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BASICS OF ACCOUNTING

ACCOUNTING: BRIEF HISTORY

The first published accounting work was written in 1494 by the Venetian monk Luca Pacioli. Initially, accounting was more concerned with just record keeping…. popularly called *book keeping*.

The Industrial Revolution of the mid-1700s created a need for more sophisticated techniques that can handle large quantities of goods and services. With the emergence of publicly owned business corporations, owned by absentee stockholders and administered by professional managers, the role of Book keeping was much enhanced and was rechristened as '*Accountancy*'. During last few decades of 20th century, role of Accountancy and accountants had to undergo a very sharp and close scrutiny (for reasons known to most of us!). Accounting Standards have been revised and various disclosure norms have been specified in order to ensure that the accounts reveal a true and fair picture and provide transparent disclosure.

Today, computers perform many of the book keeping functions that are vital to accounting systems, and accountants have to worry about true, fair and transparent disclosures.

ACCOUNTING INFORMATION

Accounting information can be classified into two categories: *Financial Accounting*, which is generally available to all and *Managerial Accounting* which is private information.

Financial Accounting thus includes information disseminated also to parties that are not part of the enterprise proper, so over & above the stake holders, it is also shared with creditors, customers, suppliers, regulatory authorities, financial analysts and trade associations. Such information relates to the financial position, the liquidity and the profitability of an enterprise.

Managerial Accounting deals with information that is not generally disseminated outside a company, such as different costs, profit targets, budjeted & standard costs of materials per unit produced etc.

The importance of management accounting has also grown tremendously over last few decades due to the growing competition and globalization.

It may be noted that the term "*Accounting*" usually means "Financial Accounting" in common parlance.

The general-purpose financial statements of financial accounting thus meet the basic information needs of most external users, whereas managerial accounting provides a wide variety of specialized reports for directors, consultants and Managers within a company.

FUNDAMENTAL PRINCIPLES OF ACCOUNTING

Accounting as it exists today, can be viewed as a system of assumptions, doctrines and conventions, all encompassed in the phrase *"Generally Accepted Accounting Principles" (GAAP).* Many of these principles developed gradually, as did much of common law. In recent decades, however, various authorities/bodies such as the Financial Accounting Standards Board, have determined standards or rules called Accounting Standards. Though different countries have different Accounting Standards, due to globlisation they are rapidly progressing towards uniformity. Even in case of partnership firms, sole-proprietry concerns and other types of business organizations, the same accounting principles and conventions apply. But for companies and some other entities, they are applicable through governing statutes.

Following are some of the Fundamental Accounting Principles:

- One of the fundamental principles on which the entire accounting is based, is that the business is seen as an entity which is distinct and separate from the owners. This is popularly known as the *Business Entity Concept.*
- One also assumes that this business entity will exist for a very very long time. This is called the *Going Concern Concept.*
- Again, there has to be a *'transaction'*, convertible in *monetary units,* to trigger off accounting.

- Accounting assumptions and procedures should conform and bear *consistency* with those followed in earlier years.
- Accounting should catch the real substance behind a transaction and should not merely reflect its legal form. This is called Principle of *Substance Over Form.*
- Accounting should present all *Relevant & Material information* that is necessary in order not to be misleading.
- A transaction is recorded in the accounts at its *Historical Cost.*

The relevance, importance and application of these fundamentals will surface later in this book.

> *Points to Ponder*
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> 1. Why is share capital shown as a liability in the Balance Sheet?
> 2. Can you think of an illustration which refers substance over form?
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THE FINAL ACCOUNTS

The following basic and prime financial information is required about any business:

a. where have the funds come from and where are they invested

b. how well are the funds invested and how has the investment grown.

The first question is attempted to be answered by the *Balance Sheet* and the second by the *Profit and Loss Account.*

The balance-sheet and profit and loss account are two basic statements giving crucial financial information and hence they are called the *Final Accounts Statements.*

In order to understand these statements better and to ensure sound financial management, the inquisitive and careful entrepreneurs and managers have developed many tools and techniques to help them perform their tasks better.

Points to Ponder

3. Name a few tools and techniques adopted by managers to effectively perform their management tasks.

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BALANCE-SHEET

A Balance Sheet highlights *two basic facts:*

i. from where have the funds come and how much has come from each source.

These are called '*sources*' of funds and shown on one side of the Balance Sheet, popularly known as the '*Liability*' side.

ii. where these funds are invested and how much in each application. The places or forms in which the funds are invested are called applications. These are shown on the other side of the Balance-Sheet, popularly known as the '*Asset*' side.

* A Balance-Sheet is nothing else but a statement of the financial position of a business entity as on a particular date. It is like a snap shot of all the assets and liabilities as on a particular point of time . One can prepare a Balance Sheet as on any day. Generally 31st March or 31st December or 30th June are preferred for drawing up Balance Sheets.

* Since accounts are to be prepared for a business entity... a Balance-Sheet can be drawn up for a limited company, for a partnership firm, for a proprietary concern, and so on.

* If the same business entity carries on more than one business, a separate Profit And Loss account and Balance-Sheet for each is also possible, and in fact, desirable (don't you agree?). But normally, a consolidated picture is prepared. Legally, as of now, this is acceptable and accepted too!!

PROFIT & LOSS ACCOUNT

* Profit/loss is nothing else but the difference between revenue and expenses for a particular period.

* The Profit And Loss Account gives the breakup of all *revenues on one side* and the breakup of all *expenses on the other side*.

* The term revenue is more popularly known as *'income'*. It is earned, not only from products sold and services rendered, but also by way of interest, rent, dividends, etc.

* The term '*expenses*' relates to sacrifice made or resources consumed in order to earn the income. Expenses are thus the costs incurred for generating revenue.

* The Profit And Loss Statement (or Profit And Loss Account) is prepared for a particular period of time, usually it is one year.

* The profit (as arrived at by the Profit And Loss Statement) for a relevant period is transferred to the *Profit And Loss Appropriation Statement.*

* Any appropriation of the profit (dividend for instance) and non-operating (not concerning the main business) items of revenue and expenses, are usually shown in a statement called Profit And Loss Appropriation Statement. Similarly, items pertaining to previous year and/or any exceptional items are also shown here.

* The net balance of the Profit And Loss Appropriation Statement is the surplus or deficit that belongs to the owners and is shown in the Balance-Sheet along with the owner's capital. The accumulated surplus is called '*Reserves*'.

* Capital and reserves put together form the '*Owner's Equity*' or the '*Net Worth*'.

Points to Ponder

4. Why are losses sometimes shown as assets?

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