Financial Accounting for Management

THIRD EDITION

PARESH SHAH

Consultant

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Forewords

It gives me great pleasure to write this foreword as I have the privilege of knowing Dr Paresh Shah, for more than three decades now. Our association started as co-students of doctoral programme under Professor I. M. Pandey of IIM, Ahmedabad. Later on it has continued as professional colleagues in academia.

I feel glad to learn that his book entitled *Financial Accounting for Management*—a third edition—is forthcoming which itself is an attestation of the quality and acceptance of the two previous editions. We use his books for teaching accounting courses at G. H. Patel Post Graduate Institute of Management, Sardar Patel University, Gujarat since the 1st edition published in 2007.

Financial Accounting for Management, 2nd edition was a fantastic outcome covering the complexity of accounting involved by removing the complexity from the mind of students and readers at large. He has developed an innovative approach in discussing the core concepts of accounting in a learner friendly mode.

In this third edition, I understand that he has enriched further, based on his feedback from teaching and conducting the workshops at a number of management development programmes, faculty development programmes, and regular management courses during this period.

Readers of financial reports often get nervous about understanding the concepts such as revenue recognition, measurement, and recording of economical events that take place within a firm and with outsiders. Strangely, such references almost invariably describe the profit of the firm.

Once the sensitivity of profit and profitability is appreciated, it is clear that a managerial decision policy is needed to understand the impact of recording of economical events, in turn its recording as an accounting event, and presentation in financial statements. Paresh has approached this key issue, by considering non-commercial and commercial background of participants. His approach has been that of detailed reasoning and straightforward through the application of an accounting equation rather than using complication of Debit and Credit treatment.

Paresh's book is being published at the right time as I have a feeling that there is really no better book for non-commerical background as well as commercial students. He has made an attempt to explain and elaborate the financial accounting in simple language without going through the technical processes and jargons.

All those who work for competitive advantage realize the need for informed managerial decisions and therefore will welcome this contribution by Paresh.

Wishing all the best for this edition, and I expect this edition too will succeed as the second edition.

With best wishes,

Prof. (Dr) P.K. Priyan
Professor (Finance)
G.H. Patel Post Graduate Institute of Business Management
MBA Department
Sardar Patel University, Vallabh Vidyanagar
Gujarat

It is indeed a pleasure to write the foreword for the books authored by Prof. (Dr) Paresh Shah, which are referred in various courses taught at PDPU and at EDII.

Financial Accounting as a subject faced a key issue, especially for non-commercial and commercial based students and that is to understand the complication of accounting procedures. Dr Shah made detailed reasoning to answer the question

'Why?' This has been converted into modern approach of accounting through the first two editions of *Financial Accounting for Management*, which makes the participants understand the recognition, measurement, and recording of economic events without going into the complication of Debit and Credit, through the application of accounting equation.

This edition of the book is enriched due to his rich teaching experience and also as an outcome of conducting workshops, number of management development programmes, faculty development programmes, and regular management courses. Dr Shah's third edition of the book is relevant in the present time as I believe there is really no good book for students in this subject at national and international levels. This book explains financial accounting in a simple language without going through the technical processes and jargons and makes the subject understandable and application oriented.

Dr Shah's other books on *Financial Management* and *Management Accounting* are also well conceptualized and blended with caselets and cases covering practical applications. *Management Accounting* by Dr Shah is a text and reference book for the subject of Principles of Finance and Costing at PDPU.

All those who desire to work with the competitive advantage have realized the need for informed managerial decisions and will welcome this contribution to academia.

Wishing all the best for this edition,
With best wishes,

Prof. (Dr) D.M. Parikh
Professor and Dean, FoET
Pandit Deendayal Petroleum University, Gandhinagar
Gujarat

It gives me great pleasure to write this foreword as I have the privilege of knowing Dr Paresh Shah over a decade as he has been associated with us as faculty member of our postgraduate management programme and Master of Business Administration programme.

Som-Lalit, a name which has been synonymous in the area of management education in the state of Gujarat for more than two decades, has imbibed a philosophy of research, creativity, innovation, and empathy in its institute resulting in unlocking the potential of the students and faculty members of the institute.

As educators, our focus has been on grooming the students towards holistic development by providing learning based on knowledge dissemination through practical understanding of current socio-economic-financial-technological developments and advancements. To achieve our academic excellence level, we use the world's best academic books. In this endeavour, we have adopted the books authored by Dr Paresh Shah, *Financial Accounting for Management* (Manac-I) and *Management Accounting* (Manac-II), published by Oxford University Press. We also use two other books authored by him—*Financial Management* and *Forex Management*.

Being an educationalist for over three decades, I would like to share some of my thoughts from my own perspective and also based on reactions of the student and reader community at large. The books authored by him are being highly appreciated by the student community in addition to the teaching faculty in the institutions of SLERF. The books provide indepth knowledge in simple and lucid language, and free from complicated arithmetical formulas, etc.

My final words: Use of books authored by Dr Paresh Shah will bring enlightenment in understanding and using the language of business and it will surely bring the prosperity of knowledge, and in turn wealth to all readers and students.

Again, I extend commendation to Paresh for making his talent available in preparing manuscripts on highly complex and technical subjects.

With Best Wishes,

Pragnesh K. Shastri
Managing Trustee
Som-Lalit Education and Research Foundation, Ahmedabad
Gujarat

Preface to the Third Edition

Financial accounting is an integral part of the study of accountancy. The scope of accounting encompasses not only recording of financial transactions of companies but also information that facilitates decision-making. This in turn inspired business schools across the world to include separate courses on financial accounting. It has been acknowledged by academicians and professionals alike that the worth of financial accounting has only increased over the years and is expected to never lose its importance.

About the Book

An attempt has been made to make the third edition of *Financial Accounting for Management* the most interesting, relevant, and comprehensible financial accounting text available in the market. The objective of the current edition of the book is to prepare readers, students, and participants of management development programmes to succeed as future business or non-business managers and/or entrepreneurs. This book introduces the concepts in a lucid way and is developed with an intention to enhance the analytical capability of the readers.

Readers cannot understand financial statements in isolation. They must look at them in the context of a firm's environment. I have learnt through experience that the way to teach financial accounting is to keep reinforcing the business relevance of accounting. This can be done by teaching examples from real-life situations and/or companies. As in the previous editions, every attempt has been made to build each chapter around the most recent cases and events from real-life Indian companies.

In the latest edition of the book, accounting procedures such as transaction analysis, journalizing, and posting are given due consideration wherever appropriate, by considering state-of-the-art technology combined with the *modern approach of accounting*. Readers can develop a better understanding of the economic consequences of a firm's transactions by summarizing those transactions into journal entries and columnar accounts format, instead of the traditional T-accounts format. Effort has been made to include the latest guidelines on IFRS, Ind AS, Ministry of Corporate Affairs, ICAI, etc. for presentation of financial statements, in addition to GST accounting.

Most of the original chapters have been realigned, revised, and updated. This edition also contains extracts from published annual reports of several corporates, to provide better insights into practices adopted in financial accounting.

Key Features

- Uses modern approach of accounting throughout the book (except for indicating debit and credit terms as per traditional approach)
- Focuses on the concepts, principles, and practices that facilitate the development of accounting skills for effective decision-making
- Provides objective type questions, numerical solved illustrations, and self-evaluation exercises
- Contains conceptual and business application cases at the end of the chapters
- Focuses on the latest development in the Indian taxation system and its impact, like GST and Indian income tax provisions

New to the Third Edition

- New chapter on Modern Approach of Accounting
- Full-fledged chapter on Regulatory Framework on Accounting and Reporting
- Discussions on IFRS norms, Indian Accounting Standards (Ind AS), deferred tax assets and deferred tax liabilities, GST accounting
- Revised and updated content in existing chapters
- Specific discussion on goodwill valuation

Coverage and Structure

The book is divided into five parts, comprising 20 chapters.

Part I: Fundamentals of Accounting

The first part starts with an introduction to accounting and deals with different kinds of economic resources and claims in Chapter 1. This chapter further explains the cyclical nature of business activities, in addition to the importance of ethics in accounting. Chapter 2 provides the fundamentals of understanding the modern approach of accounting, in addition to the traditional approach of accounting. The important accounting concepts, their vertical presentation from management and legal points of view, and utility of balance sheet are covered in detail in Chapter 3. Chapter 4 deals with a detailed analysis of income statement in the vertical format. It also discusses the cash conversion cycle.

Part II: Recognition and Types of Transactions

This part starts with Chapter 5 that introduces the readers to the concept of objectively verifiable evidence, in addition to the concepts of receipt and capital maintenance. It also explains the modus operandi of electronic banking. Chapter 6 is dedicated to revenue and expense recognition and its measurements in addition to relationship between assets and expenses. Chapter 7 takes the readers through the concept of analysing transactions wherein it explains topics such as journal proper, fundamentals of accounting as per modern approach of accounting, errors in accounting, and suspense account.

Chapter 8 discusses the concept of non-current assets and their writing off values over a period of time based on time phenomenon, capacity phenomenon, and funds management phenomenon. Additionally, different goodwill valuation methods are covered in this chapter. The management of current assets in the form of cash balance, bank balance, and their different types are discussed in Chapter 9. Chapter 10 is on receivables and inventory valuation, and discusses topics such as accounting of uncollectible receivables, receivable and inventory measurement, controlling of inventories, costing of inventories, and valuation of stock and its impact on financial statements. A critical discussion and accounting treatments related to capital and liabilities and its presentations in financial statements of corporates are discussed in Chapter 11.

Part III: Financial Statements

Part III starts with Chapter 12 that deals with the need of bank reconciliation statements and their preparation as part of internal control management, and identification of causes of differences in the balance as per the firm's record as against the banker's record. Chapter 13 deals with the different types of entries used in preparing financial statements, and the concept of worksheet and its utility. It also elaborates upon GST accounting and its impact. Chapter 14 discusses accounting from incomplete records. The modus operandi to find out missing figures are covered in this chapter.

Part IV: Analytical Accounting

This part begins with Chapter 15 discussing the concepts of average due date, account current, and negotiable instruments. Bills of exchange and promissory notes are explained in this chapter. The analytical aspects of financial statements, such as common size statements, comparative financial statements, and financial ratio analysis are covered in Chapter 16. Chapter 17 discusses the concept of cash flow statement for manufacturing firms and financial enterprises. It also explains both the methods of preparation of cash flow statements.

Part V: Special Topics

The last part begins by explaining foreign exchange accounting for import–export transactions in addition to foreign branch accounting in Chapter 18. It also discusses the different ways of quotations of foreign exchange rates, hedging transactions, and treatment of exchange differences. Chapter 19 deals with the legal and regulatory aspects of accounting. Topics such as IFRS, Ind AS, and GAAP are explained in this chapter. Chapter 20, the last chapter of the book, is about contemporary accounting concepts such as inflation accounting, human resource accounting, and forensic accounting.

Acknowledgements

I would first like to thank members of FCA, ACMA, MIMA (practicing chartered accountants) for their comments on the topics of GST accounting, deferred tax assets, and deferred tax liabilities accounting, in addition to the legal aspects of accounting and reporting.

I would like to provide my gratitude to the following individuals for the valuable comments and remarks in their respective forewords: Prof. (Dr) P.K. Priyan, MBA Department, Sardar Patel University, Vallabh Vidyanagar, Gujarat; Prof. (Dr) D.M. Parikh, Pandit Deendayal Petroleum University, Gandhinagar, Gujarat; and Pragnesh K. Shastri, Som-Lalit Education and Research Foundation, Ahmedabad.

I would also like to thank Dr Somen Saha, Indian Institute of Public Health, Gandhinagar (IIPHG); Dr Srinivas Deshpande, Principal, Gadag Institute of Medical Sciences, Karnataka; Prof. (Dr) Janardhan Pawar, Principal and Professor, Tuljaram Chaturchand College of Arts, Science and Commerce, Baramati, Maharashtra; Prof. (Dr) Rakesh Patil, Dean, Professor and Head (MBA), Sandip Institute of Technology and Research Centre, Nashik, Maharashtra; Prof. (Dr) Rajesh Rathore, Professor and Dean, Faculty of Commerce and Management, Madhav University, Abu Road, Rajasthan; and Prof. Vivek A. Bale, Assistant Professor, Tuljaram Chaturchand College of Arts, Science and Commerce, Baramati, Maharashtra.

Without the blessings of Saraswati Mataji, Sadguru P.P. Panyaspravar Shree Vinitchandravijayji Ganivarya Maharaj, and my (late) mother Lilavatiben, it would not have been possible for me to write this third edition of the book.

I am immensely grateful to my best friend and wife, Trupti, for her selfless sacrifice and unstinted support, and the significant suggestions and views she provided from time to time. I am also extremely thankful to my son, Fenil, daughter-in-law, Roma, and my grandchildren for supporting me in my endeavour. I lack words to express my deep sense of sincere gratefulness and indebtedness to my esteemed guru, Prof. (Dr) I.M. Pandey, Professor of Finance, and Ex-Dean of Indian Institute of Management, Ahmedabad, for his profuse and perpetual praise and pep, and constant motivation and encouragement to me towards becoming a moulded researcher and teacher of management.

I deeply appreciate the painstaking efforts of the editorial team at Oxford University Press, India, who have played a pivotal role in making the book more reader-friendly.

While using information from a number of books and research publications, certain errors and omissions may have crept in. I would be happy to receive your comments, suggestions, and feedback for the further improvement of the book. You can send your feedback at my email IDs profpareshshah@yahoo.co.in and paresh@profparesh.in.

Paresh Shah

The publisher and the author would like to thank the following reviewers for their valuable feedback:

- Prof. Pinky Agarwal, ITM Group of Institutions, Kharghar, Maharashtra
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- Prof. Khushboo Vora, N.L. Dalmia Institute of Management Studies and Research, Mumbai, Maharashtra
- Dr Nitin Gupta, Lovely Professional University, Jalandhar, Punjab

Praise for the Previous Editions

Financial Accounting for Management is an excellent book, balancing accounting mechanics, concepts, and practices with sufficient coverage of accounting standards and regulatory framework. It is an indispensable book for serious management students.

– Prof. (Dr) P.K. Priyan, Corporation Bank Chair, Sardar Patel University

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PART III FINANCIAL STATEMENTS

PART IV ANALYTICAL ACCOUNTING

PART V SPECIAL TOPICS

CHAPTER

1

Introduction to Accounting

Learning Objectives

After studying this chapter, you will understand

- development of business enterprise and accounting
- different forms of business organization
- difference between bookkeeping, accounting, and accountancy
- functions, objectives, users, and limitations of accounting
- kinds of accounting activities
- cyclical nature of business activity
- economic resources and claims
- basic documents and records for validating transactions
- relationship of accounting with other disciplines
- role and activities of an accountant
- job descriptions of accounting positions
- important accounting standards
- importance of ethics in accounting and corporate governance
- organizational structure of accounts and the finance department

INTRODUCTION

A business is the activity of making, buying, selling, or supplying goods or services for money. It involves the investment of money and earning reasonable returns on it. A business enterprise may function in the form of a (a) proprietorship, (b) partnership, (c) company, or (d) cooperative. It may be involved in purchasing and selling activities, producing goods, or providing services. Irrespective of the nature of the business, an enterprise has to invest capital. The business must be kept completely separate from its owners. If the business has acquired money, it owes an equal amount to its owners.

Using this capital, the enterprise can acquire assets. The economic resources employed by an enterprise are called *assets*. They may be in the form of plant and machinery, furniture and fitting, land and building, motor vehicles, stock-in-trade, amount receivable from customers, etc. A business can acquire two types of assets—*fixed* assets, which are permanently held, and *current* assets, which are currently held and change constantly.

Accounting is the language of business.

It is necessary to keep a record of production, sales, profits, etc., of any business activity. The business activity may be related to production, trade, or service and may involve some expenditure and returns. It is necessary to have proper records of such transactions to avoid confusion. The record-keeping activity of a business is known as bookkeeping. In fact, accounting is known as the language of business. Luca Pacioli, a Franciscan monk and Renaissance mathematician, is considered to be the father of the modern system of accounting known as the double-entry system of bookkeeping and accounting (Weygandt, 2006). The double-entry system involves making at least two entries for every transaction. The sum of all debits should always equal the sum of all credits. According to Pacioli (1494), ‘Books should be closed each year, especially in a partnership, because frequent accounting makes for long friendship.’

People around the world use some form of accounting everyday. Customers account for the money they spend; students plan for their educational expenses; and organizations use accounting to track performance of their operating activities. Accounting is a diverse, dynamic, and service-based discipline. An accountant's responsibility is to provide reliable and relevant information that is useful in making intelligent business decisions.

Accounting is a service-based discipline.

Accounting is also a measurement discipline. It measures results, and guides managers and external users to make relevant business decisions.

According to the 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.' The various attributes of accounting are as follows:

Accounting is a measurement discipline.

1. Events and transactions of a financial nature are recorded while the events of a non-financial nature cannot be recorded.
2. The record should reflect the importance of the transactions so recorded both individually and collectively, which includessummarization, thereby making it amenable to analysis.
3. The users of the financial statements should be able to obtain the message encompassed in such financial statements, and it is the knowledge of accountancy which enables the user to understand the contents of the financial statements.

Accounting is the process of recording financial transactions in a proper format. It then analyses, classifies, and reports these financial transactions to the user. Accounting also provides financial information by preparing reports and statements. Thus, accounting is the art of preparing significant summaries, analysing and interpreting transactions and activities, and communicating the results to those who frame judgements and take decisions.

FORMS OF BUSINESS ORGANIZATION

Human activities are broadly categorized into economic activities (employment, business, or professional practice) or non-economic activities (religious rituals, cultural and social work, etc.).

Economic activities can be of three types: business activities, professional practice, or employment.

A business may involve trading (buying and selling of finished goods), manufacturing (changing the shape of the raw material into a usable form), or providing a service. A business earns profits from the activities undertaken.

A professional may be described as a person who provides personal services of specialized and expert nature and charges fees from the client for the service(s) rendered.

Employment refers to the work performed by a person for someone else according to the contract between them. This gives rise to an employer–employee relationship, where the employee is compensated in the form of salary, or wages, or contractual payment.

Organizations can be broadly classified as *for-profit* or *non-profit*. The main purpose of organizations or firms in the first category is to earn a profit. Non-profit organizations have objectives other than generating profit. No part of the organization's income is distributed to its members, directors, or officers. Non-profit organizations include schools, charities, clinics and hospitals, legal aid societies, volunteer services organizations, and professional associations. The bookkeeping system, necessary to monitor funds, is similar in both profit-making and non-profit making organizations.

Forms or structures created for the smooth running of a business or a profession are of the following types (Fig. 1.1).

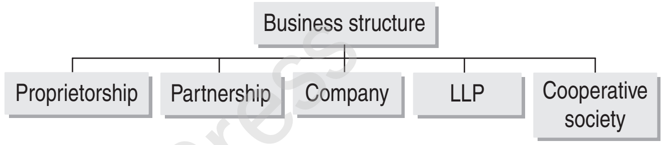

FIG. 1.1 Various business structures

Sole Proprietorship

In this structure, only one person takes all decisions related to the functioning of the business, such as purchase of goods, sale of goods, management of finance, and recruitment of staff. The sole proprietor or the one person is solely responsible for the profit or loss of the business.

Partnership

Partnership is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all. In this structure, two or more than two persons collaborate to take all decisions related to the business. They cooperate with each other to perform business or professional activities as co-owners, and are jointly responsible for the profit or loss of the business. The profits are shared in a certain ratio among them as per agreement.

Company

It is an association of persons, who contribute money to the common share capital of the company or joint stock. The company appoints managers or directors to run the activities related to the business. It is a separate legal entity and has a limited liability of persons who have contributed to the common share capital.

Limited Liability Partnership (LLP)

LLP is a new type of corporate structure. It combines the flexibility of a partnership and of a limited liability company. It provides the benefits of a company to its partners and at the same time does not put restrictions on them for organizing internal management, as applicable in case of a company. On account of flexibility in its management and operations, an LLP is useful for small and medium enterprises in the service sector, in particular.

Cooperative Societies

A particular group of persons with a common purpose may collaborate with one another and work together in order to achieve financial and/or social goals. Such a structure represents a united, collective front for the benefit of all members.

BOOKKEEPING

Bookkeeping is an activity concerning the recording of financial data related to business operations in a significant and orderly manner. It is the record-making phase of accounting. Accounting is based on a careful and efficient bookkeeping system. The terms 'accounting' and 'bookkeeping' are often used synonymously. In fact, bookkeeping is complementary to the accounting process. While bookkeeping is the systematic recording of financial and economic transactions, accounting is the analysis and interpretation of bookkeeping records.

Bookkeeping is the record-making phase of accounting.

BOOKKEEPING, ACCOUNTING, AND ACCOUNTANCY

Bookkeeping is a part of accounting that deals with record-keeping or maintenance of books of accounting which is often routine and clerical in nature. It covers the following:

- Identifying the transactions and events
- Ceasuring the identified transactions and events
- Recording the identified and measured transactions and events in proper books of accounts
- Classifying the recorded transactions and events in a ledger

Accounting refers to the actual process of preparing and presenting the accounts of an enterprise. In addition to the aforementioned functions of bookkeeping, accounting covers the following:

- Summarizing the classified transactions and events in the form of income statements and position statements
- Analysing and interpreting the summarized results
- Communicating the interpreted information to the interested parties

Accountancy refers to a systematic knowledge of accounting. It explains the reasons and the processes of accounting. Accountancy explains the method of preparing the books of accounts, and summarizing and communicating accounting information.

Accounting is the process of preparing and presenting the accounts.

An event can be considered as an accounting event if it satisfies the following four conditions:

1. There must be two parties.
2. One of the parties must have fulfilled the obligations.
3. It should be measurable in acceptable monetary terms, as per law of the land.
4. It should be legal, moral, and ethical.

FUNCTIONS OF ACCOUNTING

An entity (also referred to as an enterprise, firm, or organization) is a specific unit (i.e., individual, firm, or institution) for which the accountant records and reports economic information. As mentioned earlier, the boundaries of an accounting entity are distinct and separate from those of the owners, creditors, managers, and employees.

An accountant records and reports financial information for an entity. For example, Lakhina Traders is a business entity owned by Mr Sharma. The financial statements of Lakhina Traders will report the effect of the event on the entity, not on its owner. Accounting measures the resources held by an entity by

- ascertaining the claims and interest in the said entity;
- measuring the resources and changes in these resources;
- assigning the changes to specified period of times in terms of money;
- communicating information about an entity; and
- fulfilling the statutory requirements, particularly in respect of income tax, sales tax, etc.

From the above, it becomes clear that accounting accumulates data systemically and supplies the necessary information to the user of financial statements. The user can take proper decisions based on the financial information about an entity for a specified period. This indicates that maintaining accounts is not the primary objective of an entity. Its primary objective is to take decisions on the basis of financial facts presented by accounting statements. Thus, accounting is not an end in itself, but is a means to an end.

OBJECTIVES OF ACCOUNTING

The primary objectives of accounting are as follows.

1. Have a permanent record of each transaction and to show the financial effects on the business.
2. Ascertain the combined effects of all the transactions made during an accounting period on the financial position of the business.
3. Evaluate the earning capacity of the enterprise by supplying a statement of its financial position. A statement of periodic earnings together with a statement of financial activities is provided to the internal and external users of the information.
4. Provide necessary information about the efficiency or otherwise of the management regarding proper utilization of resources.
5. Provide necessary information for financial forecasting, formulation of overall policies, and devising remedial measures for the deviations between the actual and projected (or budgeted) performance.
6. Provide necessary data to the government for taking proper decisions related to duties, taxes, price control, etc.

USERS OF ACCOUNTING INFORMATION

Accounting information is used for making better investment and credit decisions. The demand for accounting information of any entity comes from both outside and inside the organization.

Outside Users

Accounting information is used by investors and other capital providers outside the organization. For those outside the organization, financial accounting reports constitute most of the financial information concerning the organization's status and performance.

Capital markets Investors who participate in capital markets need accounting information to make investment decisions. Investors may include equity shareholders, preference shareholders, debenture holders, brokers, etc.

Financial institutions Funding institutions such as banks, state and/or central financial institutions need accounting information for credit appraisal.

Government institutions They determine the taxes owed by the enterprise to implement a regulatory framework and to formulate economic policies.

Special interest groups Creditors, labour unions, consumer action groups, competing businesses, financial advisers, and the general public seek accounting information about an enterprise to further their own interests.

Inside Users

Accounting information is used internally by operating, marketing, and financial managers within an organization. The information provided by accounting assists the management in making pricing, product, and investment decisions.

Managers Financial information is required to control the resources of the enterprise, and to direct resources to the most promising products, sub-units, and activities of the business.

Employees They are interested in the financial performance of their company as it is their source of income. Decisions regarding wage increases and bonuses also drive employees to be on the look out for financial information.

LIMITATIONS OF ACCOUNTING

The limitations of accounting are as follows.

Financial nature The accountant measures only those events that are of a financial nature, that is, are capable of being expressed in terms of money. Non-monetary events, however, significant and important, are not measured or recorded in accounting.

Historical costs Accounting contains information related to historical costs. It does not provide day-to-day information about costs and expenses. For example, fixed assets are shown at historical cost. This value may change over time, and hence there may be a great difference between the original cost at which assets were purchased and the current replacement cost. The balance sheet, thus, may not show a true picture of the financial affairs of an enterprise on a particular date.

Measurement unit Money as a measurement unit is not stable but it changes in value. Unless changes in price levels are considered in the measurement of income, the accounting information will not show true results.

Personal judgement Accounting information is not without personal influence or bias of the accountant. In measuring income, an accountant makes a choice between different methods of inventory valuation, depreciation methods, provision for doubtful debts, etc.

Estimates Accounting data are sometimes based on estimates, and these estimates may be inaccurate. For example, the actual useful life of an asset cannot be accurately estimated for the purpose of providing and calculating depreciation.

Inexact information Accounting does not provide information to analyse losses incurred due to factors, such as idle plant and machinery, seasonal fluctuations in volume of business, etc. It is also difficult to have detailed information regarding costs relating to different departments, processes, products, jobs in the production divisions, etc. Cost control is one of the most important objectives of a firm and it cannot be achieved by using accounting processes alone.

KINDS OF ACCOUNTING ACTIVITIES

Due to growing business complexities and advanced decision processes, different kinds of accounting have been developed to serve different objectives.

Financial accounting It deals with recording and summarizing economical events and preparing financial statements in accordance with accepted accounting practices. Hence, it is also known as stewardship accounting.

Cost accounting It deals with the computation of aggregate costs of the products manufactured and/or services provided by using the same set of information used by financial accounting. In cost accounting, the production processes are broken down into financial values to calculate cost.

Taxation accounting It involves preparing records and reports necessary for filling tax returns to local, state, and central govern-ment authorities.

Management accounting It relates to the use of financial and cost data for the purpose of evaluating the performance of the enterprise, reviewing the existing policies, and making decisions about new policies.

In India, taxation accounting is merged with financial accounting, and cost accounting is merged with management accounting. Figure 1.2 depicts the pictorial presentation of the linkage between the sub-fields of accounting and the users of accounting information.

CYCLICAL NATURE OF BUSINESS

Business transactions or events form a sequence of connected and regularly repeated patterns of activity. Although these patterns or cycles vary from one business to another, broadly they involve

- receiving assets from owners and creditors;
- purchasing assets (including traded items for resale) or materials to produce saleable goods and/or services;
- selling goods or services;
- collecting cash or assets equivalent to cash-in-kind from customers; and
- repaying creditors their dues.

Financial cycle A financial cycle is the time between the receiving of assets from owners and creditors and the repayment of assets to owners and creditors. In business, the owners are repaid when the entity closes down.

Investing cycle An investing cycle indicates investing activities like the purchase of fixed or long-term or non-current assets. These expenditures are made to generate future income and cash flows for the entity.

Operating cycle The operating cycle is the average time between the purchase of assets or services and the final cash realization from that purchase. Figure 1.3 illustrates the concept of the financial cycle and the operating cycle. Usually the operating cycle is much shorter than a financial cycle. The operating cycle may exist for a year or even for a few days.

ECONOMIC RESOURCES AND CLAIMS

Economic resources are the factors of production or services used in the fulfillment of the objectives of a firm. They can be divided into human resources, such as labour and professional,

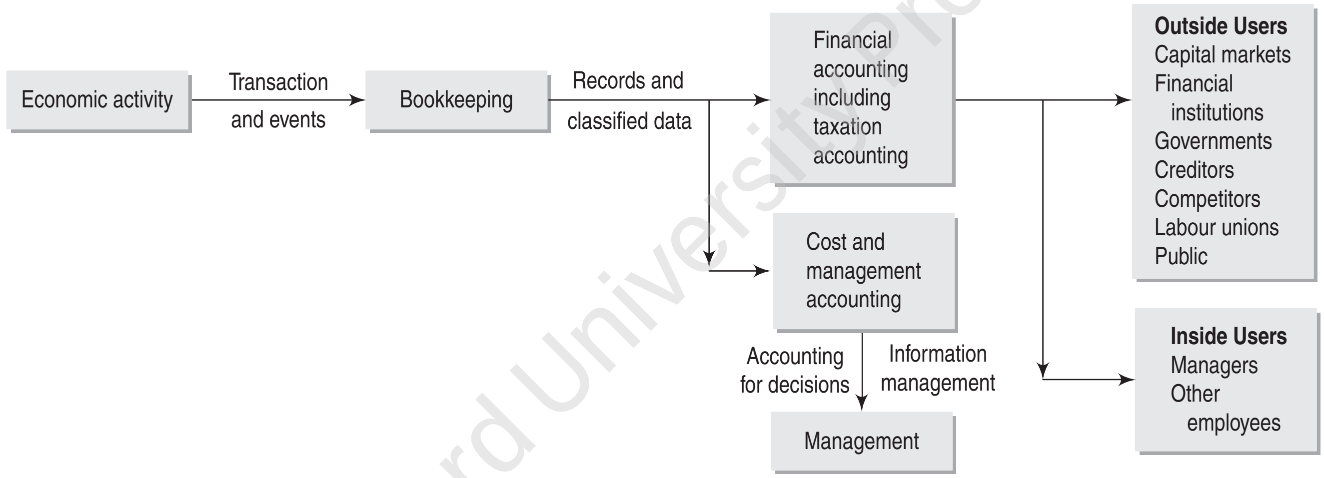

FIG. 1.2 Accounting system

Source: Adapted from C.A.P.E-I., the Institute of Chartered Accountants of India, p.8.

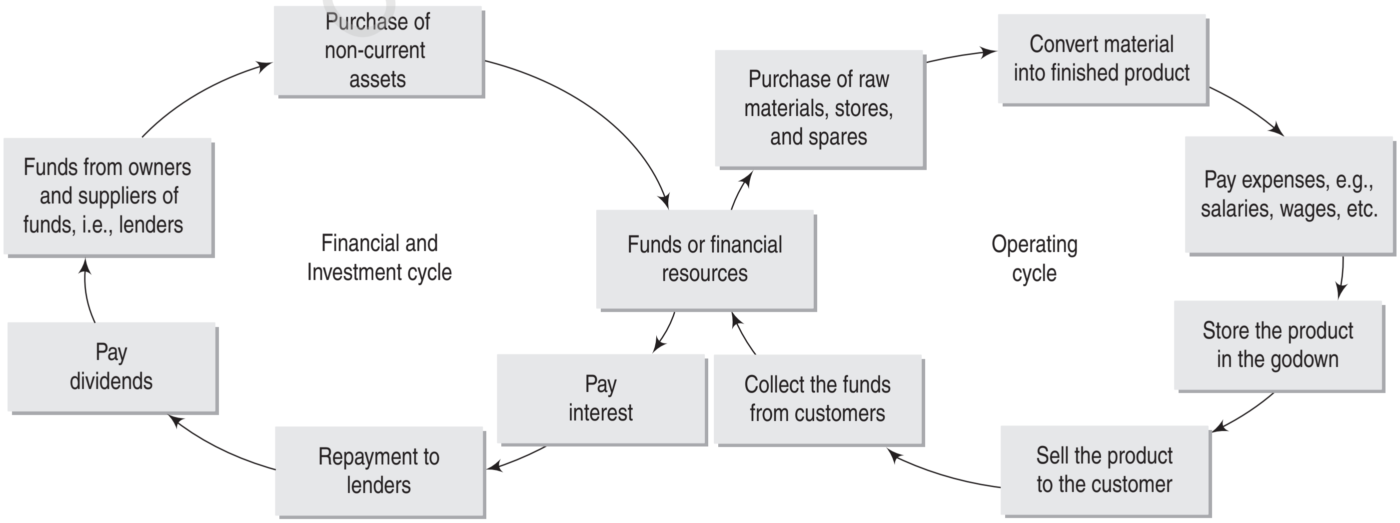

FIG. 1.3 Financial and operating cycle

and non-human resources such as land, plant, property and equipment, financial resources and technology, etc.

Economic claims arise out of contractual formal or informal relationships between parties, involving firm or enterprise or entity and outsiders. A firm's resources, that is, assets are claimed by an outsider (banks in case of bank loan, suppliers in case of credit purchases, etc.), and/or by the owners of an entity (promoters, equity shareholders in case of company, partners in case of partnership firm, etc.).

BASIC TERMINOLOGY

Due to the growing need of the spread of accounting information among its users and in order to bring uniformity in treatment of economic events in the books of accounts, the knowledge of the following terminologies is important. These terminologies can be applied in both profit-making and not-for-profit organizations.

Capital

The owner's interest in the assets of the firm, after paying off liabilities towards third parties, is known as *capital*. Capital consists of the owner's contribution in the start up of the firm's activities, additional amount brought subsequently by the owner to the firm, and also the profit (excess of income over expenses) retained in the firm. It is known as capital on the date of balance sheet. Capital is also referred to as *equity* or *net worth*.

When an owner invests personal funds in the business, such an investment is recorded in an account that carries the owner's name and is referred to as the *capital account*. In case of corporate entities, such an account is known as a share capital account, a corpus fund account, or an equity share capital account. For example, Raja Kapoor's account balance (as proprietor of the firm) in the books of Raja Associates indicates the capital balance, that is, the sum of capital contributed by Raja Kapoor at the time of start up of the firm, new capital introduced by Raja Kapoor, and profit gained from the business activities less the *withdrawals* by Raja Kapoor since the start up of the firm.

Equity

Equity refers to the right, claim, or interest in the assets of the firm by the owner or promoters or partners or shareholders. It is also known as contributed capital of an entity.

Liabilities

Liability represents the claim or right to be paid off by a firm, irrespective of the performance of the firm. If a firm fails to pay its liabilities, then the law recognizes the right of the debtor party to force recovery even by selling the firm's assets to secure the money due. For example, when RuPaltm Enterprises purchased stocks for its business from Orange Acetech on a credit period of three months, the date of receipt of goods till the date Orange is paid off is known as liability for RuPaltm. If it avails loans from bank(s) or friends and associates, then these will also be considered as the liability of RuPaltm.

Drawings

An owner invests funds in a firm in order to generate profits. The profit is earned over a period of time, such as a year. The owner may withdraw a fixed amount each week or month for living expenses or for other personal use. These withdrawals do not constitute the salary of the firm's owner in the legal sense. When an owner uses a withdrawn amount, both the assets and the capital of the firm may reduce. To exercise control over these withdrawals, a separate account referred to as *drawings* in the name of the person is used. For example, to record the drawings of Raja Kapoor, the owner of Raja Associates, an account referred to as Raja Drawings account will be maintained in the books of the proprietory concern. Drawings are also referred to as withdrawals.

Assets

Resources such as land, building, plant and machinery, furniture, and vehicles owned by the firm with an intention to be used in the operating activities of the firm are known as *assets* of the firm. The assets may be of *tangible* or *intangible* form, which provide value to a firm.

Assets that possess a physical form are known as *tangible assets*, for example, land, plant, machinery, etc. *Intangible* assets are not present in the physical form, but are valuable as they generate cash for a business. Some of the most common *intangible* assets are legal claims or rights, such as patents, goodwill, etc.

Goods or Merchandise

A business firm earns revenue by selling goods. Merchandise refers to the aggregate of the items, commodities, or goods that are either sold in the same form or converted into saleable products by the firm. For example, if Home Furniture purchases chairs for sale to its customer, the chairs constitute goods of Home. However, if the chairs are purchased by Alia Grocery Stores, they would be referred to as that firm's *fixed assets*. To consider another example, if Home Furniture purchases wooden pieces to manufacture dining tables, these wooden pieces will be referred to as *goods* of the firm. Goods are expected to be sold within a year or during the course of one business cycle. Consequently, the merchandise not sold during this period is reported as *inventory* and is considered as part of *current assets*.

Revenue, Income, or Turnover

Revenue refers to the cash and cash equivalent received or receivable for goods and commodities supplied, services rendered, or the right given to the other party for utilization of the resources of the firm. The revenue generated by a firm for the regular operating activities is known as *business income*. For example, a grocery shopkeeper earns revenue by the sale of consumable items, such as food, soaps and detergents, and cosmetics. The amount received on sale of goods is known as *sale income*. In the case of a practicing chartered accountant, the service fees charged from a client is covered under *consultancy income* or *service income*. If the firm is transferring the right to use the shop floor to a third party, and earns rental income, it is known as *other income* or *rental income*. Revenue is also referred to as turnover.

Expenses

When a payment is made or undertaken to be made for the services rendered by a third party, a firm, or a legal entity, no further future benefits can be availed from the third party. This payment is referred to as an *expense*. For example, the peon of Jeevan Software has paid ₹50 as auto fare for going to and returning from the bank for official work. This ₹50 will be considered as conveyance expense, because no future benefit will be available from this auto fare.

If an expense cannot provide future benefit, it is known as *revenue expense*. If an expense creates scope for future benefits, it is known as *capital expense*.

Discount

It is the concession in the amount payable offered by the seller to the buyer on the market price or listed price of the product. In business, the discount allowed by a firm is of two types: trade discount and cash discount.

Trade discount

It is offered by the seller to the retailer on the listed or printed price in order to enable the latter to earn profit. It is also sometimes offered by the seller to the customer, with an intention to maintain the relationship or to sell a bulk quantity. Trade discount being part of sales promotion efforts is not recorded in the account books. Trade discount is allowed in a business transaction irrespective of whether it involves cash or credit transaction.

Cash discount

It is a type of financing cost undertaken by the seller, with the intention to recover the money early in the transaction. It is a mechanism to encourage the prompt payment of money by customers, so that for the seller, financing from bankers and financial institutions is reduced and bad debts avoided. *Bad debt* refers to the failure to recover moneys due from customers. This is a type of financing cost and is recorded separately in the account books.

Debtors

When a firm pays a person or another firm cash or cash equivalent with future relationship in mind, such as to receive the paid amount back in cash or kind, then the receiving party of the transaction is known as the *debtor* for the person or the firm. For example, Packing Maker Stores delivered 30 boxes of packing material to Mr Jeeyu Kumar as on Monday, and Jeeyu agreed to pay ₹150 on Wednesday as consideration for purchase of the boxes of packing material. This means that as on Monday, based on the future relationship between Packing Maker Stores and Jeeyu, the latter, will be treated as a Debtor in the books of Packing Maker Stores.

Creditors

When a firm receives support in the form of cash or in kind from another firm or any other legal entity, then the providing firm or legal entity becomes the giver to the firm and is called the *creditor*. The firm is bound to return the cash or equivalent in kind as agreed upon to the lending or providing firm. Hence, it is considered as a *future liability*. For example, Packing Maker Stores has delivered 30 boxes of packing material to Jeeyu as on Monday, and Jeeyu agreed to pay ₹150 on Wednesday as consideration of receipt of the boxes of packing material. It means that as on Monday, based on the future relationship between Packing Maker Stores and Jeeyu, the specified amount is payable by Jeeyu to Packing Maker Stores. Hence, Packing Maker Stores would be treated as a creditor in the books of Jeeyu.

Loss

When the sales revenue is lesser than the cost of goods sold, the difference is called *gross loss.* When the sum of sales revenue including the other revenues is lower than the sum of the cost of goods sold and other administrative, selling, and distribution expenses, it is called *net loss.*

Profit

When the sales revenue is greater than the cost of goods sold, the difference is called *gross profit*. When the sum of sales revenue including the other revenues is greater than the sum of cost of goods sold and other administrative, selling, and distribution expenses, it is called *net profit.*

Cost of Goods Sold

The *cost of goods sold* is equal to the sum of the cost of opening stock of raw materials, work-in-progress, and finished goods and the cost of purchase of raw materials and/or finished goods, from which the sum of the cost of closing stock of raw materials, work-in-progress, and finished goods are deducted. In addition to the above, the sum of the directly identifiable expenses necessary to complete the operating cycle are added to the cost of goods sold. In other words, it takes into account the operating expenses, such as wages, power and fuel, inward freight expenses, etc. involved in bringing the goods to a *saleable* condition.

Expenditure

Assets, goods, or commodities purchased by a firm considering the long-term benefits that they provide to the firm, are called *long-term assets* or *fixed assets*. The amount expended or agreed to be expended in future in addition to the expense incurred to make the asset workable is referred to as *capital expenditure*.

When the amount expended or agreed to be expended in future is not concerned with the value addition of the fixed asset, but supports the firm's business activities on a day-to-day basis, it is termed as *revenue expenditure.* For example, payment of wages to workers for delivery of sold goods to customer's premises is known as revenue expenditure. If the worker is paid for installation of a newly purchased machine, then it is known as capital expenditure. Capital expenditure is capitalized. This means that the expense is booked as the value of a tangible or intangible asset of the firm. An asset provides benefits of its use over a longer period of time, that is, more than one year or one accounting period. In the said example, if the expenditure on installation of machine is not incurred, the machine cannot be made operational and put into effective and productive use over a long period.

ACCOUNTING METHODS

Cash basis accounting (also known as cash accounting) and accrual basis accounting (also known as accrual accounting) are the two principal methods of keeping track of an enterprise's income and expenses.

Accrual basis accounting is the method of recording business events or activities when they occur rather than when cash is received or paid. Thus, accrual accounting recognizes revenue and expense when goods are sold or when services are performed rather than when cash is received or paid. *Cash basis accounting* records only cash receipt and payments, and recognizes income increases and decreases when cash is received and paid.

Accrual basis accounting is superior to cash basis for measuring the performance of a business because it ties income measurement to sales. In contrast, cash basis accounting is influenced by many factors that may have little to do with the performance of the entity. Cash basis accounting is not permitted by accepted accounting principals, income tax authorities, etc.

BASIC DOCUMENTS AND RECORDS

Following are the important objectively verifiable evidences to establish the validity of the transactions recorded in the books of accounts.

Voucher

An accounting transaction is an economic event that affects an entity's assets, liabilities, or owner's equity at the time of occurrence of an event. The transaction between a firm or entity and an external party is an external transaction, whereas the transaction within a firm or entity is internal transaction. For such transactions, documentary evidence is prepared, which is known as voucher.

A voucher refers to an authorized consent of the payments made, or agreed upon to make payments of funds or receipts, or agreed upon to receive funds.

Books of Original Entry or Journal

The accounting transactions are recorded from the vouchers to the original books of accounts or journals. Transactions are recorded in chronological order. If the same type of transactions takes place a large number of times, then subsidiary books can be maintained. Subsidiary books are specialized books of original entry, and are explained in Chapters 6 to 8.

Account

An account is an accounting record that accumulates the activity of a specific item or nature of transaction and yields the balance of the specific nature of transactions. An account is the standardized record in which all the changes in each of entity's assets, liabilities, capital, income, and expenses are collected. The amount in an account at any time is called the balance of an account.

An account can take a variety of forms and accounts are traditionally shown the form of T; while in the present era, as per modern approach it is maintained in a columnar way, as explained and used throughout this book.

Ledger or Principal Books of Accounts

The accounting record in which all the accounts of the entity are kept is called the ledger in which the individual accounts are summed up to produce the aggregate amount entered in the balance sheet and income statement. In short, a ledger refers to a book or register in which financial transactions are permanently recorded after being summarized and classified. A ledger helps in preparing a trial balance, after which the final statement is prepared. A ledger is also known as a principal book.

Trial Balance

A trial balance is a listing of accounts and their balances at a specific point of time, which constitutes the first step towards the preparation of financial statement of an entity. A trial balance is generally prepared at the end of the accounting period for preparing the financial statements. It is done with the objective of checking the arithmetic accuracy of ledger positions.

RELATIONSHIP OF ACCOUNTING WITH OTHER DISCIPLINES

Accounting is closely related to several other disciplines, and thus, to acquire a good knowledge in accounting, one should understand the relevance of these disciplines. Accountants should have a working knowledge of related disciplines, so that they can understand such overlapping areas and apply the knowledge of other disciplines in their own work.

Accounting and Economics

Economics is viewed as a science of rational decisions. It deals with the efficient use of scarce resources for satisfying human wants. Accounting is viewed as a system that provides data for informed judgement and decisions. Some non-accounting data are also relevant for decision-making.

Accounting and Statistics

The use of statistics in accounting can be appreciated better in the context of the nature of accounting records. Accounting information is very precise; it is exact to the last paisa. However, for the purpose of decision-making, such precision is not necessary and hence approximations are sought.

In accounts, all values are important because they are related to business transactions. As against this, statistics involves the typical value, behaviour, or trend over a period of time, or the degree of variation over a series of observations. Therefore, whenever a need arises for generalization of relationships, statistical methods are applied in accounting data.

Statistical methods are helpful in developing and interpreting accounting data. For example, time series and cross-sectional comparisons of accounting data are based on statistical techniques. Regression analysis is useful in forecasting, budgeting, and cost control; significance tests are used in budget analysis and standard cost variances. Multiple discriminant analysis is commonly used to identify the causes of sickness in a business firm. Therefore, the study and application of statistical methods would add an extra edge to the accounting data.

Accounting and Mathematics

Double-entry bookkeeping can be converted into algebraic form. In fact, the first known book on accounting was part of a treatise on algebra.

Knowledge of arithmetic and algebra is a prerequisite for accounting computations and measurements. Calculation of interest and annuity are examples of such fundamental uses. Mathematical techniques are commonly used to calculate depreciation, installments payment transactions, loan repayment and replacement amount, lease rentals, etc. Accounting data can also be presented in ratio form.

Accounting and Law

A business entity operates within a legal environment. All transactions with suppliers and customers are governed by the Contract Act, the Sale of Goods Act, the Negotiable Instruments Act, etc. The entity itself is created and controlled by laws. For example, a partnership business is controlled by the Partnership Act. A company is created and controlled by the Companies Act.

Every country has a set of economic, fiscal, and labour laws. Laws of the land guide economic transactions and events. Often the accounting system followed is prescribed by the law. For example, the Companies Act has prescribed the format of financial statements. Banking, insurance, and electric supply undertakings have to produce financial statements as prescribed by the respective legislations controlling such entities.

Accounting and Management

Management is a broad field, which comprises many functions and encompasses applications of many disciplines. Accountants play a key role in the management team. A large portion of accounting information is prepared for decision-making by the management. Although the management relies on other data sources, accounting data are the basis for making crucial decisions. An accountant is in a better position to understand and use such data.

ROLE AND ACTIVITIES OF AN ACCOUNTANT

The training of accountants in assessing the financial implications of alternative courses of action, working with multiple constituencies, establishing systems and controls, and behaving in a responsible and credible manner, prepares them to play critical roles in organizations. The following statements list the activities of an account:

1. An accountant is engaged in accounts keeping.
2. An accountant is a functionary who aids in control.
3. An accountant keeps the conscience of an organization.
4. An accountant is a professional whose primary duties include information management for internal and external use.
5. An accountant is a financial adviser.
6. An accountant produces an income statement and a balance sheet for an accounting period, and maintains all supporting evidence and classified facts that lead to final accounting statements.
7. An accountant verifies, authenticates, and certifies the accounts of an entity.
8. An accountant provides necessary information for various managerial decisions.

Primary role Statement (1) defines the primary role of an ac- countant. Statement (6) echoes almost a similar profile, but extends an accountant's role to the production of financial statements. The work implied in these statements is that of score-keeping and the person performing such activity is known as a financial accountant (or maintenance accountant).

Decision-maker Statements (2) and (8) illustrate the accountant's role in decision-making and the management control process. These roles involve directing attention and solving problems. The functionary may be designated as a management accountant (or controller, as in the USA).

Tax planner Statement (5) underlines a narrow, specific role of an accountant. In view of high corporate tax in India, tax planning assumes a vital role in financial management. By planning the operations of the enterprise in a particular manner, the tax adviser attempts to minimize the liability of the firm by availing the concessions and incentives provided by the applicable tax laws.

External verifier Statement (7) stresses the audit, corporate watchdog, or certification role of the accountant who is not an employee of a business but who performs an external verification of the accounts. Such a functionary is a trained and qualified professional, and has an educational status and prescribed code of conduct. Chartered accountants in India, England and Wales, and certified public accountants in the USA belong to this category of accountants.

Conscience-keeper Statement (3) defines the role of an account-ant as a conscience-keeper. He/she is seen as a person whose mission is to protect and promote the interests of the enterprise. An accountant sees to it that none of the staff carries work in an unethical way, or in a manner prejudicial to the long-term legitimate interests of the enterprise.

Manager of information Statement (4) defines an accountant as a professional and underlines his/her pre-occupation with management of information for internal use (management accounting) and for external use (financial accounting). Accounting as an information system has made it easier to comprehend the role of an accountant. Information management is not necessarily associated with the sophisticated (or high-technology) areas of computers. Small firms may 'manage' information without a substantial degree of mechanization or automation. Often, the role of accounting in a small business is not properly recognized. It is widely known that a large number of small businesses fail and do not survive beyond a few years. One of the main reasons for the failure is the lack of an adequate information system to help managers control costs, forecast cash needs, and plan growth. Organizations which have poor accounting systems often find it difficult to obtain finance from banks and outside investors.

ACCOUNTING PERSONNEL

There is hardly any organization that does not have an accountant. An accountant is involved in a wide range of activities, particularly in a large and complex organization. The exact duties of an accountant might differ in different organizations.

Accountants can be broadly divided into two categories: those who are in *public practice* and those who are in *private employment*. Public accountants are generally members of professional bodies like the Institute of Chartered Accountants of India (ICAI). In addition to conducting a financial or cost audit (in accordance with the requirements of, for example, the Companies Act), accountants also provide advisory services for designing, or improving accounting and management control systems.

Accountants in various organizations perform a variety of accounting and management control functions. Accountants at higher levels generally belong to professional accounting bodies. Accounting chiefs in different organizations, depending upon their nature of work, are designated as finance officers, internal auditors, chief accountants, or accounts officers. The term 'controller' as the head of the accounting and finance function is not very popular in India. Several large organizations, both in the public and private sectors, have controllers. This section gives the job descriptions of various positions available in the field of accounting.

Auditor

Auditors are accountants in public practice who conduct financial and/or cost audit. The auditor examines the books of accounts and reports on the company's balance sheet, profit and loss account, and profit. The auditor in a company is appointed by the shareholders to whom he/she reports.

An *internal auditor* is an employee of organization in contrast to an external auditor who is paid a fee for his/her services. An external auditor is not an employee of a company, and he/she is appointed to conduct *statutory audit*. The principal objective of a statutory audit is to ensure that the financial statements prepared by the management give a true and fair view of the company's business, and are free of discrepancies resulting from frauds and errors. The internal auditor is responsible for performing and monitoring activities, designing and operating the system of internal control, auditing the data reported to the directors of the company, and assisting external auditors. The head of the internal audit reports directly either to the chief executive or to the audit committee of the board of directors.

An internal audit includes continuous verification of entries appearing in the books of accounts with the original vouchers and proper accounting assets. Further, it attempts to ensure that the policies and procedures regarding financial matters are being complied with. Internal auditing is also concerned with administering the system of internal checks so that mistakes, innocent or intentional, are prevented from taking place.

While an internal auditor devotes his/her entire time and energy to the needs of one company, an *external auditor* serves many clients. The primary function of the external auditor is to safeguard the interests of the shareholders by an independent and impartial appraisal of the financial transactions of the company so that he/she could report on the net profit earned by the company and its financial position. An external auditor performs the role of an objective outsider. He/she expresses expert opinions on the financial condition and operating results of the client's business. Apart from shareholders, other parties such as banks, lending institutions, government agencies, etc. rely on the fairness of such financial reports in making certain decisions about a company. An auditor is bound by a set of professional regulations which include an examination on technical competence and adherence to a code of ethical conduct.

Controller

In some organizations, the chief accountant is known as the controller. The controller is the overall in-charge of financial accounting, management accounting, and tax accounting activities. He/she is responsible for internal accounting and external reporting. The external reports include reports to government revenue collection and regulatory bodies, such as the Company Law Board and the Department of Income Tax. The controller supervises the company's internal audit and control systems. In addition to processing historical data, he/she supplies accounting information to the top management concerning future operations, in line with the management's planning and control needs. Besides, he/she supplies detailed information to managers in different functional areas (such as production and marketing) and at different levels of an organization to assist them in decision-making. The responsibilities of the controller are as follows:

- Designing and operating the accounting system
- Preparing financial statements and reports
- Establishing and maintaining systems and procedures
- Supervising internal auditing and arranging for external audit

- Supervising computer applications
- Overseeing cost control
- Preparing budgets
- Making forecasts and analytical reports
- Reporting financial information to top management
- Handling tax matters and ensuring other legal compliances

Treasurer

A treasurer is the custodian and manager of all the cash and near-cash resources of the enterprise. The treasurer handles credit reviews and sets the policy for collecting receivables (from the debtors of the firm, to whom the firm has sold goods or services on credit). He/she also handles relationships with banks and other lending or financial institutions. The Financial Executive Institute (USA) makes certain distinctions between the functions of a treasurer and those of a controller (see Table 1.1).

TABLE 1.1 Distinction between the functions of a controller and a treasurer

Controller	Treasurer
Planning and control	Provision of capital
Reporting and interpreting	Investor relations
Evaluating and consulting	Short-term financing
Tax administration	Banking and custody
Government reporting	Credit and collections
Protection of assets	Investment
Economic appraisal	Insurance

Finance Director

Finance is the lifeblood of any business. Procuring financial resources and ensuring their judicious utilization are the two most important aspects of financial management. Financial management includes major decisions concerning investment, financing, dividends, and working capital.

Investment decision It is perhaps the most important decision, because it involves the allocation of resources. It deals with assessing the risks an organization encounters in a business environment. The firm's strategy in allocating its scarce resources and planning its growth largely determines its value in the market.

Financing decision It deals with determining the optimum financing mix, or capital structure. It examines the various methods by which a firm obtains short-term and long-term finances through alternative sources.

Dividend decision It involves questions such as how much profit is to be retained and how much is to be distributed as dividend.

Working capital It gives investors an idea of the company's operational efficiency. The finance director has to strike a balance between the cash requirements of the enterprise, and the needs of the shareholders for adequate returns. Working capital is calculated as:

Working Capital = Current Assets – Current Liabilities

A positive working capital indicates that the company is able to pay off its short-term liabilities. A negative working capital indicates that the company is unable to meet its short-term liabilities with its current assets.

The financial management of a large company is usually the responsibility of the finance director who may be in place of, or in addition to, the controller. Often the terms 'finance director' and 'controller' are inter-changeable, and only one of these two positions may be present in a company. The finance director is concerned with implementing the financial policy of the board of directors, managing liquidity, preparation of budgets, administration of budgetary control system, managing profitability, etc.

Though financial management is regarded as a separate area, this function is performed in several countries, including India, by the accountant (or the financial controller). Several large organizations, however, have a chief financial executive besides the chief accountant. Often, finance and accounting functions are clubbed together in small organizations.

NATURE OF ACCOUNTING FUNCTION

Accounting is a service function and the accountant's role is advisory in nature. The chief accountant holds a staff position except within the accounts department where he/she exerts authority. This is in contradiction to the roles played by the production or marketing managers who hold line authority. The role of the accountant is *advisory* in nature. He/she works through the authority of the chief executive. The accountants and or the finance department(s) do not exercise direct authority over line departments. In a decentralized structure with a number of units and divisions, the accounts manager, however, exercises functional authority over all the accounting staff deployed in different segments.

There are two facets to the role of an accountant. An accountant performs the role of a corporate watchdog for the top management, and of a helper for the middle and lower management. The accountant reports to the higher management and performs the score-keeping task of accounting. The accountant performs the role of a helper by directing managers' attention to problems, and assisting them in solving these problems. Mutual understanding and rapport between the accountant and the managers, in the tasks of attention-directing and problem-solving, can be enhanced if the accountant and the staff frequently interact with the line managers and guide them in matters concerned with preparation of budgets and control documents. This will instill confidence in line managers regarding the reliability of reports.

ACCOUNTING STANDARDS

At one time, firms and corporates followed different accounting policies and practices. It was, therefore, not possible to compare different financial statements to understand outcomes. With a view to establish reliability and comparability of financial statements prepared and presented by firms, corporates, business houses, etc., India's accounting body, that is, the Institute of Chartered Accountants of India (ICAI) developed the Accounting Standards. Accounting Standards are authoritative guidelines issued by the ICAI regarding accounting norms for measurement and treatment of accounting events and transactions. The traditional debits and credits of the accounting discipline and the modern approach of accounting equation have evolved to more reliable accounting standards and the Generally Accepted Accounting Principles (GAAP).

The US GAAP are the rules and practices of accounting applicable to firms operating in the United States. While preparing and presenting the financial statements, the US GAAP are to be followed, by all companies, whether their shares are publicly traded or are not traded in the security market. The Government Accounting Standard Board (GASB) is mandated to develop accounting standards for local and state governments. The local and state governments normally operate under a different set of assumptions, principles, and constraints. Hence, a separate set of accounting standards have been developed.

Likewise, Indian firms, corporates, companies, and business houses must adhere to the various accounting standards developed by the ICAI. In addition, Indian companies have to follow the regulations prescribed by the Companies Act, 1956. The accounting standards set by ICAI, together with the legal regulations of the Companies Act, 1956 are known as Indian GAAPs. ICAI recognized the need for harmonization of diverse accounting policies and practices, and constituted an Accounting Standard Board (ASB) in the year 1977. The specific accounting standard is mandatory from the date mentioned in the standard. Mandatory means that it is the duty of the member of the ICAI to examine that accounting standards are complied by the firm, or company, or the business entity in the presentation of financial statements.

The main aim of accounting standards is to ensure comparability, credibility, and reliability of financial statements of the firm. Comparability indicates that the financial statements of firms in the same industry are prepared in a comprehensible way, and the same accounting principles and practices are used in the preparation of financial statements. By providing uniform guidelines and structure, it creates an environment of confidence among the users of the accounting information, and also provides a true and fair view of the financial position and performance.

Advantages of Accounting Standards

A few advantages offered by accounting standards and its implementation are illustrated as follows:

1. It reduces to a reasonable extent or altogether removes confusing variations in the accounting treatment of specific items of income and expense.
2. Accounting standards look into important areas of information, which may not be required to be disclosed by law or statute, but would be useful in fair presentation.
3. It is useful to have meaningful comparisons of financial statements of different companies situated over the different places.

Disadvantages of Accounting Standards

Some important demerits or disadvantages of the accounting standards are as follows:

1. It brings rigidity in the working and does not provide the important flexibility in reporting by a particular firm.
2. The difference is reflected in the treatment of a particular transaction and its reporting, on account of difference in the traditions and legal system among the countries.
3. Accounting standards cannot override the law, Act, or any legal pronouncement.
4. The choice of better alternative of accounting treatment is eliminated.

ACCOUNTING STANDARDS AND DEVELOPMENT

To provide the benefit to all countries of the globe to achieve industrialization, to facilitate free flow of capital, merchandise, goods and commodities, etc., and to achieve the harmonization of accounting standards at the international level, the International Financial Reporting Standards (IFRS) have been introduced.

The Indian Accounting Standards are discussed in Chapter 15 (Legal and Regulatory Framework of Accounting and Auditing) in addition to the applications in respective chapters. The IFRS is explained in Chapter 18 (Contemporary Issues). The comparison between Indian Accounting Standards (Ind AS), US GAAP, and IFRS are discussed in Chapter 18 in addition to the applications in respective chapters.

The Ministry of Corporate Affairs (MCA) have notified 35 Ind AS converged with IFRS which shall be applicable to the specified class of companies. (Refer Appendix of this book)

Appendix B of this book indicates relationship between International Accounting Standards/IFRS and corresponding Ind ASs.

Appendix C of the book indicates the relationship between Ind AS (as per MCA) and AS (as per ICAI). Brief explanation of AS is provided in Appendix D of this book. Professional chartered accountants' have to adhere to the AS for professional ethics and parameters.

The detailed descriptions along with examples for each and every IFRS are given in Chapter 18 of the book.

ORGANIZATIONAL STRUCTURE OF ACCOUNTING AND FINANCE DEPARTMENT

A typical organization chart for the accounting and finance department is presented in Fig. 1.4. The person at the helm

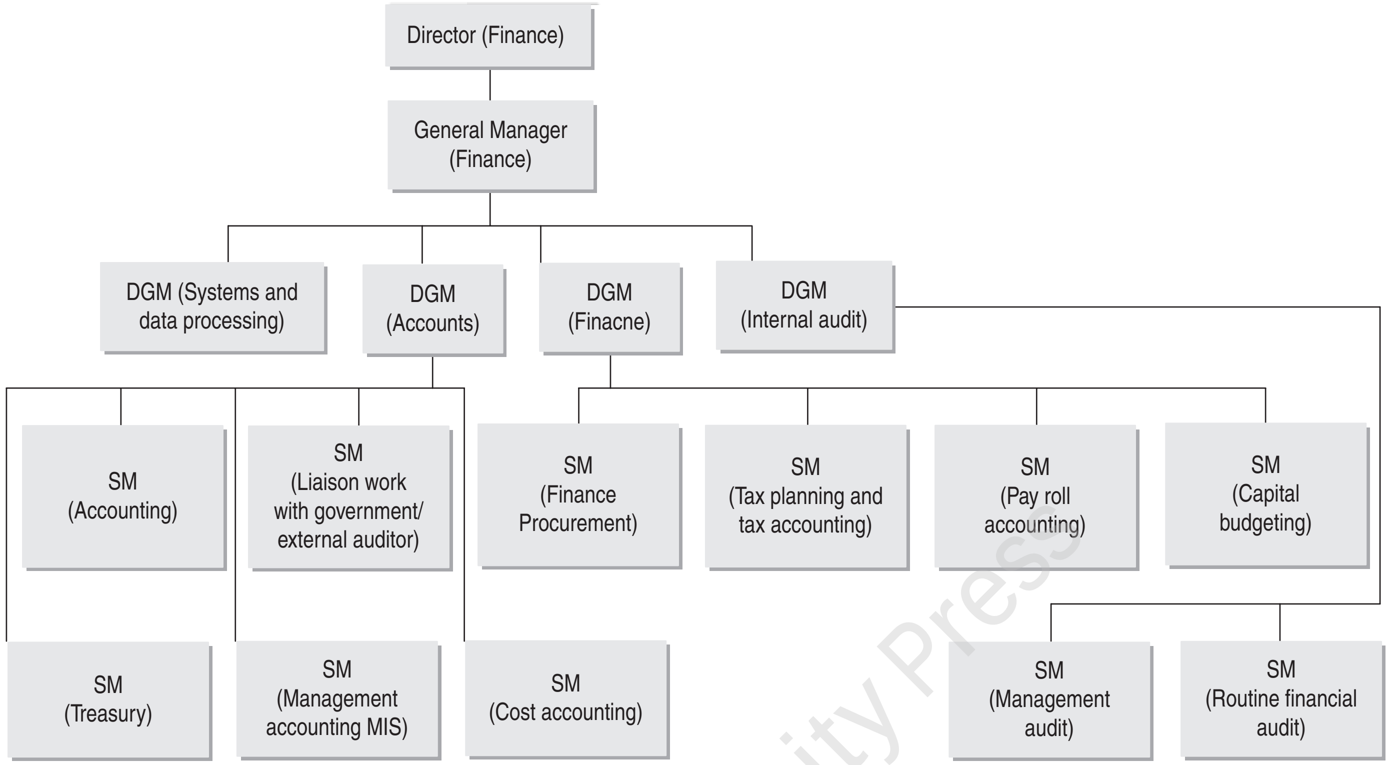

FIG. 1.4 Organization chart for accounting and finance

of affairs in the accounts and finance department is the director (finance) who is a member of the board of directors. One or more than one general manager reports to the director. Large organizations may have four or five deputy general managers in charge of different areas, such as systems and data processing, accounts, finance, and internal auditing reporting to the general manager. Some multinational companies designate general manager (finance) as president (finance or finance and accounts), and deputy general manager (finance) as vice president (finance). Each deputy general manager is assisted by a number of senior managers, who look after different components of financial accounting, tax planning and administration, management auditing, etc.

A *management audit* is a comprehensive review of the various sub-systems of the organizations, such as objectives and goals, structure, technical system, personnel policies (including succession planning), control and coordination policies and procedures, adequacy and effectiveness of communication system, etc. This type of audit is usually done by a team of people comprising the internal resource persons drawn from various functional areas and an external management consultant.

ETHICS IN ACCOUNTING AND CORPORATE GOVERNANCE

The current world economy has given rise to nearly free movement of goods, commodities, services, and capital among the countries across the globe. Hence, the commercial and economical world requires the accounting profession to provide accurate and timely financial reports, with observance of the highest standards of ethical, moral, and accounting professional code of conducts.

Professional accountants who record business transactions need to follow the guidelines based on accepted practices in accounting of their country concerned. The code of conduct has been defined and enumerated by the governing body of professional accountants with the intention to achieve the highest level of integrity by an accountant. In India, the governing body for financial accounting and auditing is the ICAI, and for cost and management accounting it is the Institute of Cost Accountants of India (ICAI). The respective code of conduct expects the members of the Institute to strictly follow the standards and maintain the highest degree of professional integrity. Integrity means honesty, impartiality, and truthfulness. It aims at the maintenance and fulfilment of professional objectivity during the performance of duties by an accountant in the role of employee, practice, business, or as an auditor. Objectivity is the state of mind that takes into consideration all aspects relevant to a task undertaken. An accountant, according to the guideline of the Institute, should accept or perform work according to competence. He/she is required to work with skill, care, and diligence.

The ethical codes of the accounting profession have changed significantly over time due to two critical tests: first, whether the accounting rules accepted and applied are appropriate and reasonable for both the public and the firm who follow them; second, whether the practice enumerated by accounting rules are valid over the period or need to be challenged.

Corporate governance pertains to systems through which companies are directed and controlled, keeping in mind the long-term interest of stakeholders. It is a blend of good legal, regulatory, and voluntary practices that enable companies to attract financial and human capital, perform efficiently, and provide sustainable economic value to all its stakeholders.

It aims to align the interests of the company with those of its stakeholders. The incentive for companies and those who own and manage them, in adopting global governance standards, is that these standards help them to achieve a long-term sustainable partnership with their stakeholders efficiently. The principal characteristics of corporate governance are as follows:

- Transparency
- Independence
- Accountability
- Responsibility
- Fairness
- Social responsibility

The financial statements are governed by fundamental accounting assumptions of going concern, consistency, and accrual. Any deviation must be disclosed. An organization is guided by the following considerations in selecting accounting policies.

Prudence Do not recognize anticipated profits but provide for all acquired losses.

Substance over form Economic reality and financial consideration get preference over legal form in reporting.

Materiality Financial statements should disclose all material items.

Summary

- A business consists of investment of a certain amount of money in fixed assets and current assets.
- Luca Pacioli is considered to be the father of accounting.
- Accounting is the language of business.
- Accounting is the art of recording, classifying, and summarizing transactions which are of a financial nature and interpreting the results.
- Accounting is the art of recording, classifying, and summarizing transactions which are of a financial nature and interpreting the results.
- Bookkeeping is the record-keeping phase of accounting. Accounting refers to the actual process of preparing accounts. Accountancy refers to a systematic knowledge of accounting.
- Accounting provides the permanent record of each transaction.
  - Accounting information is useful to investors, financial institutions, banks, government, creditors, labour unions, managers, employees, etc.
  - Assets are valuable resources owned by an entity.
- Liabilities are measurable, future economic sacrifices arising from a company's obligations to convey assets or perform services.
- Owners' equity is the residual balance remaining after total liabilities are deducted from total assets.
- Accounts are maintained for a business entity.
- A business entity is a specific unit separate from its owner.
- Accrual basis accounting is the method of recording business events or activities when they occur.
- Cash basis accounting records transactions or business events when cash is received and paid.
- Accounting is closely related with several other disciplines such as economics, statistics, mathematics, law, and management.

Keywords

Accountancy It refers to a systematic knowledge of accounting.

Accounting It is the process of recording, analysing, classifying, and reporting of economic events in a proper manner.

Accrual basis accounting It is the method of recording business events or activities when they occur rather than when cash is received or paid.

Assets Economic resources employed by an enterprise or organization to accomplish the organization's goals are called assets.

Bookkeeping It deals with record-keeping or maintenance of books of accounting, which is often routine and clerical in nature.

Cash basis accounting It records only cash receipts and payments, recognizes increases or decreases in income only when cash is received and paid.

Cost accounting It involves the computation of the aggregate costs of products manufactured and for services provided.

Creditors The individuals, suppliers, and/or institutions who loan goods and/or services to an entity.

Entity An entity is a specific unit for which the accountant records and reports economic information.

Liabilities They are probable, measurable future economic sacrifices arising from company's obligations to provide assets or perform services to a person or other organizations outside of the company at some time in future.

Management accounting It relates to the use of financial and cost data for the purpose of evaluation of performance of the entity, reviewing policies, and planning.

Owners Those who have contributed capital for starting an enterprise. Owners have a residual interest in the enterprise.

Owner's equity It represents the stockholders' claim on the resources of the business.

QUESTIONS

I. Answer the following questions.

1. Define 'accounting'.
2. Who are the users of accounts?
3. State briefly the information needs of these users.
4. What are the sub-fields of accounting? Distinguish between the various sub-fields.
5. Discuss briefly the relationship of accounting with economics, statistics, mathematics, law, and management.
6. Explain in detail the role of a treasurer and a controller.
7. Explain the nature of the accounting function.

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