Unit 1: Introduction

1. Accounting Equation:

The accounting equation states that a company's total assets are equal to the sum of its liabilities and its shareholders' equity.

This straightforward relationship between assets, liabilities, and equity is considered to be the foundation of the double-entry accounting system. The accounting equation ensures that the balance sheet remains balanced. That is, each entry made on the debit side has a corresponding entry (or coverage) on the credit side.

The accounting equation is also called the basic accounting equation or the balance sheet equation.

Formula: Assets = (Liabilities + Owner's Equity)

2. Accounting Cycle

The accounting cycle is a collective process of identifying, analyzing, and recording the accounting events of a company. It is a standard 8-step process that begins when a transaction occurs and ends with its inclusion in the financial statements and the closing of the books. The key steps in the eight-step accounting cycle include recording journal entries, posting to the general ledger, calculating trial balances, making adjusting entries, and creating financial statements.

Steps of the Accounting Cycle

There are eight steps to the accounting cycle.

- Identify Transactions: An organization begins its accounting cycle with the identification of those transactions that comprise a bookkeeping event. This could be a sale, refund, payment to a vendor, and so on.
- Record Transactions in a Journal: Next comes the recording of transactions using journal entries. The entries are based on the receipt of an invoice, recognition of a sale, or completion of other economic events.
- Posting: Once a transaction is recorded as a journal entry, it should post to an account in the general ledger. The general ledger provides a breakdown of all accounting activities by account.
- Unadjusted Trial Balance: After the company posts journal entries to individual general ledger accounts, an unadjusted trial balance is prepared. The trial balance ensures that total debits equal total credits in the financial records.

- Worksheet: The fifth step is to create and analyze a worksheet of debits and credits to identify necessary adjusting entries, if there are discrepancies.
- Adjusting Journal Entries: At the end of the period, adjusting entries are made. These result from corrections made on the worksheet and the passage of time. For example, an adjusting entry may involve interest revenue that has been earned over time.
- Financial Statements: Upon the posting of adjusting entries, a company prepares an adjusted trial balance followed by the actual, formal financial statements.
- Closing the Books: An entity finalizes temporary accounts, revenues, and expenses, at the end of the period using closing entries. These closing entries include transferring net income to retained earnings. Finally, a company prepares the post−closing trial balance to ensure debits and credits match and the cycle can begin a new.

3. Cash Basis Accounting

Cash basis refers to a major accounting method that recognizes revenues and expenses at the time cash is received or paid out. This contrasts accrual accounting, which recognizes income at the time the revenue is earned and records expenses when liabilities are incurred regardless of when cash is received or paid. Cash basis accounting is advantageous because it is simpler and less expensive than accrual accounting. For some small business owners and independent contractors who carry no inventory, it is a suitable accounting practice. Many small businesses avoid employing accountants and using complex accounting systems when using this method because of its ease of use. It also gives an accurate picture of how much cash is on hand.

4. Accrual Basis Accounting

Accrual accounting is a financial accounting method that allows a company to record revenue before receiving payment for goods or services sold and record expenses as they are incurred.

In other words, the revenue earned and expenses incurred are entered into the company's journal regardless of when money exchanges hands. Accrual accounting is usually compared to cash basis of accounting, which records revenue when the goods and services are actually paid for. The general concept of accrual accounting is that accounting journal entries are made when a good or service is provided rather than when payment is made or received. Entries are also made for debts and payments due.

Accrual accounting follows the matching principle, which states that revenues and expenses should be recorded in the same period.

Accrual accounting is encouraged by International Financial Reporting Standards(IFRS) and Generally Accepted Accounting Principles (GAAP). As a result, it has become the standard accounting practice for most companies except for very small businesses and individuals.

Accounting Concepts

1. Entity Concept

The business entity concept should be applied to every type of business (sole proprietorship, partnership, and corporation) to retain financial integrity for those involved in the company. The purpose of the concept is to ensure the business' financial statements reflect the company's performance. It allows shareholders and other stakeholders to determine its financial performance and positioning. A business entity consists of many persons and bodies. They include the owners, which are the shareholders (in the case of a corporation), partners (in the case of partnership firms), or proprietors (in the case of proprietary concerns).

While some businesses, particularly partnerships and proprietary concerns are managed by the owners, many business enterprises are managed by persons other than their owners.

The hierarchy of managers may range from Chairman, Managing Director, or member of the Board of Directors, right down to the sectional heads appointed to manage specific operations of the enterprise.

In addition to the managers, there are employees and workers who perform specific tasks under the overall supervision of the owners or managers.

A business exists primarily to produce goods and services at minimum cost and then sell them for a profit.

However, the profits earned (or losses incurred) cannot be ascribed to any single person regardless of whether they are the owner, manager, or employee of the business. In the ultimate analysis, the results of the business operations must be related to the entity itself.

It is for this reason that the accounting process must be related to the operation of the business as a separate entity, one that is distinct from the persons interacting within organizations.

2. Money Measurement Concept

The monetary measurement concept is a core accounting principle that requires businesses to only record transactions if they can be quantified in money. This means that any events or transactions which cannot be directly expressed as a monetary value, such as goodwill or going concern, should not be recorded in the financial statements. Instead, things such as sales to customers, purchases from suppliers, and taxes paid to the government are recorded because they can all be directly expressed as money.

There are several reasons why the monetary measurement concept is important. First, it ensures that financial statements are consistent and comparable. This is because if businesses can choose to record or not record transactions at their discretion, then there would be no way to compare one business's financial statements to another. Second, the monetary measurement concept provides a level of objectivity in financial reporting. By only recording transactions that can be directly expressed as a monetary value, businesses are less likely to include their own biases and judgments in their financial statements. Finally, the monetary measurement concept helps to ensure that financial statements are accurate and reliable.

3. Periodicity Concept

The periodicity concept, can be also called the time interval concept, is a period during which business enterprises are required to prepare financial statement at specified intervals. Interim reporting (Halfyearly/Quarterly) cannot be termed as accounting period. Financial i.e. from 1st April to 31st March is normally termed as Accounting Period for the business organizations. Accounting period is not just to know the result (Profit/Loss) for period but it is also to conclude and not further recording should be possible for that accounting period.

4. Going 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. Further, It is also presumed that there is no Intention/Need contrary to this concept exists.

5.Consistency Concept

This convention is linked with the comparability of the Financial Statements. Accounting Principles are followed Year to Year and uniformly in one Industries to make Financial Statements comparable. Deviation from consistency is permissible if it is required by Law or any Accounting Standard or it may give better presentation to the Financial Statements users. Consistency refers to a company’s use of accounting principles over time. When accounting principles allow a choice between multiple methods, a company should apply the same accounting method over time or disclose its change in accounting method in the footnotes to the financial statements.

6. Conservatism Concept

In accounting, the convention of conservatism, also known as the doctrine of prudence, is a policy of anticipating possible future losses but not future gains. This policy tends to understate rather than overstate net assets and net income, and therefore lead companies to “play safe”. Example : Provision for Bad Debts, Discount on Debtors, Valuation of Inventories at lower of Cost or Market Price which ever is Lower.

7. Materiality Concept

Materiality concept in accounting refers to the concept that all the material items should be reported properly in the financial statements. Material items are considered as those items whose inclusion or exclusion results in significant changes in the decision making for the users of business information. 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.

8. Matching Concept

Matching concept states that expenses that are incurred in an accounting period should be matching with the revenue earned during that period. Thus all expenses for that accounting period whether or not paid during that year and all revenue whether earned or not during the period should be considered to calculate profit or loss. Hence, depreciation of the current year is charged against the current year's revenue. In other words, the full cost of the asset is not treated as an expense in the year of its purchase itself rather it is spread over its useful life.

Business concerns should follow this concept as :

1. Matching concept portrays the exact financial status of the business.

2. As revenue and expenses are matched, the profit or loss is not over or under–stated.

3. Expenditure of capital assets which span over a period cannot be determined in one accounting period. Hence, depreciation as an expense can be more suitable for calculating business profits.

4. It ensures transactions occurring in one accounting period although realised in another accounting period will be recognised for the accounting period in which it occurred

9. Full Disclosure

The Full Disclosure Principle states that all relevant and necessary information for the understanding of a company's financial statements must be included in public company filings. For example, financial analysts who read financial statements need to know what inventory valuation method has been used, if there have been any significant write–downs, how depreciation is being calculated, and other critical information for the understanding of the financial statements. The full disclosure principle is crucial to ensuring that there is limited information asymmetry between the company's management and its current shareholders, debtors, or other third parties.

Generally Accepted Accounting Principles

Generally accepted accounting principles, or GAAP, are standards that encompass the details, complexities, and legalities of business and corporate accounting. The Financial Accounting Standards Board (FASB) uses GAAP as the foundation for its comprehensive set of approved accounting methods and practices.

U.S. law requires businesses releasing financial statements to the public and companies publicly traded on stock exchanges and indices to follow GAAP guidelines. GAAP incorporates the following 10 concepts:

- Principle of Regularity: GAAP–compliant accountants strictly adhere to established rules and regulations.
- Principle of Consistency: Consistent standards are applied throughout the financial reporting process.
- Principle of Sincerity: GAAP–compliant accountants are committed to accuracy and impartiality.
- Principle of Permanence of Methods: Consistent procedures are used in the preparation of all financial reports.
- Principle of Non–Compensation: All aspects of an organization's performance, whether positive or negative, are fully reported with no prospect of debt compensation.
- Principle of Prudence: Speculation does not influence the reporting of financial data.
- Principle of Continuity: Asset valuations assume the organization's operations will continue.
- Principle of Periodicity: Reporting of revenues is divided by standard accounting periods, such as fiscal quarters or fiscal years.
- Principle of Materiality: Financial reports fully disclose the organization's monetary situation.
- Principle of Utmost Good Faith: All involved parties are assumed to be acting honestly.

GAAP compliance makes the financial reporting process transparent and standardizes assumptions, terminology, definitions, and methods. External parties can easily compare financial statements issued by GAAP–compliant entities and safely assume consistency, which allows for quick and accurate cross–company comparisons.

Because GAAP standards deliver transparency and continuity, they enable investors and stakeholders to make sound, evidence–based decisions. The consistency of GAAP compliance also allows companies to more easily evaluate strategic business options.

History of GAAP

Without regulatory standards, companies would be free to present financial information in whichever format best suits their needs. With the ability to portray a company's fiscal standing in a favorable light, investors could be easily misled.

The Great Depression in 1929, a financial catastrophe that caused years of hardship for millions of Americans, was primarily attributed to faulty and manipulative reporting practices among businesses. In response, the federal government, along with professional accounting groups, set out to create standards for the ethical and accurate reporting of financial information.

According to accounting historian Stephen Zeff in The CPA Journal, GAAP terminology was first used in 1936 by the American Institute of Accountants (AIA). Federal endorsement of GAAP began with legislation like the Securities Act of 1933 and the Securities Exchange Act of 1934, laws enforced by the U.S. Securities and Exchange Commission (SEC) that target public companies. Today, the Financial Accounting Standards Board (FASB), an independent authority, continually monitors and updates GAAP.

All 50 state governments prepare their financial reports according to GAAP. The Governmental Accounting Standards Board (GASB) estimates that about half of the states officially require local and county governments to adhere to GAAP.

Benefits of Accounting Standards

Accounting Standards (AS) are basic policy documents. Their main aim is to ensure transparency, reliability, consistency, and comparability of the financial statements. They do so by standardizing accounting policies and principles of a nation/economy. So the transactions of all companies will be recorded in a similar manner if they follow these accounting standards.

These Accounting Standards (AS) are issued by an accounting body or a regulatory board or sometimes by the government directly. In India, the Indian Accounting Standards are issued by the Institute of Chartered Accountants of India (ICAI).

Accounting Standards mainly deal with four major issues of accounting, namely

Recognition of financial events

Measurement of financial transactions

Presentation of financial statements in a fair manner

Disclosure requirement of companies to ensure stakeholders are not misinformed

Accounting Standards are the ruling authority in the world of accounting. It makes sure that the information provided to potential investors is not misleading in any way. Let us take a look at the benefits of AS.

1. Attains Uniformity in Accounting: Accounting Standards provides rules for standard treatment and recording of transactions. They even have a standard format for financial statements. These are steps in achieving uniformity in accounting methods.

2. Reduces Confusion: If certain standards are followed during the creation of financial reports, then it can reduce confusion due to multiple people creating the reports in their own way.

3. Comparability: Accounting Standards ensure that the reports of any organisation can be compared with that of others across the globe.

4. Uniformity: Each transaction can be easily identified with the use of Accounting standards, as a particular type of transaction will follow certain rules and standards to record it in the reports and statements.

5. Reliability: Financial Statements and Reports that follow accounting standards allow stakeholders to take important decisions regarding investment easily, as the company's financial reports are a major source to make decisions for them. Accounting standards ensure that the financial reports and statements of an organisation are fair and transparent.

Accounting Standards

The Accounting Standard is the collection of the accounting procedures, common principles, and Accounting Standards which forms the foundation of policies, financial accounting, and financial principles. The Accounting Standards are used for improving transparency of financial reporting across the world. The Generally Accepted Accounting Principles make up the accounting set standard that is widely accepted for the preparation of financial statements. The international companies follow IFRS, which are set by the International Accounting Standards Board, and it also serves as a guideline to GAAP and non–US companies as a measure of reporting financial statements.

Accounting Standards Formulation in the Country

The Accounting Standard board (ASB) is a committee belonging to the ICAI, which has the responsibility for the creation of Accounting Standards in India, after the passing of statute by the government of India. Let us have a brief look at the functioning of ASB and the procedure behind the Formulation of Accounting Standards in India.

ICAI is widely considered as the highest accounting body in India. The ASB, Accounting Standard board, is the committee of the ICAI that devises all Accounting Standards for Indian enterprises and companies. The entire process is completely transparent and incredibly thorough, plus it is fully independent of any government involvement or intervention. While devising the standards, ASB tries to incorporate and include the IFRS and its principles within the Indian framework and standards itself.

India has no plans to adopt the IFRS system and hence this process provides the merging of both the standards and takes advantage of both the standards. The ASB is responsible for modifying IFRS so that it aligns with the laws, common usages, and customs that are used and prevalent in the country.

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The Accounting Standards board (ASB) is made up of representatives from various industries, regulatory authorities, government departments, academic and professional bodies, and financial institutions. The industry is represented on ASB by the associations CII, FICCI, and ASSOCHAM amongst others.

The process of formulating Accounting Standards in India is very detailed and comprehensive. We take a brief look.The setting process of Accounting Standards has the following steps.Identifying broad matters of ASB and preparing preliminary drafts.Constituting study groups by ASB to prepare for preliminary drafts. Considering preliminary drafts that are prepared by a study group involving ASB.Circulating drafts among ICAI council members and within some outside bodies such as Indian banks association, SEBI, DCA, CAG, etc.

Meeting with representatives of outside bodies for their opinion on the proposed Accounting Standards draft.Finalizing the draft for proposed Accounting Standards based on the comments received from various bodies.Issuing the invite for exposure draft for public opinion.Finalizing the draft for Accounting Standards and submitting to the ICAI council for consideration and then approving it for issuance. Considering Accounting Standards drafts from institute council and modifications to be done in the drafts if necessary, in consultation with the ASB. The finalized Accounting Standards are issued under the council authority.

Formulation of Accounting Standards in India

After the government passed a statute, the Accounting Standard Board (ASB) which is a committee of the ICAI took the responsibility for the formulation of the accounting standards in the nation, India. For this we need to take a brief look at the functioning of the ASB and the procedure which is behind the formulation of the accounting standards in India.

Accounting Standard Board

ICAI is recognised as the highest accounting body in the country, India. The ASB is a committee of the ICAI which devises all the accounting standards for the Indian Companies. The process is accurately transparent, the process is also very thorough and completely independent of any government intervention or involvement. While designing the standards, the ASB tries to incorporate the IFRS and its principles in the Indian standards itself. India does not plan to adopt the IFRS system, thus this process helps the merge of the two standards and thus reap the benefits of the both. So, the ASB modifies the IFRS to align with the laws, and the customs and the common usages that are used by the country.

International Financial Reporting Standards (IFRS)

International Financial Reporting Standards (IFRS) are a set of accounting rules for the financial statements of public companies that are intended to make them consistent, transparent, and easily comparable around the world. IFRS currently has complete profiles for 167 jurisdictions, including those in the European Union. The United States uses a different system, the generally accepted accounting principles (GAAP). The IFRS is issued by the International Accounting Standards Board (IASB). The IFRS system is sometimes confused with International Accounting Standards (IAS), which are the older standards that IFRS replaced in 2001.

IFRS specify in detail how companies must maintain their records and report their expenses and income. They were established to create a common accounting language that could be understood globally by investors, auditors, government regulators, and other interested parties.

The standards are designed to bring consistency to accounting language, practices, and statements, and to help businesses and investors make educated financial analyses and decisions.

They were developed by the International Accounting Standards Board, which is part of the not–for –profit, London–based IFRS Foundation. The Foundation says it sets the standards to “bring transparency, accountability, and efficiency to financial markets around the world."