Chapter 1: Theoretical Framework: Accounting and Accounting standards

1.1 Accounting: Concept

Human being is a social animal. We can survive without food and water for some days but not without society and other human beings. We do different types of activities in our day to day life for different types of needs like, physiological need, safety need, social need, esteem need and self-actualization need. One of the basic needs of a human being is social need for which specific type of activity is needed which is known as economic activity. In this world, every person has to do some sort of economic activity to earn for his livelihood. As we know, any activity carried down with the expectation of some financial return, is known as Economic Activity whereas rest of the activities are known as non-economic activity. As described, every economic activity has an expectation of some financial return which can be in form of profit, fees, salary etc. these all three words represent different form of an economic activities that is business, profession and job respectively.

Out of these all, business involves supply of goods as well as providing different type of services to the customers. Wherever the financial transactions are concerned, it is must to keep their records of all inflow and outflow of money. As it is rightly said, Money is a blood for every business. Every businessman targets to earn supreme possible profit by applying different ways but it is very much important that one is aware about the financial result of the business which has been carried out during the year. Recording of financial transactions related to business in rough manner and then transferring them into systematic books is a process to be carried on by every businessman which is commonly known as Accounting.

As per the definition given by American Institute of Certified Public Accountants (AICPA), Accounting is the art of identifying, 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.
Accounting has rightly been termed as the language of the business. The basic function of a language is to serve as a means of communication and Accounting also serves this function. It communicates the results of business operations to various parties who have some stake in the business viz., the proprietor, creditors, investors, Government and other agencies. Though, accounting is generally associated with business but it is not only business which makes use of accounting. It is equally used by salaried people as well as by professional persons.

As mentioned, Accounting is the language of business, the definition given by Warren Reeve, *Accounting is an information system that provides reports to stakeholders about the economic activities and conditions of business.*

Now, accounting has become an integral part of any business. It has become a measure of efficiency of a business enterprise. The wording of Mr. R N Anthony, righty supports this, by adding, “Nearly every business enterprise has accounting system. It is a means of collecting, summarising, analyzing and reporting in monetary terms, information’s about business”. The business which does not maintain proper books of account is to close down the business sooner or later. Nowadays, trade and business have expanded to such a scale that the owner of the business is not able to remember all the transactions and hence must be systematically recorded in the books of accounts. Hence accounting has become the lifeblood of business.

There are many definitions of accounting and there is no way we can define accounting without referring to book keeping. In this case, I will first define bookkeeping before defining accounting because there has to be bookkeeping before we can make account. Bookkeeping is the systematic recording, sorting and summarizing of events that affect the financial condition of a business. Bookkeeping is the recording and safe keeping of the accounting information for the preparation of accounting statements in forms suitable for understanding. To be more precise,

---

1 Carl S. Warren and James M. Reeve Financial & Managerial Accounting, Jan 6, 2015, Carl S. Warren and James M. Reeve
Bookkeeping is the prior step of accounting and accounting is not possible without founding stone of bookkeeping.

1.2 Accounting: History and Growth

When money was not invented, barter system was used for exchange of goods and there was no need of accounting as in the system goods or services may directly interchanged on the basis of the need of the owner of goods. As trade and commerce was developed, money was invented following to which need for accounting also was developed. Accounting was very simple in initial stage i.e. only inflow and outflow of cash that recorded just to find out gain or loss during a specific time period.

In the mid of 15th century Luca Pacioli, a mathematician, wrote a book on mathematics in which he discussed principles of accounting for the first time.\(^3\) This book was on the basis of double entry bookkeeping and accounting system, since then it is perceived as *accounting was first invented in 15th century*. The actual development and need of accountancy was engendered in the mid the of 18th century when industrial revolution took place and business transactions increased manifold due to large-scale production, development of commerce, evaluation and transport etc. This revolution not only increased the number of transactions but also added different varieties of transactions in nature, cash transactions, credit transactions to name a few. As a compilation of these all, need of detailed and elaborate accounting arouse and this led to formation of different rules, laws and standards for maintaining accounts.

In India, in the beginning of accounting foundation, it was known as Bahikhata System or Deshi Nama System. During the Maurya period in Indian history, Chanakya wrote a book named *Arthashastra*\(^4\) which also contained a separate chapter on accounting.

The main purpose of accounting is to ascertain profit and loss during a specified period, to show financial condition of the business on a particular date and to the

\(^3\) *Tractatus mathematicus ad discipulos perusinos* (Ms. Vatican Library, Lat. 3129),

\(^4\) between 2nd-century BCE to 3rd-century CE
present true and fair picture of the wealth of the business. Such an accounting records are required to be maintained to measure the income of the business and to represent the same systematic manner is to the stakeholders. Accounting is a discipline which records, classifies summarises and interprets the financial information about the activities of a concerned so that it will be helpful in the decision-making. American Accounting Association (AAA) defines accounting is “the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information.”

With the help of above definitions, we can draw out following attributes of accounting:-

1) Recording:- it is concerned with the recording of financial transactions in an orderly manner, soon after their occurrence in the proper books of accounts.

2) Classifying:- it is concerned with the systematic analyses of the recorded data so as to accumulate the transactions of similar type at one place. This function is performed by maintaining their ledger in which different accounts are opened to which related transactions are posted.

3) Summarising:- it is concerned with the preparation and presentation of the classified data in a manner useful to the users. This function involves preparation of financial statements such as income statement, balance sheet, statement of changes in financial position, statement of cash flow, statement of value-added etc.

4) Interpreting:- nowadays due to new technology, electronic data processing devices conducts main three tasks that is recording classifying and summarising but one of the major aspects of accounting is to interpret the data which has been recorded, classified and summarised by the electronic device. One of the main objectives of preparing accounts systematic is interpretation of data which is again subjective and may differ from person to person. The accounts explain not only what has happened but also why it happened and it also forecasts what is likely to happen.

---

1.3 **Bookkeeping v/s Accounting**

In the words of Dr. Mahesh Garg, (2008) *Book-keeping is a part of accounting and is concerned with the recording of transactions which is often routine and clerical in nature, whereas accounting performs other functions as well, viz., measurement and communication, besides recording.* An accountant is required to have a much higher level of knowledge, conceptual understanding and analytical skill than is required of the book-keeper. Bookkeeping is the recording of financial transactions, and is part of the process of accounting in business.\(^6\) An accountant designs the accounting system, supervises and checks the work of the book-keeper, prepares the reports based on the recorded data and interprets the reports. Nowadays, he is required to take part in matters of management, control and planning of economic resources.

In India before the advent of double entry system, there existed a sound system of accountancy called DESHI NAMA system which was much similar to today's double entry system. This system is still in use by small traders. There is a mention of the use of the accounting in Kautilaya’s Arthashastra written by Chanakaya before around 2000 years.

Today's double entry system developed in Europe in a round of 80 century by Luca Pacioli from Italy. Since then India is following double entry system which is derived from traditional Indian system which is basically known as book keeping.

Following are some of the basic differences between bookkeeping and accounting.

<table>
<thead>
<tr>
<th><strong>Bookkeeping</strong></th>
<th>v/s</th>
<th><strong>Accounting</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bookkeeping is the primary stage of recording financial transactions</td>
<td></td>
<td>Accounting is the secondary stage of recording financial transactions. That is after the process of bookkeeping ends, the process of accounting starts.</td>
</tr>
<tr>
<td>Bookkeeping is the part of accounting</td>
<td></td>
<td>Accounting is a long and continuous</td>
</tr>
</tbody>
</table>

| **Process which includes bookkeeping.** | **The main aim of accounting is to analyse and interpret the financial records which are provided by bookkeeping by preparing final accounts.** |
| **The basic aim of bookkeeping is to record routine financial transaction by the use of double entry system.** | **The main aim of accounting is to analyse and interpret the financial records which are provided by bookkeeping by preparing final accounts.** |
| **Bookkeeping records only financial transactions but doesn't reflect any type of analysis.** | **Accounting represents profitability, liquidity and financial position of business during certain period.** |
| **Generally, bookkeeping is the work performed by junior staff is it does not require any higher knowledge of accountancy.** | **In usual notation, accounting work is performed by a senior staff who is expected to have higher knowledge of accountancy is compared to book keeper.** |
| **Only basic knowledge of rules of debit credit is required to prepare book keeping.** | **Accountancy requires not only knowledge but also specific skill because it includes analysis and interpretation of financial transactions. In addition to this, it also requires managerial skills because following to interpretation, it also leads to decision making for the organisation.** |

### 1.4 Accounting: Objectives

(1) **To keep systematic records:** Accounting is followed to keep a systematic record of financial transactions. In the absence of accounting, it is next to impossible to remember all the business transactions to find out profit or loss at the end of the year.

(2) **To protect business wealth:** Accounting provides protection to listless properties from unjustified and unwanted use. The account supplies following information to the manager due to which protection of business wealth is possible:

a. the amount of proprietor’s funds invested in the business.

b. How much amount is payable to outside parties?

c. How much the business has to recover from others?

d. Position of business in the form of financial status.
(3) To ascertain the operational profit or loss: accounting helps in ascertaining the net profit earned or loss suffered on account of carrying the business. This is done by keeping a proper record of revenues and expense of particular period. The profit and loss account is prepared at the end of a period beneath the amount of revenue for the period is more than the expenditure incurred in the same time the said amount is known as profit and vice versa. The profit and loss account will help the management, investors, creditors etc. in knowing whether the business has proved to be reasonable in context of remuneration or not. In case, it has not proved to be remunerative or profitable, the cause of such a state of affairs will be investigated and necessary remedial steps will be taken.

(4) To ascertain the financial position of the business: as mentioned above, the profit and loss account gives the amount of profit or loss made by the business during a particular period, however it is not enough. In addition to this, the businessmen must know about his financial position i.e. where he stands, what he owes and what he owns. This objective is served by the balance sheet or position statement of assets and liabilities of the business on a particular date. Thus, where P&L account shows profit or loss of the business, at the same time balance sheet shows financial status of the business. In short, when we talk about financial statements, both profit/loss and financial position are reflected from such statements.

(5) To take the decisions: as mentioned above, accounting not only classifies and summarises the transactions, it also helps in interpreting the situation so that the businessmen can take decisions for future. Of course, it is not an easy task in any manner.

(6) Information system: accounting functions as an information system for collecting and communicating economic information about the business enterprise. This information helps the management in taking appropriate decisions.

1.5 Accounting information: Uses and Users
As discussed in the meaning of accounting, the basic objective of accounting is to provide information which is useful for persons inside the organisation and outside the organization. That is why the users of accounting information are divided into

two parts i.e. external users of accounting information and internal users of accounting information. However it is very broad term to use and that is why these both are subdivided as follows:-

(I) External users of accounting information: - external users are those persons or group of persons who are outside the organisation, in other words they are not in the management team nor in the group of employees, they are as follows:-

a. Investors, the person or group of persons who are either interested or have already invested money in the organisation. As they have invested money, it is very obvious that they are interested in knowing the financial situation of the business, for this purpose, they will refer the books of accounts and will take a decision to invest more money or disinvestment.

b. Suppliers/creditors, the supplier of goods or services on credit will definitely want to know the financial position of the business concern before giving loans or lending the money. They want to be sure that the business will not face any other difficulties in repaying the money. In other words, they will definitely like to know the liquidity of the business. The liquidity is represented by current assets, quick assets and current liabilities which are available in the financial statements.

c. Government, state or central Governments are interested parties in knowing the books of accounts with the special context of taxation. The government also needs accounting information through which they will compile the statistics of industry or service sector of the country which will helpful in identifying occurrence of growth, GDP, national income and many more. Sometimes government also lends money on the basis of performance of past few years which is reflected from books of accounts.

d. Customer, is the person or group of persons on which business is dependent. Some of the customers, do compare prices and quality of the products or services before purchasing them, for such comparison, it is a must that proper cost of production is calculated so that best equality can be given at a reasonable price.

(II) Internal Users of Accounting Information: - Unlike the external users, Internal users are the ones who are within the organization. They are part and parcel of the management team who takes decisions and who is responsible for performance of the business, they are as follows

---

a. Owners, is the person or group of persons who initiate the business idea and execute it with proper planning as well as funding. Though, owners and business are two different is entities, yet they cannot be separated from each other. The owners need accounting information to know the profitability and financial position of the business. They have to revise these accounts at frequent intervals so that they can review the past performance and can take the decisions for the future.

b. Employees, they are interested in financial position of the concern as they devote their mental and physical hard work for the development and growth of the business. They are also aware that increments or bonus depends upon the amount of profit on by the organization.

1.6 Accounting concepts and principles

There are numbers of accounting concepts and principles based on which we prepare our accounts. Accounting concept are accepted assumptions and guidelines. The basic accounting concepts and principles are:

(1) Entity
In accounting the business is a separate entity different from its owner. For example if Mr. X incorporates a company known as X enterprises; in this case Mr X is a different person from X enterprises. Each of them can be sued separately and they can even sue themselves. Another example is that if the owner has personal incomes and expenses, it should not be treated as the incomes and expenses of the business. The personal property of the owners should not be included in the premises account of the business.

(2) Monetary Unit
This means that all the transactions of the business should be recorded in terms of money. This concept provides a common unit of measurement. If all items are stated in monetary terms, the disadvantages are that the value of money may not remain stable especially in the period of inflation. This concept does not record whether or not the company has a good management team because it cannot be measured in monetary terms. Accounting also cannot measure the moral of employee and strength of the competition in monetary terms. In summary, this concept says that accounting

---

9 Principles and Practice of Accountancy, Bharat Publications, 2010-11
does not provide all information about the firm but it only provides the economic information that can be expressed in monetary terms.

(3) Periodicity
This means that accounting information should be prepared periodically or at stated intervals for example monthly, quarterly, half yearly and yearly. The reason why it is necessary to prepare accounting periodically is that, accounting information or results of an enterprise are required quite often by the users such as government, investors, management, employees. The period of results varies from company to company. It is the desire of the investors that the information is timely and reliable.

(4) Historical Cost\(^\text{10}\)
One of the most difficult problems in accounting is the determination of the amounts to be recorded and reported for various assets and liabilities. Accountants, businessmen, tax authorities and other accounting professionals and users have found out that cost is generally the value most useful as a basis for accounting records. Assets and liabilities are accounted for on a basis of cost. In other words assets should be shown on the balance sheet at the cost of purchase instead of current value. By using cost as a basis for record keeping, accountants can provide objective and verifiable data in their reports.

(5) Prudence/conservatism
This concept demands exercising great care in the recognition of profit whilst all known losses are adequately provided for. The concept of prudence says that, accountants should take the figures which understate rather than overstate profit. The accountants should take the figures which will cause the capital of the firm to be shown at a lower amount rather than higher amount. The accountants should also select a figure which will result to a lower value of assets rather than a higher value. In summary this concept means “Anticipate no profit but provide for all possible losses.” For example Stock valuation is on the basis of lower of cost and net realizable value. The provision for doubtful debts should be made. Fixed assets must be depreciated over their useful economic lives.

(6) Materiality

\(^{10}\) Anthony, R. N. and J. S Reece : Accounting Principles (6th Ed.) p. 26
Materiality depends on the size and nature of an item. Accounting statements should concern themselves with matters which are significant because of the size and should not consider trivial matters. What is material in a small business could be different from what is material in a large organization. For example a bottle of ink is bought and used for more than one year, it may be termed as fixed asset but the price of the ink is too small that it is not worth recording it as a fixed asset. If it is not a material item then it should be charged as an expense in the period it is bought even if it lasts for more than one accounting period.

Another good example is that, the cost of staple machine, pencil sharpener and paper clips should be charged as expenses in the profit and loss account even though it lasts for more than one accounting year. The size and type of the firm also determines which items are materials. For example a firm having a great deal of machinery may treat all items of machinery costing less than Rs.1000 as not material whereas another firm which makes about the same profit but has very little machinery may treat Rs.1000 machinery as a material item. In other words, whether the amount is significant or not will differ from firm to firm.

(7) Objective
This means that accounting information should be presented in a verifiable manner. There must be availability and adequate evidence supporting the validity of the accounting data. If accounting information is objective, it also means that if two people look through an accounting report they should be able to come to the same conclusion and accounting information should be free from bias.

For example if there is sales contract, there must be verifiable evidence like invoice or contact papers. Another example is that the recognition of revenue should be based on verifiable evidence like delivery of goods or issue of invoices. The principle of objectivity also helps the accounting users of accounting information/data to minimize time of information scrutiny.

(8) Consistency
This principle says that there should be consistency in accounting policies used in the preparation of the accounts. Companies should choose the most suitable accounting methods and treatment and then consistently apply them in every period. There are different methods of treating depreciation and stock valuation. For example if a
company adopts the reducing balance method, the company should not change to straight line method in other period. Another example is that, if a company adopts first-in-first-out method as stock valuation method the company should not change to weighted average method in other period. Although changes can also be made but with a very good reason for instance when the new method is considered better than the old method and can also reflect the true and fair view of company’s financial position. When there is a change, the change and its effect should be disclosed in the financial statements as well.

(9) Accrual or Matching

This concept means that for any accounting period, the revenue and all the costs incurred that generate the revenue must be matched and reported for the periods. And if revenue is carried over from a period or deferred to future period, all elements of costs and expenses relating to that revenue should also be carried over or deferred.

In summary revenue are recognized when they are earned but not until cash is received. Expenses are also recognized as they are incurred, but not until when cash is paid. net income for the period is determined by subtracting expenses incurred from revenues earned.

(10) Revenue Realization

The revenue realization principle provides the answer to when revenue should be recognized. Revenue is realized when the earning process is virtually complete, when an exchange transaction has occurred and when the buyer has admitted his liability to pay for goods or services provided and the ultimate collection is very certain. For example sales are recognized when the goods are sold and delivered to the customers or services are rendered and the customer agreed to the terms on the invoice. The principle also provides that revenues are recognized when it is earned and not when money is received.

(11) Uniformity

In summary uniformity principle means that if there are different companies in the same industry they should adopt the same accounting methods and treatments for similar transactions. The practice helps in the aspect of inter-company comparisons of their financial positions.
(12) Full disclosure
This principle means that financial statements should be prepared to show a true and fair view of the financial position and the performance of the business organization. All materials and relevant information must be disclosed in the financial statements.

(13) Relevance
The financial statements should be prepared in such a way that it will meet the requirements and objectives of the users of financial accounting. The relevant information that will satisfy the needs of most users should be recorded in the financial statements.

1.7 Financial statements: A methodical financial reporting

In the words of Anthony and Reece,

“The balance sheet may be described as a statement which reports the financial condition of an entity as of one moment of time. The income statement summarises the result of operation for a period of time. It is therefore a flow report, in contrast with the balance sheet which is status report.”

Every business enterprise maintains day-to-day monetary transactions in its books of accounts and at the end of the year; based on this information, a firm prepares financial statements. It mainly includes two statements – profit and loss account and balance sheet. In addition to these two, other certain annexures are also attached to understand these financial statements in detail.

Financial statements are prepared and presented annually and it is also a part of the process of financial reporting. The whole set of financial statements are balance sheet, income statement, cash flow statement and notes and explanatory materials to the account.

Financial statements are mainly prepared and presented for the external users. In some cases, financial statements may look similar but still there are differences which may be caused by external factors which are economical, legal, and economic situations.

Profit and loss A/c is also known as Income statement, which shows the result of operating activity of the business during a particular period e.g. one year. Profit and
loss account shows either profit or loss due to change in the business during accounting year.

Balance sheet is another part of financial statement which shows the financial position of the firm on a particular day e.g. at the end of the year. Financial position means what a firm owes and what it owns, i.e. liabilities and assets. Balance sheet is prepared systematically in proper sequence for increasing understanding of financial statement for its readers and from it, users can easily analyse soundness of the firm.

From the definitions given by experts, we can conclude following characteristics of Financial Statements:  

1. Two statements: Financial statement mainly contains two statements. First, the Balance sheet showing financial position on a particular day and the second is the income statement, which is also known as Profit and Loss account which shows result of operating activity during a period. Certain annexure are also attached to understand these financial statements in detail.

2. According to Legal provision: Business must follow the laws in which it is registered, and specially for the preparation and presentation of financial statements e.g. companies registered under Companies Act are supposed to prepare financial statements in the prescribed format according to Companies Act, 1956.

3. Accounting Principles and Concepts: Financial statements are prepared in accordance with generally accepted accounting principles and accounting standards e.g. stock is valued at cost or market price whichever is less.

4. Personal Judgments Opinions to Operations: Financial statements are prepared in accordance with accounting principles and standards, but account writers and the management’s personal opinions have its own impact on these statements e.g. method of valuation of stock by FIFO, LIFO, method or providing depreciation on assets etc.

5. Various Objectives: The financial statements are multipurpose statements, which are used for many objectives e.g. for making provisions for income tax, for the purpose of managerial remuneration etc.

---

(6) Historical Cost: Financial Statements can be expressed in monetary terms only and they are compressed with business transactions which are recorded in books of accounts e.g. Assets are recorded at its cost price irrespective of high or low market price.
Preparation of Financial Statements is the need of the hour with following list of objectives:

(1) Information: Financial statements provide information about performance, progress and position to all concerned parties / stake holders.

(2) Increase Credibility: Published financial statements are relied upon by the public at large and it increases the credibility of the company.

(3) Reputation: Up to certain level, financial statements increase the reputation of the firm because they are properly prepared and presented.

(4) Confidence: Shareholders can increase their level of confidence in the company by getting more information about the company from financial statements.

(5) Safety of Investments: Money lenders and creditors get more useful information from financial statements related to the safety of their investments. They can take decisions regarding investment in the company very easily with the help of financial statements.

(6) Useful for framing policies: Financial statements are useful in framing different policies related to finance. They are also used by management as a tool for budgetary control.

(7) Analysis: Financial statements can be analysed between two years as well as between two firms. The stake holders have interest to know profitability; liquidity etc. of the company and it can be done only by proper analysis of financial statements.

Every coin has two sides, Financial Statements too have a negative side which can be narrowed down as:

(1) Ignorance of market Value of Assets: Fixed assets are shown in balance sheet at their book value i.e. cost less depreciation, which may not match with the market values. Also, balance sheet cannot show usefulness or efficiency of the assets. It may happen that, in the time of inflation, the market value of assets is high as compared to book value. Then also book values of assets are recorded in the financial statements.
(2) Individual’s efficiency cannot be judged: Individual’s efficiency cannot be judged, because it is not directly presented in such statements, but it is an important factor affecting profitability of business. Profit and loss accounts depict this factor.

(3) Less accurate: Sometimes it may happen that information disclosed in financial statements is incomplete and to that extent it is less accurate.

(4) Ignorance of Human Resources: There is an ignorance & absence of human resources in the financial statements, which are the main contributor in the progress, profitability and productivity of the business.

(5) External factors: Financial statements may not present true or proper financial position because it may be affected by many external factors like policies of competitors, political factors, general economic conditions etc. Impact of all these factors may be influencing financial statements and it may change the value of financial statements. But due to ignorance of these external factors, financial statements may not reflect a real picture.

(6) Static: Financial Statements are prepared on a certain date. Due to this, most of the companies prepare balance sheet in such a way that it will show rosy picture of the firm. A change during two balance sheets is not reflected in balance sheet. e.g. a director had taken loan from company before the balance sheet date and he had paid all the outstanding amount back to the company. So, this transaction is not recorded in balance sheet.

(7) Only viewpoint of Shareholders and Management: Financial statements are prepared from the viewpoint of shareholders and management. Viewpoint of all the stake-holders associated with the concern are not considered, so interest of other stakeholders are neglected.

Financial statement Analysis aims at comparing different information and figures to find out liquidity, profitability and solvency of business enterprise. Stakeholders have their own objectives in the company, like creditors are interested to know the liquidity; investors are in profitability and debenture holders are in solvency of the company. Such information is required in the form of percentage, ratio, proportion or rate of turnover for the analysis of financial statements.
Financial statements are analysed with various objects by various users of financial statements e.g. 1) Management of the company wants to measure its efficiency in terms of earning capacity. 2) Trade unions or employees analysed the financial statements for possibility of better salaries and operating efficiency. 3) Potential investor wants to know the safety of money and regular return on his investments. 4) Equity shareholders are interested to find out safety of their investments, dividend earning capacity of the company etc.

Following is a list of users of financial statements:

1. Management: the management needs financial statements for assets control, to determine the efficiency of management policy and to definitely know the proportion of cost incurred to revenue. The information needed from the financial statements are records concerning assets, records of cost revenue and the level of profitability.

2. Shareholders and investment Analysts: the shareholders and investment analysts need the financial statement to make appropriate investment decisions for example buying and selling of shares. The information needed from the financial statements are: profitability level and share value.

3. Lenders including Banks: the lenders and Banks need the financial statement to make decision whether more facility can be granted or not. The information needed form the financial statements are: Liquidity level, interest coverage and the ratio of debt to equity.

4. Employees: the financial statements help the employees to decide whether more facility can be granted or not. The information needed form the financial statements are: Liquidity level and profitability level.

5. The Tax Authority: the financial statements help the tax authority to determine the amount of tax payable by the company. The information needed form the financial statements are details of revenue and expenses.

6. Auditors: the auditors need the financial statements of the organization for general audit purpose and to give an opinion concerning the company’s state of affairs. The information needed form the financial statements are: Liquidity level and profitability level.
7. Government: the government of a country needs the financial statements to formulate fiscal policies. The information needed form the financial statements are: details of revenue and expenditure and the details of assets and liabilities. The other users include: the Stock Exchanges, the Trade Associations, the Financial Reporters and Analysts.

The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions. Financial statements also give a well view of the stewardship and accountability of management. This also help the users to make economic decision may be to hold or sell their investment and may be to change the management. Financial statement is also prepared to meet the common needs of the users.

Financial statements are a structured representation of the financial position and financial performance of an entity. The objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. Financial statements also show the results of the management's stewardship of the resources entrusted to it.

To meet this objective, financial statements provide information about an entity's: (a) assets; (b) liabilities; (c) equity; (d) income and expenses, including gains and losses; (e) contributions by and distributions to owners in their capacity as owners; and (f) cash flows. This information, along with other information in the notes, assists users of financial statements in predicting the entity's future cash flows and, in particular, their timing and certainty.

There are four main qualitative characteristics of an ideal financial statements which are: Understandability, relevance, reliability and comparability.

1. Understandability: A good quality of the information in the financial statement is that the users must be able to understand it. It is also important that users of financial statement should have a good and proper knowledge concerning the business,
accounting and economic activities of the business enterprise. The users of financial statements should also be ready to read it voluntarily.

2. Relevance: The information on the financial statement must be useful or relevant to the users for decision making (economic decision). Materiality is mentioned as an aspect of relevance. Information is said to be material if its omission or misstatement could affect the user’s economic decision on financial statements.

3. Reliability: The information on the financial statement must be reliable so that users can depend on it. For financial statement to be reliable, it means the information must not have error and must not be biased. It is also said that, information may be relevant but not reliable. If the information on the financial statement is not reliable, it will always mislead the users in making economic decision. Faithful representation, substance over form, neutrality (freedom from bias), prudence (subject to neutrality), and completeness is mentioned as aspect of reliability.

4. Comparability: The financial statement must possess the attribute which will help the users to compare it in order to pinpoint the movement of the financial position and performance. The financial statement must show the corresponding information for the periods. For example the financial statement showing the Balance sheet for 2009, 2010 and 2012 for easy comparison.
1.8 Accounting Standards

The basic objective of any business unit is to maximise profit followed by maximization of wealth. The performance of the business is measured on the basis of its efficiency which is derived out of profitability of the business. Well maintained accounts and financial statements are basic foundation of reflecting the profitability of the business. Various business enterprises present their accounts in their own way, while presenting such accounts, asserting owing to would arise for which the opinions of accountants will differ that is the depreciation methods, one company may adopt straight-line method and the other company may adopt to reducing balance method. Another example, for valuation of stock one company may adopt FIFO whereas another company may adopt LIFO method. Now this kind of differences in opinion will bring professional presentation of accounts which will lead to chaos and confusion among stakeholders.

In the words of T. P. Ghosh, “Accounting standards are the policy documents issued by the recognised expert accountancy body relating to various aspects of measurement, treatment and disclosure of accounting transactions and events.”

The financial results of different companies cannot be compared and evaluated unless full information is available about the accounting methods which have been used. The lack of uniformity among accounting practices have made it difficult to compare the financial results of different companies. It means that there should not be too much discretion to companies and their accountants to present financial information the way they like. In other words, the information contained in financial statements should conform to carefully considered standards. Obviously, accounting standards are needed to:

a) provide a basic framework for preparing financial statements to be uniformly followed by all business enterprises,

b) make the financial statements of one firm comparable with the other firm and the financial statements of one period with the financial statements of another period of the same firm,

c) make the financial statements credible and reliable, and

---

13 Accounting Standards., D S Rawat, Taxmann, June, 2004
d) create general sense of confidence among the outside users of financial statements.

In this context unless there are reasonably appropriate standards, neither the purpose of the individual investor nor that of the nation as a whole can be served. In order to harmonize accounting policies and to evolve standards the need in the USA was felt with the establishment of Securities and Exchange Commission (SEC) in 1933. In 1957, a research oriented organisation called Accounting Principles Boards (APB) was formed to spell out the fundamental accounting principles. After this the Financial Accounting Standards Board (FASB) was formed in 1973, in USA. At the international level, the need for standardization was felt and therefore, an International Congress of accountants was organized in Sydney, Australia in 1972 to ensure the desired level of uniformity in accounting practices. Keeping this in view, International Accounting Standards Committee (IASC) was formed and was entrusted with the responsibility of formulating international standards.

Above all revolutions took place at Global level, whereas in order to harmonise varying accounting policies and practices in India, the Institute of Chartered Accountants of India (ICAI) formed the Accounting Standards Board (ASB) in April, 1977, though, basic structure of the board was same as IASC. ASB includes representatives from industry and government. The main function of the ASB is to formulate ac-counting standards. This Board of the Institute of Chartered Accountants of India has so far formulated Accounting Standards, which are known as Indian Accounting Standards (IAS). Regarding the position of Accounting standards in India, it has been stated that the standards have been developed without first establishing the essential theoretical framework. As a result, accounting standards lack direction and coherence. This type of limitation also existed in UK and USA but it was remedied long back.

As prescribed by Sanjiv Agarwal, “accounting standards are nothing but the written documents, a policy document issued by government or other regulatory body or expert institute covering various aspects of recognition, measurement, treatment, presentation and disclosure of accounting transactions in the financial statements.”, the main function of ASB is to identify the areas in which uniformity in standards is acquired and develop draft standards after wide discussion with representatives of the government, public sector undertakings, industry and other organisations.

ASB gives due consideration to the International accounting standards as India is a
member of International account setting body. The border submits the draft of standards to the Council of ICAI, which finalises them and notifies them in the presentation of financial statements. The board also makes up periodic over view of the accounting standards.

Accounting standards are written statements of uniform accounting rules and guidelines or practices for preparing the uniform and consistent financial statements and for the other disclosures affecting the users of accounting information. However, the accounting standards cannot override the provision of applicable laws, consumers, usages and business environment in the country. The Institute tries to persuade the accounting profession for adopting the accounting standards so that uniformity can be achieved in the presentation of financial statements. In the initial years, the standards are recommendatory in nature. Once awareness is created about the requirements of a standard, steps are taken to enforce its compliance by making them mandatory for all the companies to comply with. In case of non-compliance, the companies are required to disclose the reasons for the deviations and financial effect, if any, arising due to such deviation.

Accounting standard is formed with four parts which are:

1. First part deals with the subject matter of the standards in the mode of implementation of the standards.

2. The second part contains introduction which deals with the need of the standards on the subject matter, what are the current practices of accounting in respect of the subject of standards and discuss the diversities and limitations of the current practices.

3. The third part gives definitions of the terms used in the standard and explains background of the standard with a detailed explanation on information contained in main part of the recommended standards.

4. The fourth part contains main text of the standards and recommendations to follow the same.

Following are some important objectives that are served by accounting standards:
To standardise accounting methods and procedures.

(2) To lay down principles for preparation and presentation.

(3) To establish benchmark for evaluating the quality of financial statements prepared by the enterprise.

(4) To ensure the users of financial statements get creditable financial information.

(5) To develop uniformity in preparing financial statements as well as final accounts of business enterprise so that the stakeholders can take various decisions on the basis of true and fair picture of accounts.

‘Accounting Standards’ is the need of the hour. The accounting standards are originally formed for bringing uniformity in the presentation of accounting standards to the stakeholders. As the accounts are prepared on the basis of common policies, they become compatible for the third-party. It also helps for improvisation in performance for the weaker forms of the industry by comparing their performance with others. It is also to be noted that, many accounting experts, accountants, etc. have different opinions for handling certain issues which has been narrowed down with the help of common accounting standards which are applicable for all. In addition to this, the readers know which items presented in accounts differ from generally accepted accounting principles. The standards provide guidance given to government in making new rules and laws. Further, the need and importance of accounting standards can be described in detail as follows:

(1) There are many users of financial statements namely profit and loss account and balance sheet. These stakeholders include shareholders, prospective shareholders, creditors, customers, employees etc. who use them for their own purposes. Thus, it is important that the statements must be prepared in such a way that is all parties can rely on them and can understand them is systematic manner. Hence, the accounting standards make it possible for users to get their reliable accounting data and can protect their interest.

(2) The primary task of auditors is to detect malpractices, fraud, cheating, technical error etc. if they fail to do so, they will be held responsible and will help to compensate their clients. To avoid this situation, it is must for auditors that they are well aware of accounting standards and with help of them they can evaluate the books of accounting of the particular firm. Thus, accounting
standards help auditors in their professional work by maintaining their goodwill and prestige amongst their clients.

(3) If there are no accounting standards, there would be subjective style of preparation and presentation of accounts which will make confusion among stakeholders, though chartered accountants who to follow certain principles which are directed by the Institute. But if other common accountants will not follow the rules, it will defame the accounting profession as a whole. In this kind of situation, accounting standards will help accountants to maintain uniformity in preparing financial statements which will reflect true and fair picture of each and every firm.

(4) The efficiency of the business is measured on the basis of its profitability which is derived from the books of accounts only. The accounts present different parameters to measure profitability like progress, wealth, solvency, liquidity etc. which will ultimately reflect efficiency of the business management. If accounts are prepared on the basis of accounting standards, the stakeholders will get proper idea about efficiency of the business which will be totally reliable and dependable. In addition to this, if all the forms of the same industry have prepared accounts by taking a common base, it will be easy for third parties to compare the performance of two different business units.

(5) In addition to above, following also are soon less of accounting standards in day to day business life:-

   a. In two or more institutes and uniformity is brought in preparing accounts and financial statements.
   b. In two or more institutions of the reason of accounts and financial statements, accounting standards are useful.
   c. Accounts become objective and reliable by following accounting standards.
   d. Comparison of different years as also of different institutes becomes possible because of accounting standards.
   e. Accounting standards provide useful information to the government in preparing law relating to accounting matters.
f. Accounting standards also become useful to auditors. If the accounts are not maintained following accounting standards, auditors can resort to detailed analysis and can find accounting frauds.

g. Accounting standards are also useful to the accountant in the accounting work. If you follow accounting standards, personal opinions or prejudice does not creep in accounts.

Scope of Uniformity in the context of accounting standards can be explained as under:

(1) One of the pioneer requirements of accounting standards is the standard must be compatible to other laws, rules and regulations and business environments of our country. In other words, the efforts are to be made to issue accounting standards which are in conformity with such generally accepted principles. Over a period of time, if a particular accounting standard is not found to be in conformity with such a low and provisions than necessary amendments should be prepared so that the standard must be in conformity with such low.

(2) It is very important to note down that the accounting standards should not overpower the local regulations in special context of preparation and presentation of financial statements. However, it is the privilege of the Institute to decide the level of disclosure to be made in financial statements and auditor’s reports. Such disclosures can be carried forward by just putting notes explaining the treatment of particular item.

(3) The accounting standards are intended apply only to the items which are material. Any limitations with regard to the applicability of standard will be made clear by the ICAI from time to time. It will be also issued by the ICAI that with standard will come into effect from which date and to which enterprises it will be applicable.

(4) The ICAI will put their best efforts to appeal government, appropriate authorities, industrial and business community to adopt the standards in the described form in order to achieve uniformity in the presentation of financial statements.

(5) The basic task of formulation of accounting standards, the intention is to create concrete basic foundation for preparation of financial statements but it should be done in easy and practically applicable standards must be followed.
In other words, not to make them so much complex that it cannot be applied effectively and it must be on nationwide basis.

1.9 **Indian Accounting Standards**

The paradigm shift in the economic environment in India during last few years has led to increasing attention being devoted to accounting standards as a means towards ensuring content and transparent financial reporting by corporate. In addition to this, inter-country transactions have given a huge rise in the amount of capital generated considerable interest in the generally accepted accounting principles in advanced countries such as USA. The Institute of chartered accountants of India, being the premier accounting body in the country, took upon itself the leadership role by establishing Accounting Standards Board more than 25 years ago, to fall in line with the international and national expectations. Today, accounting standards in India have come a long way.

As per the need of the time, International harmonisation of accounting standards, in 1973, the International accounting standards committee (IASC) was established. It may be mentioned here that the IASC included promotion of International accounting standards for worldwide acceptance and observance so that the accounting standards in different countries are harmonised. In recent years, the need for International harmonisation of accounting standards followed in different countries has grown considerably as cross-border transactions of capital are becoming increasingly common.

Accounting standards are formulated with a view to harmonize different accounting policies and practices in use in a country. The objective of accounting standards is, therefore, to reduce the accounting alternatives in the preparation of financial statements within the bounds of rationality, thereby ensuring compatibility of financial statements of different enterprises which are viewed to provide meaningful information to various users of financial statements to enable them to make informed economic decisions. The Institute of chartered accountants of India being a member body of the IASC, constituted the accounting standards board on 21st of April 1977, with a view to harmonies that diverse accounting policies and practices in use in using India. After the adoption of liberalisation and globalisation, Indian economic policies in early 90s and growing concern about the need of effective corporate governance.
While formulating accounting standards, ASB takes into consideration the applicable laws, customs, usages and business environment prevailing in the country. The ASB also gives due consideration to International accounting standards issued by IASB and tries to integrate them, to the extent possible, in the light of conditions and practices prevailing in India.

The accounting standards setting, by its very nature involves reaching an optimal balance of the requirements of the financial information for various stakeholders. With a view to reach consensus, to the extent possible, considerable research consultations discussions with the representatives of different groups etc. becomes necessary at different stages of formulation of accounting standard. The standard setting process of the board, as briefly outlined below, is designed in such a way so as to ensure such consultation and discussions:

(1) identification of the broad areas by the ASB for formulating the accounting standard.
(2) Constitution of the study groups by the ASB for preparing the preliminary drafts of the proposed the accounting standards.
(3) Primary draft prepared by the study group of ASB and revision if any, of the draft on the basis of discussions at the ASB.
(4) Circulation of the draft among the Council members of ICA I and 12 specified outside bodies such as, standing conference of public enterprises, Indian Banks Association, Confederation of Indian industry, securities and exchange board of India, comptroller and auditor general of India and Department of Company affairs, four comments.
(5) Meeting with the representatives of specified outside bodies to the ascertain their views on the draft of the proposed the accounting standard.
(6) Finalisation of the draft of the proposed accounting standard on the basis of comments received and discussion with the representatives of specified outside bodies.
(7) Declaring the draft inviting public comments.
(8) Consideration of the comments received on the exposure draft and finalisation of the draft accounting standard by the ASB for submission to the Council of the ICA I for its consideration and approval for issuance.
(9) Consideration of the draft accounting standards by the Council of the Institute, and if necessary, modification of the draft in consultation with the ASB.

(10) The accounting standard, so finalised, is issued under the authority of the Council.

Status of the Accounting Standards issued by the ICAI\textsuperscript{14}

<table>
<thead>
<tr>
<th>Number</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>AS 1</td>
<td>Disclosure of accounting policies</td>
</tr>
<tr>
<td>AS 2</td>
<td>Valuation of inventories</td>
</tr>
<tr>
<td>AS 3</td>
<td>Cash flow statement</td>
</tr>
<tr>
<td>AS 4</td>
<td>Contingencies and events occurring after the balance sheet date</td>
</tr>
<tr>
<td>AS 5</td>
<td>Net profit or loss of the period, prior period items and changes in accounting policies.</td>
</tr>
<tr>
<td>AS 6</td>
<td>Depreciation accounting</td>
</tr>
<tr>
<td>AS 7</td>
<td>Accounting for construction contracts</td>
</tr>
<tr>
<td>AS 8</td>
<td>Withdrawn and included in AS-26</td>
</tr>
<tr>
<td>AS 9</td>
<td>Revenue recognition</td>
</tr>
<tr>
<td>AS 10</td>
<td>Accounting for fixed assets</td>
</tr>
<tr>
<td>AS 11</td>
<td>The effects of changes in foreign exchange rates</td>
</tr>
<tr>
<td>AS 12</td>
<td>Accounting for government grants</td>
</tr>
<tr>
<td>AS 13</td>
<td>Accounting for investments</td>
</tr>
<tr>
<td>AS 14</td>
<td>Accounting for amalgamations</td>
</tr>
<tr>
<td>AS 15</td>
<td>Accounting for retirement benefits in financial statements of employers</td>
</tr>
<tr>
<td>AS 16</td>
<td>Borrowing costs</td>
</tr>
<tr>
<td>AS 17</td>
<td>Segment reporting</td>
</tr>
<tr>
<td>AS 18</td>
<td>Related party disclosures</td>
</tr>
<tr>
<td>AS 19</td>
<td>Leases</td>
</tr>
<tr>
<td>AS 20</td>
<td>Earnings per share</td>
</tr>
<tr>
<td>AS 21</td>
<td>Consolidated financial statement</td>
</tr>
<tr>
<td>AS 22</td>
<td>Accounting for taxes on income</td>
</tr>
<tr>
<td>AS 23</td>
<td>Accounting for investment in associates in Consolidated financial</td>
</tr>
</tbody>
</table>

\textsuperscript{14} Accounting Standards., D S Rawat, Taxmann, June, 2004
<table>
<thead>
<tr>
<th>Statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>AS 24</td>
</tr>
<tr>
<td>Discontinuing operations</td>
</tr>
<tr>
<td>AS 25</td>
</tr>
<tr>
<td>Interim financial reporting</td>
</tr>
<tr>
<td>AS 26</td>
</tr>
<tr>
<td>Intangible assets</td>
</tr>
<tr>
<td>AS 27</td>
</tr>
<tr>
<td>Financial reporting of interesting joint-venture</td>
</tr>
<tr>
<td>AS 28</td>
</tr>
<tr>
<td>Impairment of assets</td>
</tr>
<tr>
<td>AS 29</td>
</tr>
<tr>
<td>Provisions, contingent liabilities and contingent assets</td>
</tr>
</tbody>
</table>

1.10 References:

• Jelsy Josheph Kupappally, (2010). Accounting For Managers, PHI, delhi,
• Paresh Shah, (2007). Basic Accounting For Managers, Oxford, Delhi,
• Ambrish Gupta, (2004). Financial Accounting For Management, Pearson, Delhi,
• Narayanaswamy R, (2011). Financial Accounting , PHI, Delhi,