

## Chapter-2

# Theory Base of Accounting

## Business Transactions

An exchange of goods or services for cash or on credit by the business with outsiders is called a transaction.

**In the words of L. C. Copper,** “ A person’s dealings in money or money’s worth are termed as transactions.”

**Entity:-** Business entity means a specific identifiable business enterprise like Tata, Reliance, Amul, Sony etc.

**Transactions:** - Exchange of goods and services for consideration.

**Assets:-** These are properties or economic resources of an enterprises which can be expressed in monetary terms it can be divided in two parts

(a) Non Current Assets : Fixed assets : Tangible & Intangible ( more than 1 year period)

Tangible Assets	Intangible Assets
Land and Building	Goodwill
Plant and Machinery	Patents
Furniture	Trademarks
Office Equipments	Copyright Computer software

(b) Current assets (less than 1 year period)

Examples of Current Assets are :

- Debtors
- Bills Receivable
- Cash in hand
- Cash at bank
- Cheques in hand
- Drafts in hand
- Stock
- Prepaid Expenses

### Definition of Assets

“ Assets are future economic benefits, the rights, which are owned or controlled by an organization or individual.” -- **Finney and Miller**

“ Assets are property or legal right owned by an individual or a company to which money value can be attached.” -- **R. Brockington**

**According to Institute of Certified Public Accountants, U.S.A ;**

“ Current Assets include cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business.”

**Liabilities**:-These are certain obligations or dues which firm has to pay. Liabilities can be divided into two categories i.e. Non Current Liabilities and Current Liabilities.

Non Current Liabilities	Current Liabilities
Bank Loan	Creditors
Mortgage	Bills Payable
Loan from other financial institutions	Outstanding Expenses
Other long term liabilities	Bank overdraft

**Trade Receivables :** Debtors + Bills Receivables

**Debtors:** - There are persons who owe to an enterprise an amount for buying goods and services on credit.

**Bills Receivables :** Amount to be received against B/R (from debtors).

**Trade Payable :** Creditors + Bills Payable

**Creditors:** - These are persons who have to be paid by an enterprise an amount for providing the enterprise goods and services on credit.

**Bills Payable :** Amount payable against the bills (to the creditors).

**Capital:** It is an essential investment for commencement of every business.

**Sales:** It can be credit or cash, in which goods are delivered to customers.

(a) Cash Sales (b) Credit Sales

**Revenues:** - It is the amount which is earned by selling of products.

**Expense:** - It is known as cost of assets consumed or services which used.

**Expenditure:** - It means spending money for some benefit.

**Profit:** - Excess of revenues over expenses is called profit.

**Gain:** - It generates from incidental transaction such as sales of fixed asset, winning of court case.

**Loss:** - Excess of expenses over income is termed as loss.

**Discount:** - It is defined as concession or deduction in price of goods sold.

**Voucher:** - It is known as evidence in support of a transaction.

**Goods:** - It refers all the tangible goods (Raw material, work in progress, finished goods.)

**Drawings:** - Amount of goods or cash which is withdrawn from business for personal use.

**Purchases:** - It means of procurement of goods on credit or cash.

**Stock:** - It is a part of unsold goods. It can be divided into two categories.

1. Opening stock

2. Closing stock

**Balance Sheet :** Balance Sheet is prepared at the end of each accounting period to ascertain the financial position of the business.

### Proforma of Balance Sheet

Liabilities	Amount	Assets	Amount
<b>Capital</b>	...	<b>Land</b>	...
<b>Creditors</b>	....	<b>Building</b>	....
<b>Bills Payable</b>	....	<b>Furniture</b>	....
<b>Outstanding Expense</b>	...	<b>Machinery</b>	....
<b>Loans</b>	...	<b>Stock</b>	....
	....	<b>Bills Receivable</b>	....
		<b>Debtors</b>	....
	....		....

### Capital expenditure:

“Outlay resulting in the increase or acquisition of an asset or increase in the earning capacity of the business are capital expenses”. **William pickles**

Benefit of this expenditure we [business] enjoy for a long time. Capital expenditure is incurred for the purpose of enjoying long term advantage for the business.

- This expenditure is mostly incurred for buying assets [tangible or intangible] which can later to be sold and converted into cash.
- This expenditure is incurred to increase the earning capacity of the business.

### Some examples of capital expenditure:

- ✓ Expenditure which are only for acquisition of fixed Assets
- ✓ Expenditure which are used for the extension or improvement in fixed Assets
- ✓ Legal charges incurred
- ✓ purchase of land, building,
- ✓ Purchase of furniture,
- ✓ Or any fixed asset for permanent use in the business.

**Revenue expenditure :** Mostly benefit of this expenditure we [business] enjoy only within the current year. Expenses of administration, manufacturing, selling expense, Office expense and all day to day expenses of the current year, are example of revenue expenditure.

**According to Kohlar**, it is “an expenditure charged against operation: a term used to contrast with capital expenditure.”

### Accounting Principles & Conventions

#### Accounting Principles

Changing your Tomorrow

Principles of Accounting are the general law or rule adopted or proposed as a guide to action, a settled ground or basis of conduct or practice. Accounting principles are man-made. Unlike the principles of physics, chemistry, and the other natural sciences, accounting principles were not deducted from basic axioms, nor is their validity verifiable by observation and experiment. Instead, they have evolved. This evolutionary process is going on constantly; accounting principles are not “eternal truths”.

#### Business Entity Concept

This concept considers a business unit as a separate entity. Business and businessman are two separate entities and all the business transactions are recorded in the books of accounts from business point of view.

### Dual Aspect Concept

This Concept also known as equivalence concept signifies that every business transaction has two fold effects or every transaction affects at least two accounts. This concept is, in fact, the base on which Double Entry System of Book-Keeping is based. According to this principle, every debit has a corresponding credit.

### Accounting Period Concept

According to this concept the long life of business is divided into justifiable accounting periods so as to help businessman to know the results of his investment during each such period. This period is known as accounting period and the length of this period depends on the nature of business. Accounting period may be either a calendar year (From January 1 to December 31) or the fiscal year of the Govt. (April 1 to March 31)

### Going Concern Concept

This concept assumes that every business has a long and indefinite life. Since financial statements are prepared on the basis of this concept, all fixed assets are shown in the books at their cost ignoring their market value.

### Cost Concept

According to this concept all fixed assets are recorded in the books at cost i.e. the price paid to acquire them. Any subsequent increase or decrease in their value will not be shown in the records except the depreciation of these assets. In subsequent years, therefore fixed assets are shown at cost less depreciation provided on them up to date. Continuous charging of depreciation on the asset will ultimately eliminate the asset from the books.

### Money Measurement Concept

According to this concept only those transactions are recorded in the books of accounts which can be expressed in monetary terms. The non-financial or non-monetary transactions do not find any place in the accounting records. Money is the common denominator to denote the value of the various assets of diverse nature to give a meaningful total of these assets.

### Matching Concept

This concept states that it is necessary to charge all the expenses incurred to earn revenue during the accounting period against that revenue in order to ascertain the net income or trading results of the business. The matching concept which is so closely related to accrual concept and accounting period concept helps a businessman in realizing his objective i.e. in ascertaining the trading results or profit or loss from the business. For ascertaining the net income.

### Accounting Equivalence Concept

According to this concept assets owned by the business must be equal to the funds contributed by the businessman in the form of capital. These days when business is to be carried on a large scale, funds may be borrowed from third parties to supplement the funds contributed by the proprietor.

### Realisation Concept

According to this concept income is treated as being earned on the date on which it is realized i.e. the date on which goods or services are transferred to the customers. Since this exchange of goods or services may be for cash or on credit, it is not important whether cash has actually been received or not.

### Objective Evidence Concept or Verifiable Objective Concept

This concept justifies the significance of verifiable documents supporting various transactions. According to it, each transaction should be supported by objective evidences like vouchers. Objective evidence, here, means evidence free from bias of the accountant.

### Materiality

This principle emphasizes that only those transactions should be recorded which are material or relevant for the determination of income from the business. All immaterial facts should be ignored.

### Full Disclosure

This concept implies that financial statements should disclose all material information which is required by the proprietor and other users to assess the final accounts of the business unit.

### Consistency

This principle requires that accounting practices, methods and techniques used by a business unit should be consistent. A business unit can adopt any accounting practice, but once a particular practice is chosen, it must be used for a number of years.

### Conservatism or Prudence

This principle is nothing but a formal expression of the maxim "Anticipate no profits and provide for all possible losses." In other words, it considers all possible losses but ignores all possible profits.

### Timeliness of Information

Accounting information to the management should be supplied in time and frequently so that some rational decisions may be taken. If information is not supplied in time, it will obstruct the quick decision making process of the undertaking.

### Accounting Standards

#### History and Development of Accounting Standards

The International Accounting Standards Committee (IASC) came into existence on 29<sup>th</sup> June 1973. The main objectives of IASC are to develop the accounting standards. In India the Institute of Chartered Accountants of India (ICAI) had constituted the 'Accounting Standards Board' in April 1977 for developing the Accounting Standards

#### Meaning of Accounting Standards :

Accounting standards are the rules in written form that ensure the uniformity of Accounting Standards, and provide guidance for the preparation, presentation and reporting of accounting information.

#### Features/Characteristics/Nature of Accounting Standards :

- a) Provide Guidance to the Accountants ;
- b) Brings Uniformity;
- c) Accounting Standards are flexible ;
- d) Provide information

#### Advantages of Accounting Standards

- a) Helpful in bringing the uniformity
- b) Helpful in improving the reliability of financial statements
- c) Helpful in resolving the conflicts among the users of financial information.

**Accounting Standards issued by the ICAI :** Amendment is made recently in the section 211 of companies act 1956. According to this amendment, the financial statements (Profit and Loss Account and Balance Sheet) of a company should comply with the Accounting Standards. The Council of the Institute of Chartered Accountants of India has so far issued the following 32 Accounting Standards (AS).

#### Process of Accounting :

- (1) Collecting and identifying financial transactions
- (2) Recording
- (3) Classifying
- (4) Summarising
- (5) Deals with financial transactions
- (6) Analysis and Interpretation
- (7) Communicates

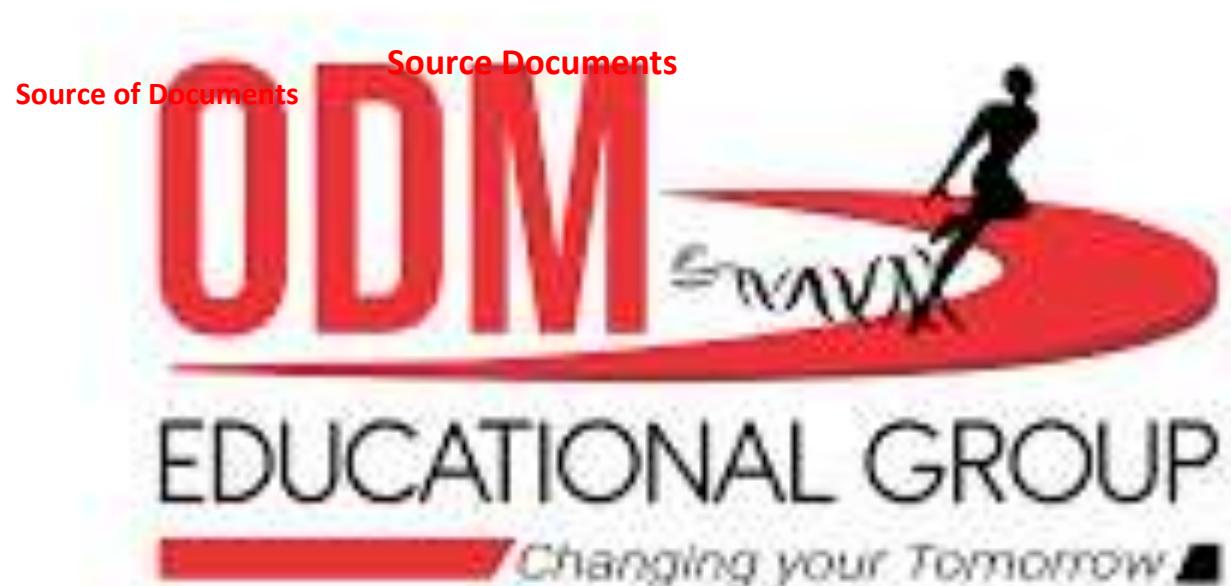
**Basis of Accounting :**

1. Cash Basis of Accounting
2. Accrual Basis of Accounting

**Cash Basis of Accounting :** Under this method only cash transactions are recorded in the books of accounts. Entries are made only if cash is received or paid.

**Accrual Basis of Accounting :**

Under this method all transactions are recorded in the books of accounts (Cash and Non-Cash). Entries are made on the Accrual basis, it means cash and Non-cash both transactions are recorded in the books of accounts.



All financial transactions are recorded in the books of accounts on the basis of source document or on the basis of some evidence. Source documents are helpful to prove that a transaction is actually made or not.

**Cash Memo :** Cash Memo is A **bill of sale**, it is a written document by a 'seller' to a **purchaser**, reporting that on a specific date, a particular sum of money or other "value received",

**Invoice or Bill :** When goods are sold on credit, An **invoice** or **bill** is issued on the name of the buyer, indicating the products, quantities, and agreed prices for products or services, the seller has provided the buyer.

**Receipt :** A **receipt** is a written acknowledgment that a specified a sum of money has been received from the customer as an exchange for goods or services. The receipt is evidence of purchase of the goods or service.

**Pay-in-Slip :** Pay in slip is a form that is filled when the money is deposited by a customer in to his bank account.

**Cheque :** A **cheque** is a document (usually a piece of paper) that orders a payment of money. The person writing the cheque, the *drawer*, usually has a account where the money is deposited.

**Debit Note :** When we return goods back to the supplier, a debit not is made on the name of supplier, it means his account his debited. Debit Note proves that a debit entry has been made to a debtor's or creditor's account.

**Credit Note:** When we receive goods back from our customer, then a credit not is made on the name of the customer, it means customer's account is credited.

**Meaning of Voucher :** Voucher is the documentary proof or evidence in support of a transaction. For example when we purchase goods for cash, we get cash memo, and when we purchase goods on credit, we get an invoice, when we make payment we get Receipt.

### **Types of Vouchers**

There are two types of vouchers

a) **Cash Voucher**

b) **Non Cash Voucher**

**Cash Vouchers:** Cash vouchers are prepared for cash transactions only, when cash is received or paid. There are two types of cash vouchers:

a) **Debit Vouchers**

b) **Credit Vouchers**

**Debit Vouchers:** Debit vouchers are prepared only for cash payments

**Credit Vouchers :** Credit vouchers are the opposite side of debit vouchers, Credit vouchers are prepared when we receive cash

**Preparation of accounting vouchers:** All business transactions recorded in the books of accounts can be compared with the source documents. Accounts are debited or credited on the basis of these source documents. After deciding, that what to be debited or credited, the next step is the preparation of the vouchers.

#### Meaning of Accounting Equation

The *Accounting Equation*' is based on the double-entry book keeping system. For every debit there must be a credit. The accounting equation states that the sum of the Total assets must be equal to the sum of the liabilities.

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

+ Capital Or

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

Liabilities Or

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

- Capital Or

$$\text{Assets} = \text{Total Liabilities or}$$

Total Equity Or

$$\text{Total Assets} = \text{Internal Liabilities} + \text{External Liabilities}$$