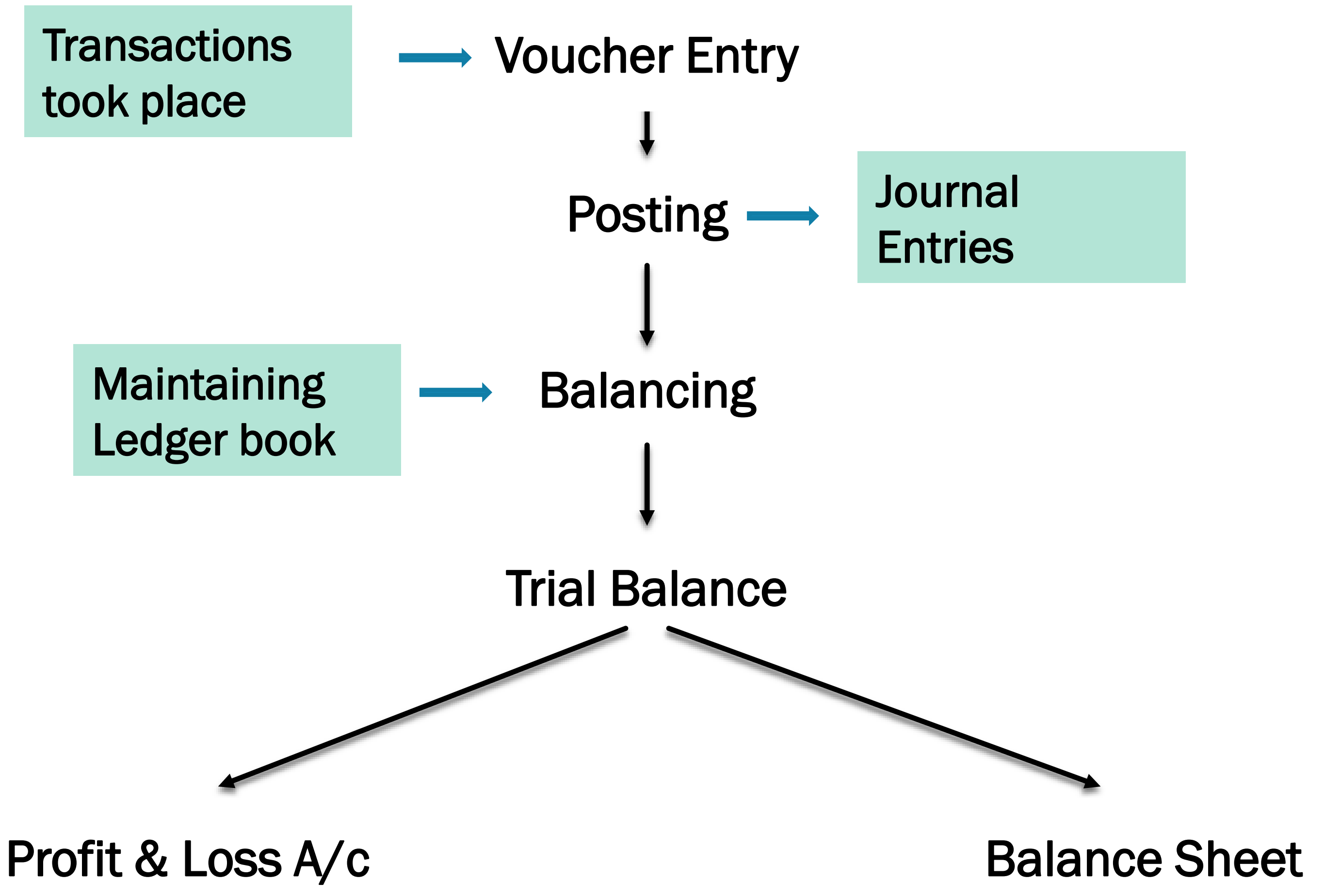
- Non financial transactions can not be tracked in the books of accounts.
- Data based on estimates.
- It ignores the price level change.
- It ignores qualitative information.
- Records may be biased.
- Manipulation of accounts.

Accounting Hierarchy

Basic Accounting relations



Flow of Accounts



Journal Records

A journal is a detailed account that records all the financial transactions of a business, to be used for the future reconciling of accounts and the transfer of information to other official accounting records, such as the general ledger. A journal states the date of a transaction, which accounts were affected, and the amounts, usually in a double-entry bookkeeping method.

- A journal is a detailed record of all the transactions done by a business.
- Reconciling accounts and transferring information to other accounting records is done using the information recorded in a journal.
- When a transaction is recorded in a company's journal, it's usually recorded using a double-entry method, but can also be recorded using a single-entry method of bookkeeping.
- The double-entry method records a transaction in two (or more) entries. Each entry identifies the account affected, and whether the account is a credit or a debit. The respective totals of the credits and debits must be equal.
- Single-entry bookkeeping is rarely used and only notes changes in one account.
- A journal is also used in the financial world to refer to a trading journal that details the trades made by an investor and why.

Journal Entries Rules

- **Personal Account -** A personal account is that of a person, company or an organization. In this case, debit the receiver and credit the giver.
- **Real Account -** Real account involves tangible and intangible items such as cash, bank, plant and machinery etc. In this case, debit what comes in and credit what goes out.
- **Nominal Account -** This account is related to expenses, incomes, gains and losses. In this case, debit all expenses and losses and credit all incomes and gains.

Basic Format of Journal Entries

Date	Particulars	L.F	Debit	Credit
	X Account…….Dr. To Y Account (Being…………………………….)		xxx	 xxx

Few Basic Examples of Journal Entries

Events	Particulars	L.F	Debit	Credit
Capital	Cash A/c…..............Dr.		xx	
	To Capital A/c			xx
	(Being a Business started with cash)			
Purchases	Purchases A/c….......Dr		xx	
	To Cash A/c			xx
	Being goods pruchased with cash)			
Drawings	Drawings A/c…........Dr		xx	
	To Cash A/c			xx
	(Being Cash withdrawn by owner for personal use)			
Sales	Cash A/c…..............Dr.		xx	
	To Sales A/c			xx
	(Being Goods sold for Cash)			
Expenses(Salary Paid)	Salary A/c….........Dr		xx	
	To Cash A/c			xx
	(Being Salary Paid to employeed)			
Income (Rent Received	Cash A/c…..............Dr.		xx	
	To Rent A/c			xx
	(Being rent for the month receieved)			

Ledger Accounts

All the Accounts recognized based on transactions recorded in different journals will be opened and maintained in a separate book called Ledger.
So a Ledger is a book of Accounts; in which all types of Accounts relating to assets, liabilities, capital, expenses and revenues are maintained. It is a complete set of Accounts of a business enterprise.
Ledger is in a book with pages consecutively numbered. It can also be a bundle of sheets.
All the items from the journal are recorded in Ledger Accounts and this process is known as posting entries from Journal to Ledger Accounts.

Types of Ledger Account

1. General Ledger-

A general Ledger is the master collection of all the Accounts that summarize all transactions occurring within an enterprise. There may be a small set of Ledgers that fall under the general Ledger. The general Ledger is used to record all the transactions in the financial statements of the business.
It comprises a debit and credit entry for every transaction recorded into it, to match the total debit and credit balance. It has to match to prepare the financial statements from it.
They are of two types-

i. **Nominal Ledger-** As the name suggests it contains all nominal Accounts i.e. expense, losses, incomes and gains. Examples – Salaries, Sales, Purchases, Returns Inward/Outward, Rent, Stationery, Insurance, Depreciation, etc.

ii. **Private Ledger-** Private Ledger consists of Accounts that are confidential such as capital, drawings, salaries, etc. These Accounts are only accessible by selected individuals.

2. **Purchase Ledger-**

Purchase Ledger records all the transactions the company has done with the suppliers. It shows which purchases are paid and which are outstanding. If the purchasing volume is relatively low, then there is no need for a purchase Ledger. Instead, this information is recorded directly within the general Ledger.
Each Account will generally have a credit balance and this shows the amount owed to a supplier by the business. The Sum of all the money owed by a business to its suppliers is known as Accounts payable.

3. **Sales Ledger-**

If the business just has one customer, it will not need to maintain a sales Ledger but just one Account in the Nominal Ledger will be enough. But, many businesses sell in credit and have many customers, for them maintaining a sales Ledger is very important.
This Account records all the transactions in which the goods have been sold to the customer in credit. The Sum of all the money which has been given on credit is called Accounts receivable.

Dr **Cash A/c** Cr

Date	Particulars	J/F	Amount	Date	Particular	J/F	Amount
	To Capital A/c	-	xxx		By Furniture A/c	-	xxx
	To Goods stock A/c	-	xxx		By Machinery A/c	-	xxx
					By balance c/d		xxx

Dr **Capital A/c** Cr

Date	Particulars	J/F	Amount	Date	Particular	J/F	Amount
					By Cash A/c	-	xxx
	To balance c/d	-	xxx			-	
					By balance b/d		xxx

Dr **Furniture A/c** Cr

Date	Particulars	J/F	Amount	Date	Particular	J/F	Amount
	To Cash	-	xxx		By balance c/d	-	xxx
						-	
			xxx				xxx

Dr **Goods A/c** Cr

Date	Particulars	J/F	Amount	Date	Particular	J/F	Amount
		-			By Cash A/c	-	xxx
	To balance c/d	-	xxx			-	
			xxx				xxx

Trial Balance

A trial balance is regarded as a bookkeeping worksheet where the balance of all ledgers is grouped together into debit and credit account column total equally. Preparation of trial balance for the company is done periodically, generally at the end of every reporting period, when the managers are required to report the company’s data to the top executives. The prior purpose of producing the trial balance is to be sure that the entries in a company's bookkeeping system are valid mathematically.

Trial balance for a company serves to detect any types of mathematical errors which might have occurred in the double-entry system of accounting. If the debit column is equal to the total of the credit column, the trial balance is then considered to be balanced, and there should be 0 mathematical errors in the ledgers. This of course does not mean that there are no errors in a company's accounting system as transactions which are classified improperly or those which are simply missing from the system is still an accounting error. This type of error cannot be detected by the trial balance procedure

Trial Balance			
Particulars	**L/F**	**Debit**	**Credit**
Plant & Machinery		xxx	
Furniture		xxx	
Inventory		xxx	
Debtors		xxx	
Bank		xxx	
Capital			xxx
Loan			xxx
Creditors			xxx
Sales		xxx	xxx
Sales Returns		xxx	xxx
Advertising		xxx	
Membership Fees		xxx	
Water and electricity		xxx	
Telephone		xxx	

THANK YOU!