

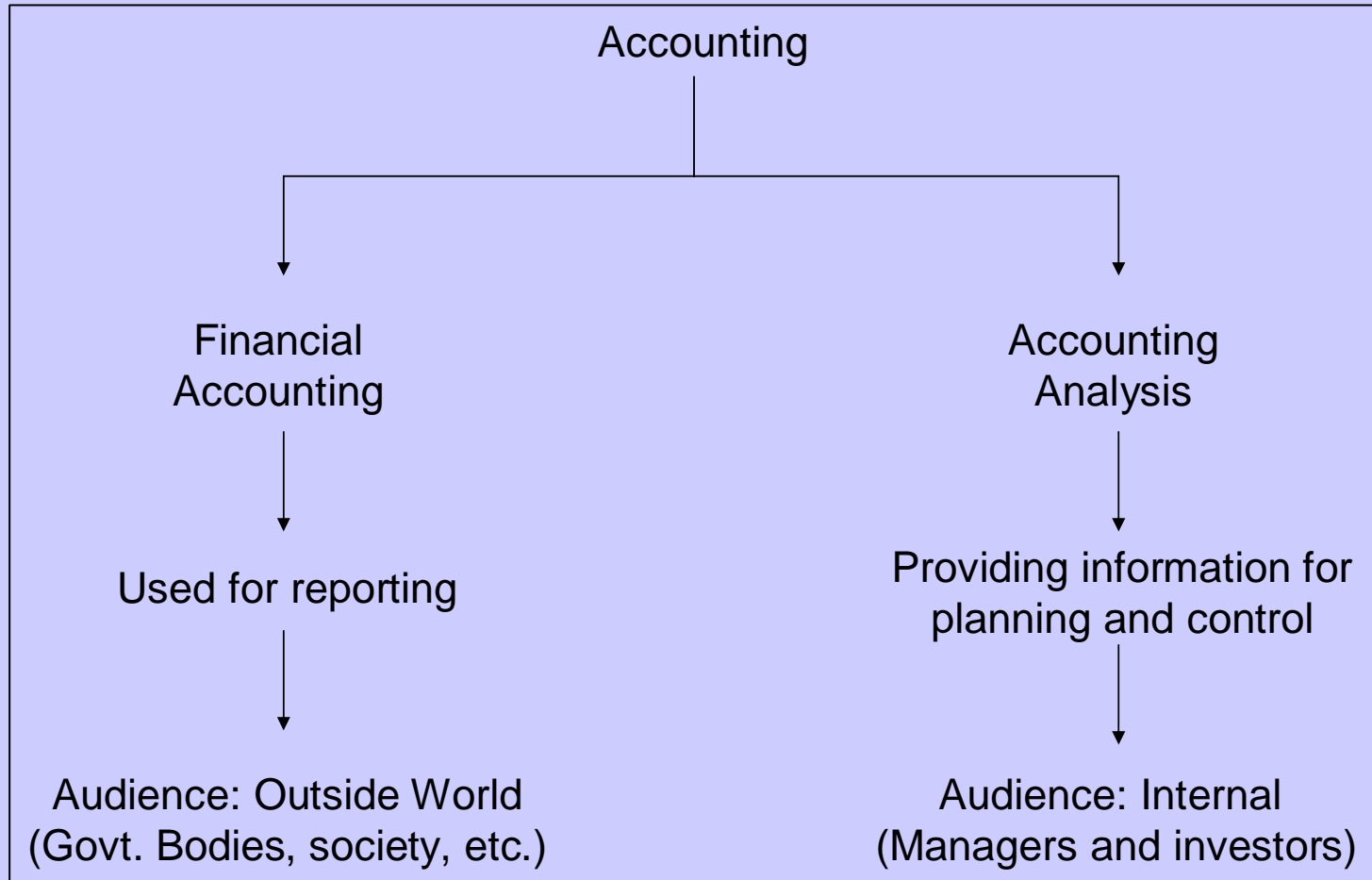
Chapter 1: Conceptual Basis of Accounting

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Introduction



Financial Accounting – Evolution

- Evidence of recording of economic transactions in ancient civilizations
- Franciscan Monk Fra Luca Pacioli (1445-1515) known as the father of modern accounting
- *His Summa de Arithmetica, Geometria, Proportioni et Proportionalita*, is considered as the first text on accounting



Pacioli structured and organized the initial accounting system based on the 'benefit and sacrifice' principle

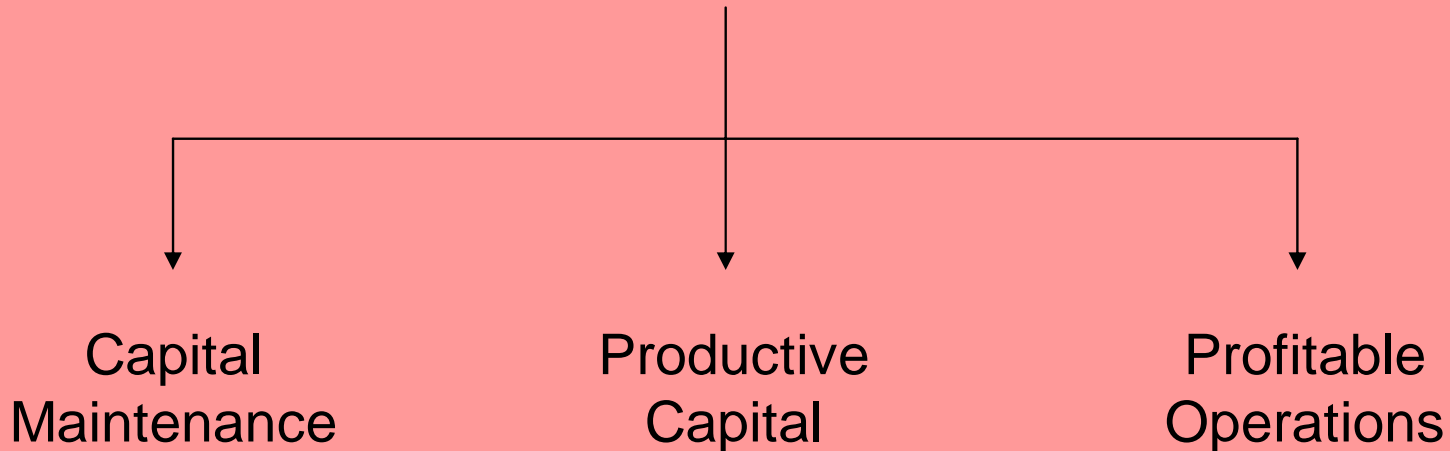
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- Accountant as a historian – keeps records
 - But with a difference
 - Respects the facts
 - Bring into focus all known and knowable relevant facts
 - Finally, provide an interpretation of the history proposed

Financial Accounting – Evolution

- ❑ Product of economic environment
- ❑ Gradually evolved as a profession with the development of economic activity
- ❑ especially ... Industrial Revolution
- ❑ Scope and nature of accounting is closely associated with the gradual changes in the field of organization and management of organizations
- ❑ In the modern IT era, accounting is getting integrated into software packages and constantly adapting itself

Foundations of Accounting

3 Founding Ideas of Accounting



Capital Maintenance

- The idea is to preserve and maintain resources used for generating wealth
 - *Implies the generation of wealth while keeping intact the resource used for such generation*
- Income (during the year) =
Capital at the end of the year – Capital at the beginning
- If the above figure is negative, there is 'capital erosion'
- Continuous capital erosion threatens business survival

Productive Capital

- ❑ Productive organization of modern industrial society is founded on the use of capital
- ❑ 'Wealth' is used for generation of further wealth
- ❑ Accumulation and deployment of large-scale productive capital involves the problem of maintenance and preservation of such resources
- ❑ Consider the Oil Wells owned by the Oil Companies
- ❑ Throws up the important information function of the valuation of such resources.

Profitable Operations

- ❑ The idea of profit is the motive force
- ❑ This induces one to go in for future consumption in preference to present consumption
- ❑ Resources can be deployed for large number of alternative uses. There is an important criterion for making decisions in the exercise of choice
- ❑ This coupled with the idea of maintenance of capital makes the problem of measurement of profit crucial to accounting.

Development of Accounting

- Early medieval commerce was agency book-keeping for a specified venture
- Development of Joint Stock Companies
 - Operating individuals were not the owners
- Investment Banking – keeping records for inspection
- Large scale manufacturing and service organizations
 - creation of artificial juridical entities based on common stock of capital collected from large number of investors

-
- Recording and summarizing of business related events and transactions for the purpose of financial reporting
 - Two basic principles
 - Form of the 'account' – the basic information formats
 - Equilibrium of the complete set of accounts forms the foundation of the accounting system

Accounting as a Measurement & Valuation System

- ❑ Basic orientation of financial accounting is income determination
- ❑ Oriented towards an entity- a business unit
- ❑ Tries to prescribe a series of concepts, standards, postulates and principles
- ❑ Accounting theory as a doctrine is explanatory in nature and the underlying reasoning and justifications are related to practice

Definition of accounting

- Multiple definitions exist

According to *American Institute of Certified Public Accountants (AICPA)* –

“accounting is 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.”

Valuation in Accounting

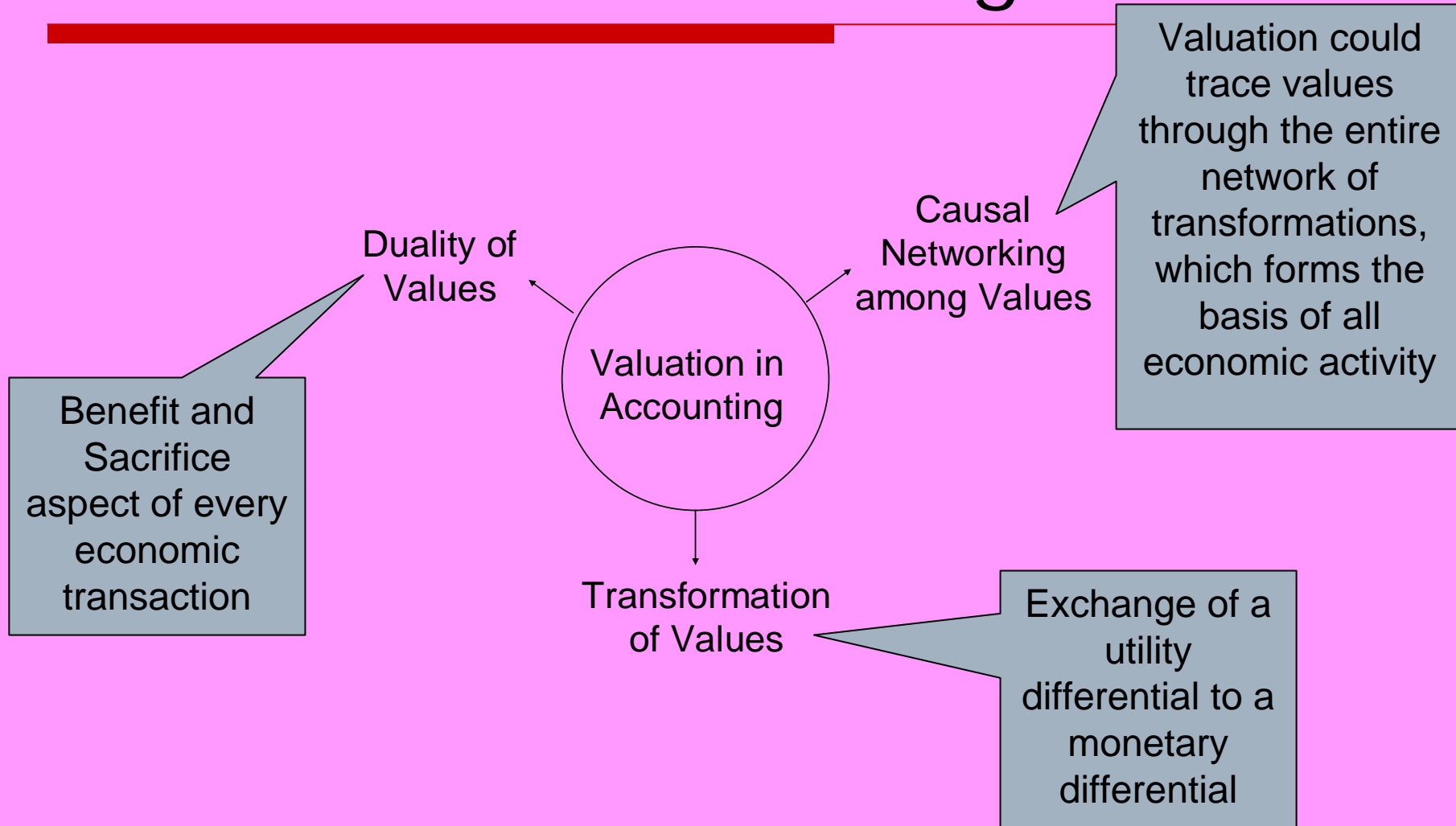


Illustration – Valuation of a Machine

Adeep, a cotton yarn manufacturer, purchased a machine paying cash Rs. 70,000. At which value do you record this transaction?

- **Historical Cost**
- **Current (Replacement) Cost**
- **Net Realizable Value**
- **Present Value**

Due to its many advantages, historical cost is the most used in the field of accounting

Three Types of Business Entities

	Sole Proprietorship	Partnership	Company
Examples	M/s Ladduram & Sons	S S Billimoria & Co.	Mro-tek Limited
No. of Shareholders	One Person	Minimum: 2 Maximum: 20	Minimum: 7 Maximum: No Limit
Management Control	Proprietor	Partners	Board of Directors
Liability	Unlimited	Unlimited	Limited
Legal Registration	No Provision	Voluntary	Compulsory
Flexibility	Maximum	Depends on Partners	Comparatively Less

Basic Framework of Accounting

- Concept refers to an idea, a general notion, thought or assumption.
- Standards are something established for use as a rule, intended to act as a basis of comparison and reference in measuring, quantity, and or quality and assigning value
- Postulates are assumptions; they are taken to be true or real
- Principles refer to a law, the method or a rule of conduct.

Concepts \longleftrightarrow Standards \longleftrightarrow Postulates \longleftrightarrow Principles

Generally Accepted Accounting Principles - GAAP

- ❑ Combination of authoritative standards (set by policy boards) and the accepted ways of doing accounting
- ❑ Differs from country to country based on the accounting principles and standards adopted in that country
- ❑ Rules that business entities are expected to follow while preparing their financial statements

Accounting Standards-setting Organization in Selected Countries

Country	Policy Setting Board
Australia	Australian Accounting Standards Board (AASB) sets GAAP
Canada	Canadian Accounting Standards Board (CASB) of the Canada Institute of Chartered Accountants (CICA) sets GAAP
India	Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India (ICAI) is the body entrusted with the work of preparing the standards.
U.K.	Accounting Standards Board (ASB) is comprised of nine members drawn from different user groups.
U.S.A.	Financial Accounting Standards Board (FASB) is the body solely in charge of issuing standards.

Interpreting GAAP and Accounting Standards

GAAP	Accounting Standards
Accounting practices holding sway in a country.	Authoritative standards (set by policy boards)
Country specific	International standards exist

Indian GAAP is to be followed in the pecking order of:

1. Accounting Standards laid down by ICAI
2. Statements issued by the ICAI.
3. Guidance notes issued by the ICAI.
4. Expert Advisory opinions issued by the ICAI
5. Technical guides and monographs issued by the ICAI.

Conceptual Basis

- ❑ Concepts are essential ideas that permit the identification and classification of phenomena or other ideas
- ❑ A concept must state all that the given class includes and all that it excludes
- ❑ Formed primarily by observation and established through agreement

Basic concepts of accounting – accepted as principles

□ **Property Rights**

- the right of accounting entities to possess and alienate property – value

□ **Business Entity**

- the entity is separate and distinct from the owners and the entity is liable to the owner
- Hence, in a limited liability company, the enterprise is liable to the owner (shareholder) based on the proportion of the capital investment (share capital) made by the latter

Concepts ...

□ **Going Concern**

- entities have a life of infinite duration, unless facts are known that indicate otherwise
- the basis of valuation of resources is influenced more by their future utility to the business entity than by their current market valuation

□ **Money Measurement**

- Representation in a common denominator and amenable to summarization by addition & subtraction

Accounting Concepts

□ Matching

- Determining the profits after charging the expenses of a period with the revenues earned in the same period

□ Realization

- Determines the point of time when revenue and hence returns (or profits) can be recognized objectively, unbiased, and with certainty

□ Consistency

- Once a choice is made for the treatment of a transaction, the same is consistently followed

Concepts ...

□ **Diversity among Independent Entities**

- There are wide variations in the organization and operations of entities → requirements and demands are different

□ **Conservatism**

- “Anticipate no gains, but provide for all possible losses” and “if in doubt, write it off”
- Results in an understatement of profits and values
- Close nexus with idea of ‘capital maintenance’

Concepts ...

□ **Dependability of Data**

- Accounting entities ensure the standard of internal controls to ensure that the data used as the basis of accounting records are controlled to ensure their quality

□ **Materiality**

- Necessitated by practicability and feasibility

□ **Timeliness**

- The idea of accounting periods is used so as to ensure regularity and timeliness of reporting

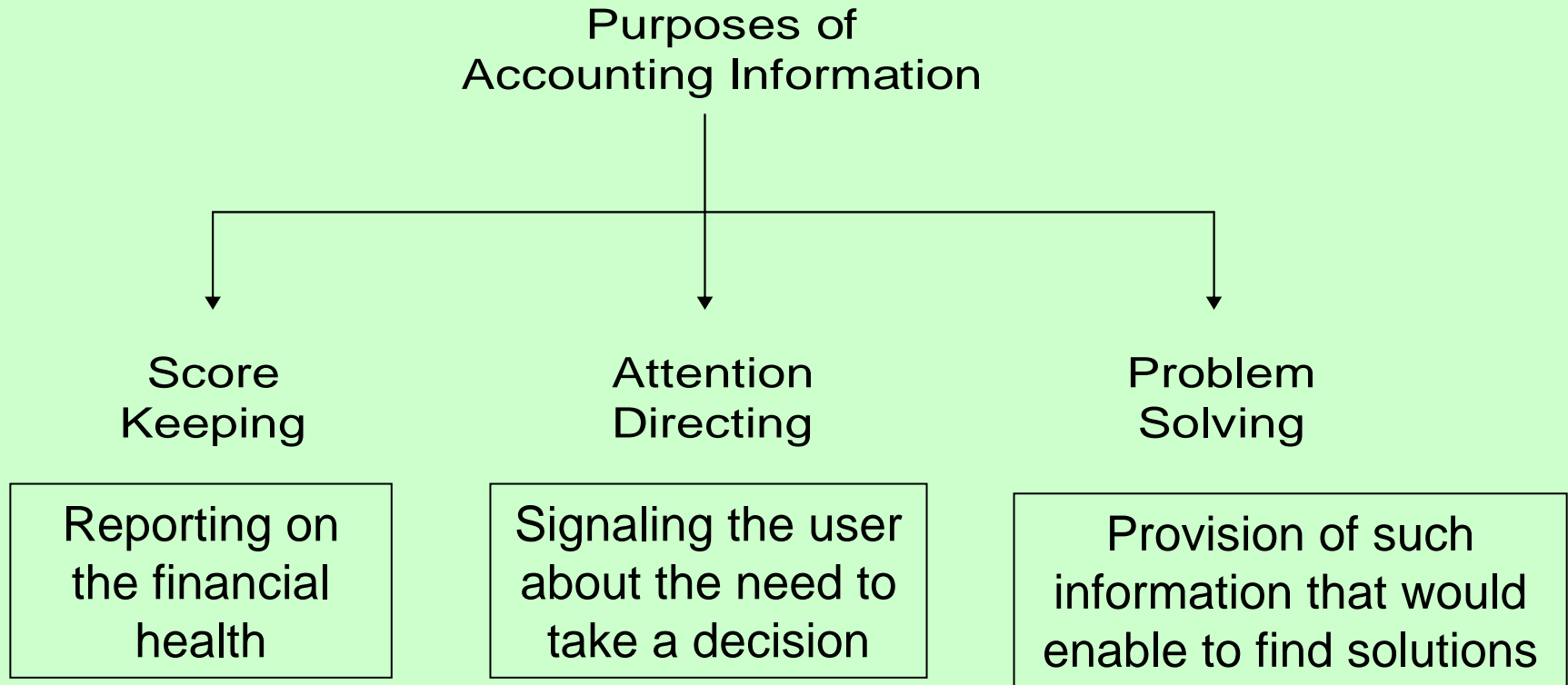
Accounting Policies

- Specific accounting principles and the methods of applying these principles for the preparation and presentation of financial statements of an enterprise
- based upon the accounting concepts followed by the enterprise
- Areas of applicability
 - Valuation of Inventories, Fixed Assets, Investments
- Role of ICAI
 - Guidance Notes

Objectives of Accounting

- **Income determination**
 - For rational economic decision-making
- **Financial reporting**
 - Summarized as all those things of value owned by the entity and all the claims against these possessions
- **Disclosure**
 - All the relevant & pertinent information is supplied to the information users

Purposes Of Accounting Information



Accounting & Management Control

- Control means the process of keeping the organization in course
 - This involves measurement through the control system
 - The controller (accountant) and managers obtain information, which enables them to diagnose the situation

Illustration on using Accounting Information

- A firm sells three products P1, P2, P3. Profit of the firm is declining

	Year 1	Year 2
Sales	Rs 1000	Rs 1000
Less: cost of goods sold	400	500
Gross margin	600	500
Less: Depreciation	200	200
Other operating expenses	100	100
Profit	Rs 300	Rs 200

Illustration...

- ❑ The Problem:
 - Decrease in profits during the period - as a result of overall increase in the cost of goods sold
- ❑ Now, which product is losing money?

	Year 1			Year 2		
	P1	P2	P3	P1	P2	P3
Sales	300	300	400	400	400	200
Less: COGS	150	150	100	200	200	100
Gross margin	150	150	300	200	200	100

Sales of P3 have decreased.

Cost of sales to sales of P3 has doubled

Accounting Information users

- Stakeholders are the ones who have an interest in what happens as a result of the entities activities
- Stakeholders classified as
 - Internal users viz. managers
 - External users viz. creditors and equity investors, government, society

Class Discussion...

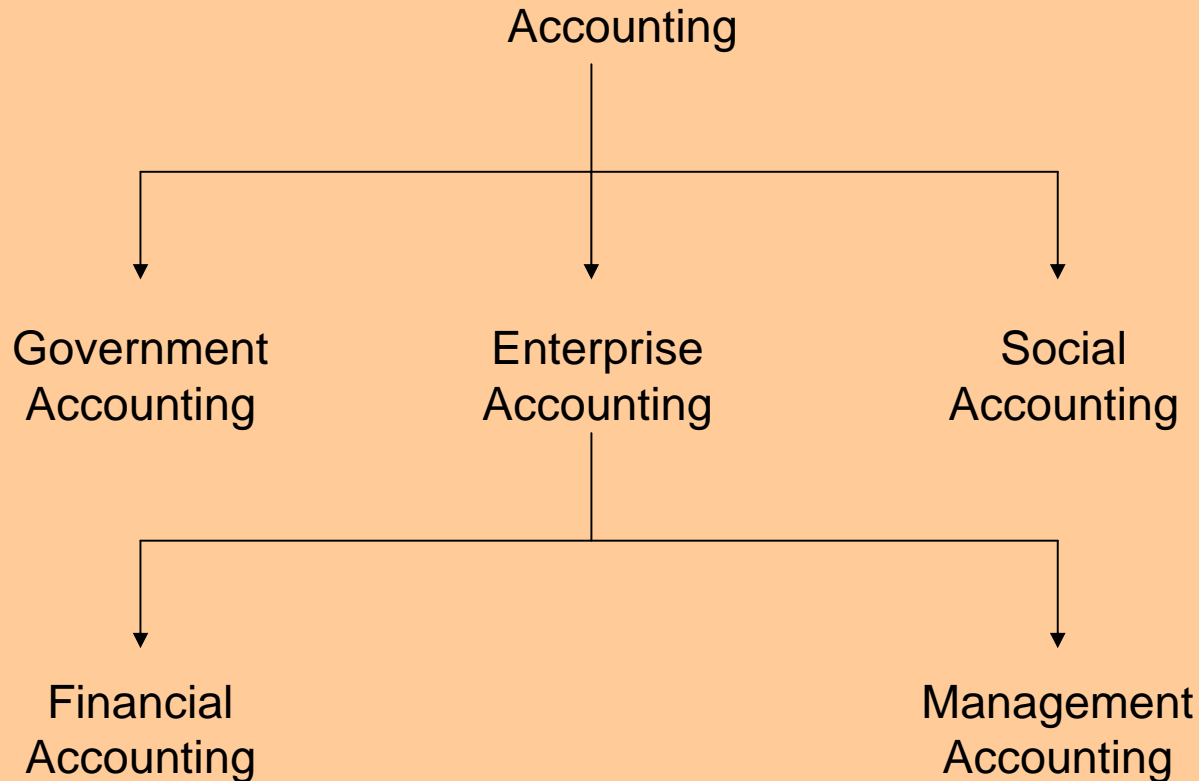
Stakeholder	Area of interest
Government	Tax liabilities of the firm
Unions & staff	Potential for pay awards and bonus deals
Public/Society	Ethical & environmental activities of the firm
Lenders	Whether the firm is has a long-term future
Shareholders	Profitability and share performance
Customers	Ability of the firm to carry on providing a service or producing a product

Note: These should not be regarded as the 'only' answers

BHEL and its Stakeholders

Stakeholder	Would be interested due to
Government & its agencies	Income tax & other tax liabilities
Top Managers, Workers, Unions	Potential for pay hikes, bonus, and incentives
Public	Ethical and environmental activities
Long-term Lenders, Present & Potential Shareholders	Whether the firm has a long-term future
Fund managers & Analysts	Profitability & share performance
Customer	Ability to take a bigger order, etc
Supplier & Other Creditors	Whether to offer the firm credit and if so, terms

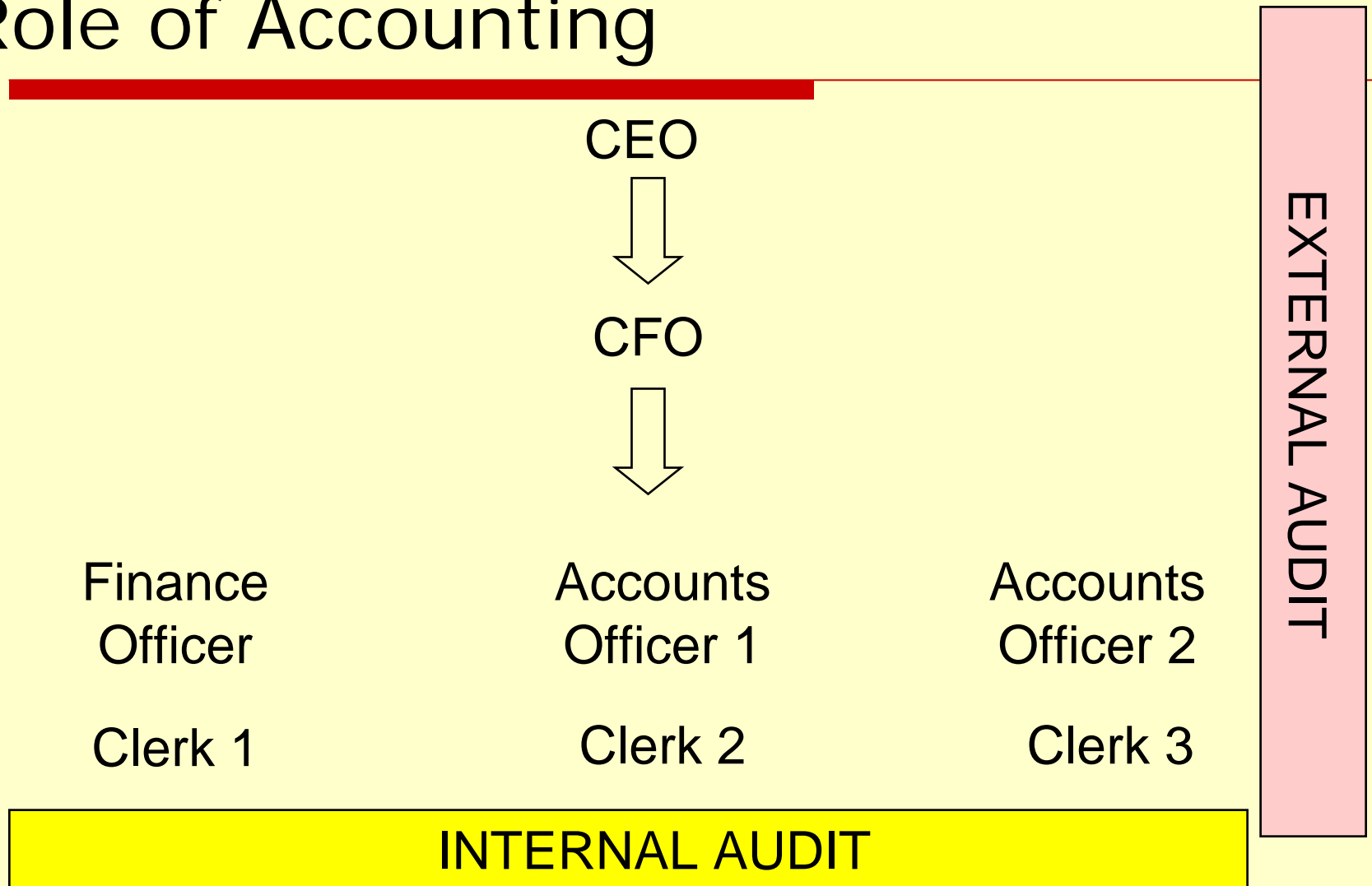
Branches of Accounting



Enterprise Accounting

- Specifically addresses issues of measurement and valuation in the context of business enterprises
- Has evolved into two disciplines
- Financial Accounting
 - Providing financial information relating to the entity to 'outsiders'
- Management/Cost Accounting
 - Reporting the activities of the entity to managers so as to enable them to plan and control the activities of the entity vis-à-vis other competing entities

Organizational Structure vis-à-vis Role of Accounting



Thank You

