## CHAPTER-2

### FOCUS ON ACCOUNTING CONCEPTS

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2.1 Evolution of Accounting

Double entry system of accounting as understood today is believed to have originated in the last quarter of the 13th century and evidence leads to its use in Florence at that point of time. The oldest surviving records include those of Rinerio and Baldo Fini between 1296 A.D and 1305 A.D and the branch ledger of Giovanni Forolfi for the years 1299A.D and 1300 A.D. The first record of complete double entry system is the Massari (treasurers) accounts of the city of Genoa in 1340.

Luca Paciolo, a Franciscan friar’s book Summa de Arithemetica Geometria Proporroni et proportionalita Review of Arithmetic Geometry and Proportions published in 1494 is the first book on double entry book-keeping. But there are contentions that Benedetto Cotrugli was the first person to write on double-entry book-keeping in 1458 but his book was published only in 1573. Thus Luca Pacioli got the distinction of publishing for the first time a book on double-entry book-keeping.

The whole of Pacioli’s book is not on double-entry book-keeping discourse on double-entry book-keeping is contained in part-I, section 9, treatise 11 under the heading Partiularis de computis et scripturis (Particulars of Reckoning and their Readings). Pacioli did not invent double-entry. He has stated that his writings are based on the system prevalent in Venice 100 years before. For debit and credit Pacioli has used debito (owed to) and crediis (owed by) which in turn derived from Latin debo and credo. Debo means “owed to me the proprietor and credo means “trust” “believe” in the proprietor. Paciolo’s principle was that “All entries have to be double entry that is if you make one creditor you must make someone debtor”.


2.2 Definition of Accounting

The Committee on Terminology of the American Institute of Accountants in its Accounting Terminology Bulletin No.1 has defined “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 American Accounting Association in its A Statement of Basic Accounting Theory has defined Accounting is the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information.

The Accounting Principles Board (APB) of the AICPA in its statement No.4 ‘Basic Concepts of Accounting Principles Underlying Financial Statements of Business Enterprises’ 1970 have defined

“Accounting is a service activity. Its function is to provide information primarily financial in nature about economic entities that is intended to be useful in making economic decisions.”

Patton and Littleton has stated “The purpose of accounting is to furnish financial data concerning a business enterprise, compiled and presented to meet the needs of management, investors and the public”

Chamber has stated in his article Blue Print for a Theory of Accounting that “the basic function of Accounting is the provision of information to be used in making rational decisions”

Stanbus has stated that “a major objective of accounting is to provide quantitative economic information that will be useful in making investment decisions.”
The above statements reveal that accounting is activity oriented. They try to explain what accounting is, as an activity. Accounting is the recording of business transactions with an objective of measuring business performance and communicating the same to various interested parties. The other definitions lay stress on the objective of accounting. According to them accounting is concerned with making available useful information to meet the needs of management, investors and the public.

Accounting is considered to be an information system as well as a language of the business for communicating financial information to various stakeholders.

As information system accounting is concerned with communicating information about business entity to others. It involves the measurement, accumulation, classification, summarization, analysis and interpretation of business transactions of a business entity during a defined period of time. Thereafter it is transmitted to various users in order to enable them to study and base decisions on the conclusions reached by them.

R. J. Chambers has stated that when accounting is looked upon as a communication system it denotes

“The process of encoding observations in the language of the accounting system of manipulating the signs and statements of the systems and decoding and transmitting the result”.

Accounting is considered to be a language of the business by means of which business information is communicated to various outside parties. Just like any other medium of communication it should be thoroughly studied and understood.

Yuji Ijiri has stated “As the language of business, accounting has many things common with other languages. The various business activities of a
firm are reported in accounting statements using accounting language. Just news events are reported in newspapers, in the English language. To express an event in accounting or in English we must follow certain rules. Without following certain rules diligently, not only does one run the risk of being understood but also risks a penalty for misrepresentation, lying or perjury. Comparability of statements is essential to the effective functioning of a language whether it is in English or in Accounting. At the same time, language has to be flexible to adapt to a changing environment.

Anthony and Reece have described accounting as a language in the following terms. “Accounting resembles a language in that some of its rules are definite, whereas others are not. Accountants differ as how a given event should be reported, just as grammarians differ as too many matters of sentence structure, punctuation and choice of words. Nevertheless, just as many practices are poor English (language) many practices are definitely poor accounting. Language evolves and changes in response to the changing needs of society, and so does accounting”.

Thus accounting as a language of business helps to communicate financial information relating to business entities by the use of symbols and rules like any language. Just like language it undergoes various changes over a period of time and adjusts itself to changing needs of the users of the accounting information.

2.3 Accounting Concepts and Conventions

Accounting is the language through which the performance and financial status of an enterprise is communicated to the outside world. In order that the messages communicated through the accounting language is understood by the users, there should be certain common principles. Accountants all over the world agree on certain basic points on which

Accounting principles in other words are those rules of action or conduct which are adopted by the accountants universally while recording accounting transactions. They are a body of doctrines commonly associated with the theory and procedure of accounting, serving as an explanation of current practices and as a guide for selection of conventions or procedures where alternatives exist. Accounting principles are also known as accounting postulates or accounting assumptions.

M W E Glautier and B Underdown would like to use ‘accounting conventions’ for those principles on which accounting are based.

According to them “the term ‘accounting conventions’ serve in another sense to understand the freedom which accountants have enjoyed in determining their own rules”.

“We may classify accounting conventions into two broad groups-those which may be said to go to the very roots of financial accounting, which may call ‘fundamental conventions’ and those which bear directly on the quality of financial accounting information, which we shall describe as ‘procedural conventions’.

“In our view, there are only two fundamental conventions which may be said to characterize financial accounting.

(a) The entity convention which states that financial accounting information relates to the activities of a business entity only, and not to the activities of the owners.
(b) The money measurement convention which limits the recognition of activities to those which can be expressed in monetary terms.

The alteration of either of these two conventions would change the entire nature of financial accounting.

There are several procedural convention which though of great importance affect the manner in which financial accounting information is selected, analysed and communicated. Some of these conventions are subjected to criticism, for example, the realization convention which holds that a gain in value may only result from a transaction. The following conventions are generally regarded as the most important conventions in this group.

(a) The going concern convention
(b) The cost convention
(c) The realization convention
(d) The accrual convention
(e) The matching convention
(f) The convention of periodicity
(g) The convention of consistency
(h) The convention of conservatism.

Ahmed Raili Belkaoui preferred to classify the basic points of agreement in accounting into accounting postulates and accounting principles. He has given the following list of postulates and principles.
Accounting Postulates

1. Entity Postulate
2. Going Concern Postulate
3. Unit of Measure Postulate
4. Accounting Period Postulate.

Accounting Principles

1. Cost Principle
2. Revenue Principle
3. Matching Principle
4. Objectivity Principle
5. Consistency Principle
6. Full Disclosure Principle
7. Conservatism Principle
8. Materiality Principle

Robert N. Anthony and James S. Reoce, have described the basic accounting principles as ‘Accounting Concepts’ and has the following concepts.

Accounting Concepts

1. Money Measurement
2. Entity
3. Going Concern
Harry I Wolk, Michael G. Terney and James L.Dodd have given the following list of postulates and principles.

**Accounting Postulates**

1. Going Concern
2. Time Period
3. Accounting Entity
4. Monetary Unit

**Principles**

(Input Oriented Principles)

General Underlying Rules of Operation

1. Recognition
2. Matching

**Constraining Principles**

1. Conservatism
2. Disclosure
3. Materiality
4. Objectivity or Verifiability

Output–Oriented Principles

Applicable to users
1. Comparability

Applicable to Preparers
1. Consistency
2. Uniformity.

FASB, USA, Statement of Financial Accounting Concept No.6 has given the following classification of the basic principles of accounting.

(a) Assumptions of Accounting (b) Principles of Accounting
2. Continuity Assumption. 2. Revenue Principle
3. Unit of Measure Assumption 3. Matching Principle

Thus we see that there is little agreement amongst the various authorities in accounting regarding the definition and classification of accounting principles.

Postulates

Accounting postulates are those basic assumptions emerging from accounting environment and which does not require further proof. They are self–evident truths and do not require proof. They are non-verifiable.
Belkauoi defines accounting postulates “as self-evident statements or axioms, generally accepted by virtue of their conformity to the objectives of financial statements, that portray the economic, political, sociological and legal environment in which accounting must operate.”

AICPA (AICPA, The Basic Postulates of Accounting) has defined accounting postulates as

“Postulates are few in numbers and are the basic assumptions on which principles rest. They necessarily are derived from the economic and political environment and from the modes of thought and customs of all segments of the business community. The profession, however should make clear their understanding and interpretation of what they are, to provide a meaningful foundation for the formulation of principles and the development of rules or other guides for the application of principles in specific situations.”

**Concepts**

Accounting concepts are also basic assumptions or truths which are accepted by people without further proof. They are conceptual guidelines for application in the financial accounting process.

According to Glenn A. Wisch and Daniel G. Short (Fundamentals of Financial Accounting, Irwin 1987, p 144) the concepts are important because they

i) Help to explain the ‘why’ of the accounting

ii) Provide guidance to deal with new accounting problems

iii) There is no need to memorize accounting procedures.

**Principles**

According to AICPA (USA) principles means “a general law or rule adopted or professed as a guide to action, a settled ground or basis of conduct or practice”.

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Thus principles are general guidelines for action or conduct.

According to Robert N. Anthony and James S. Reece “Accounting principles are manmade. Unlike the principles of physics, chemistry and other natural sciences, accounting principles were not deducted from basic axioms, nor can they be verified by observation and experiment. Instead, they have evolved. Thus evolutionary process is going on constantly; accounting principles are not eternal truths.”

According to Harry I Wolk, Michael G. Tearney, James L. Dodd accounting principles can be classified into

i) Input oriented principles which guide the recording of business transactions. They are classified into underlying rules of operation and constructing principles.

ii) Output oriented principles are concerned with the preparation and presentation of financial statements.

Conventions

The term ‘convention’ includes those customs and traditions which guide the accountant while preparing the accounting statements. Conventions have their origin in the various accounting practices followed by the accountant. It is very difficult to trace the origin of the conventions and establish their authenticity as accounting principles. But by usage they have attained the status of accounting principles.

In this study the basic principles on which accounting is based are proposed to be classified into ‘Accounting Concepts ‘and’ Accounting Conventions’. All those basic assumptions or conditions upon which the science of accounting is based are grouped under accounting concepts. Those
customs or traditions which guide the accountant while preparing the accounting statements are included under the head accounting conventions.

**Accounting Concepts**
1. Separate Entity Concept
2. Going Concern Concept
3. Money Measurement Concept
4. Cost Concept
5. Dual Aspect Concept
6. Periodic Matching of Cost and Revenue Concept
7. Realization Concept

**Accounting Conventions**
1. Convention of Conservatism
2. Convention of Full Disclosure
3. Convention of Consistency
Figure - 2.1: The following chart depicts the above classification

**Accounting Principles**

Accounting Concepts | Accounting Conventions
---|---
Separate entity | Conservatisms
Going Concern | Materiality
Money measurement | Consistency
Cost | Full disclosure
Dual aspect
Accounting period
Periodic matching of cost and revenue
Realization
2.3 (a) Separate Entity Concept

In separate entity concept the business is treated as a separate entity from the owner even though statutes recognise no such distinct entity. In accounting the concept of separate entity is applicable in the case of all organisations. This concept is very much relevant in the case of sole proprietorship entities and partnerships. In the case of a company it is recognised as a separate entity by statutes as well as from the accounting point of view. The separate entity concept helps to keep the affairs of the business separate from that of the private affairs of the proprietor.

2.3 (b) Going Concern Concept

This concept assumes that the business will continue for a fairly long period of time in future. There is no need of forced sale of the assets of the entity. Otherwise every time the annual financial statements are prepared the probable losses on account of the possible sale of assets should be accounted. This would distort the operating result as revealed by the profit and loss account and the financial position depicted in the balance sheet. On the basis of this principle depreciation is charged on fixed assets on the basis of expected life rather than its market value and intangible assets are amortized over a period of time. The annual financial statements are considered to be interrelated series of statements.

2.3 (c) Money Measurement Concept

Money is the unit in which economic events affecting a business entity are measured. The money measurement concept implies that accounting could measure and report only those transactions and events which could be measured in terms of money. It cannot account for qualitative aspects like employee relations, competitive market, advantages of the entity over others etc. This concept imposes a restriction on the ability of the financial
statements to present a correct picture of the entity as those events which are unable to be quantified in money terms are left out. Further the money as a unit of measurement is not stable. The variation in the value of money fails to present a correct picture of the operating results and financial position of the entity. Over a period of time the value of money fluctuates and even when we are employing the same unit of money the values represented by them are not equal. Thus money as a unit of measurement fails.

2.3 (d) Cost Concept

The basis on which assets are recorded in the books of accounts is the cost- that is the price paid to acquire them. Cost will form the basis of which further accounting will be done as regards the asset. No adjustment is made in the cost to reflect the market value of the asset. The cost concept does not imply that asset will always appear at cost in the balance sheet. It only means that cost will be the basis for further accounting treatment. The cost of the asset may be reduced gradually by the process of charging depreciation.

Further the cost concept means that if nothing is paid for the acquisition of an asset it cannot be shown as an asset in the books of account. Cost concept brings objectivity in the preparation and presentation of financial statements. The assets appearing in the books should be based on objective evidence and not on the subjective view of the person who makes such statements or of some other person.

Paul Grady has observed the cost concept in the following words.

“Value as used in accounts signifies the amount at which an item is stated in accordance with the accounting principles related to that item. Using the word value in this sense, it may be said that balance sheet values generally represent cost to the accounting unit or some modifications thereof; but sometimes they are determined in other ways, as for instance on the basis
of market values or cost of replacement, in which cases the basis should be indicated in financial statements. The word value should seldom if ever, be used in accounting statement without a qualifying objective.”

2.3 (e) Dual Aspect Concept

The basic equation of accounting is

Assets = Equities

Or

Assets = Outsiders’ Equity + Owners’ Equity

Or

Assets = Liabilities + Capital

Every transaction affecting an entity has dual aspect on the accounting records. Both aspects are recorded in the books of accounts. Hence accounting is called ‘double entry system’. The two aspects are expressed as ‘debit’ and ‘credit’. In other words ‘for every debit there is an equivalent credit’.

The term ‘assets’ denotes the resources owned by a business while equities denote the claims of various parties against the assets. Equities are two types

i) Owners’ Equity and

ii) Outsiders’ Equity

Owners’ equity otherwise called ‘capital’ denotes the claims of the owners against the assets of the entity whereas outsiders’ equity denotes the claims of creditors, debenture holders, lenders etc against the assets of the entity.
The dual aspect of transaction may result in
i) Increase of an asset and decrease of another asset.
ii) Increase of an asset and increase of a liability
iii) Decrease of an asset and decrease of a liability
iv) Decrease of an asset and decrease of a liability
v) Increase of a liability and decrease of another liability.
vii) Increase in a liability and increase of an asset.
vi) Decrease in liability and increase in another liability
viii) Decrease in liability and decrease of an asset.

2.3 (f) Accounting Period Concept

As per the going concern concept, the life of a business is indefinite. The actual working result of the entity and its real financial position could be ascertained only after a very long period of time. This will be of not much help to various interested parties who have to take decisions considering the operating results and financial position of the entity. In order to overcome these practical difficulties the life of an entity is divided into segments known as accounting period. Usually accounting period is a period of one year.

The accounting period concepts facilitate the preparation of income statement and statement of financial position at the end of each accounting year and ascertain the operating results (profit/loss) and the financial position of the entity. Only the income and expenses pertaining to the accounting period alone is considered for preparing the income statement distinguishing between ‘capital’ and ‘revenue’. Since the statement of financial position reflects all the transactions till the date of its preparation, all items not considered in the preparation of income statement should be considered in its
preparation. The concept of annual financial reporting has arisen out of the accounting period concept.

2.3 (g) Periodic Matching of Cost and Revenue Concepts

The concept is based on the accounting period concept. The objective of maintaining accounts is to prepare the income statement to ascertain the profit/loss of the entity. In order to fulfill this objective the ‘revenues’ of the period for which income statement is prepared should be matched with costs. ‘Matching’ means the appropriate association of related ‘revenues’ and ‘costs’. Profit/loss could be ascertained only when the revenue earned during the period is compared with the expenditure incurred during the same period. Receipts and payments of cash is irrelevant. The right to receive revenue and liability to pay the expenses are the criteria. Actual receipt or payment may take place later on. On account of the periodic matching of costs and revenue concept, adjustment is made for all outstanding expenses, income accrued, prepaid expenses and unearned income at the time of preparing the financial accounts at the end of the accounting period.

2.3 (h) Realization Concept

According to the realization concept ‘revenue’ should be recognised only when the entity is legally entitled to receive payment. The AICPA has defined revenue as “Revenues results from the sale of goods and the rendering of services and is measured by the charge made to customers, clients or tenants of goods and services furnished to them. It also includes gains from the sale or exchange of assets other than stock in trade, interest and dividend earned on investments and other increase in owner’s equity except those arising from capital contribution and capital adjustment. Revenue is sometimes described as operating revenue.”
Thus revenue is an inflow of assets resulting from the sale of goods and rendering of services to the customers in the ordinary course of business. For the purpose of preparing the annual financial statements business entities have to recognise revenue. What is revenue recognition? It is the process of identifying the items of revenue receipts, which are to be considered for the matching of costs and revenues. When is revenue recognized? Under accrual system of accounting, revenue is recognized at the time of sale or rendering of services whether cash is received or not, provided that at the time of performance it is not unreasonable to expect ultimate collection.

The accounting conventions followed in the preparation of accounting statements are

2.3 (i) Conservatism

The rule of the accountant is ‘anticipate no profit but provide for all possible losses’ at the time of recording the business transactions and preparation of annual financial statements. The accountant wants to be on the safer side by not taking some profits which may be received but which is not yet received and providing for losses which he thinks may happen but which has not yet happened. This is because he thinks the chances of non-receipt of anticipated profit and the incurring of losses anticipated are higher. If he is very optimistic regarding receipt of profits and non-incurring of losses, the financial statements may present a very rosy picture of the state of affairs of the entity which may not subsequently materialize. So he acts conservatively by not taking anticipated profits and but taking anticipated losses in the preparation of the financial statements.

Because of the convention of conservatism inventory is valued at ‘lower of cost or market price and provision is made for bad and doubtful debts out of current year’s profits. But reckless application of this convention may lead
to creation of ‘secret reserves’ and the financial statements may fail to disclose a true and fair view of the state of affairs of the business.

2.3 (j) Materiality

The convention of materiality advocates that the accountant should give importance to transactions and events which are material in the preparation of accounts and presentation of financial statements. He should ignore those items in the recording of transactions and preparation of financial statements, items which are immaterial or not having much bearing in giving a true and fair view of the state of affairs of the entity. It is very difficult to fix a threshold limit in deciding materiality or non-materiality of events. It is left to the discretion and best judgments of the accountant to decide upon the materiality and non-materiality of events. Materiality is dependent on the purpose for which reporting is being done. For example at the time of preparing the annual financial statements the accountant may ignore paise altogether and may even round of the figures to the nearest 10 rupees without affecting the true and fair view of the statement.

According to Kohler “Materiality is the characteristic attaching to a statement, fact or item whereby its disclosure or method of giving it expression would be likely to influence the judgment of a reasonable person.”

Accounting is designed by man with a set of objectives. AICPA (Inventory of Generally Accepted Principles for Business Enterprises) has observed “The accounting principles cannot therefore be derived from or proven by the laws of nature.” They are rather in the category of conventions or rules developed by man from experience to fulfill the essential and useful needs and purposes, in establishing reliable financial and operating information system to control business activities. In this respect they are similar to principles of commercial and other social disciplines.
2.3 (k) Consistency

According to the convention of consistency the accounting practices employed should be consistent, that is, applied without change in the coming periods also. In other words the practices should not be changed without sufficient reason. For example if stock is valued on the basis of ‘cost or market price whichever is lower’ the same method should be employed year after year. If depreciation is charged on straight line method, the same method of computing depreciation should be used thereafter. Consistency of the methods employed should be maintained due to various reasons. First of all it will help the users to make comparative study of financial statements by employing methods of intra-firm and inter-firm comparison.

Again consistency increases the acceptability of the financial statements since the users are averse to frequent changes. Consistency should not be maintained at the cost of accounting development. There should be flexibility in the methods and practices employed. Otherwise it will stifle the growth of accounting thought. But full disclosure of the changes effected and its effect on the working results and financial statements of the business should be disclosed. This will help the users to ascertain the impact of the changes on the performance of the business.

2.3 (l) Full disclosures

The very purpose of accounting is to facilitate the preparation of the income statement and the statement of financial position so that the operating results of the entity and the financial position could be ascertained. This is done at periodic intervals usually on an annual basis. The business enterprise should provide through the financial statements all the relevant information required, so as to enable the external parties to make sound economic and investment decisions. Any information which is relevant and likely to
influence the decision making process of the user should not be left out. This is more important in the case of joint stock companies since the members and outsiders have no access to the accounting records of the company and have to depend on the published annual financial statements to dig out information relating to the company. If full disclosure is not made the financial statements may present a distorted picture of the entity. In India the Companies Act 1956 prescribes the form in which the balance sheet should be presented, the items to be disclosed in the profit and loss account and the accounting policies followed by the entity etc with a view that the principle of full disclosure is followed.

2.4 Methods of Accounting

Business transactions are recorded in two different ways.

a) Single Entry

b) Double Entry

2.4 (a) Single Entry:

It is incomplete system of recording business transactions. The business organization maintains only cash book and personal accounts of debtors and creditors. So the complete recording of transactions cannot be made and trail balance cannot be prepared.

2.4 (b) Double Entry:

It this system every business transaction is having a twofold effect of benefits giving and benefit receiving aspects. The recording is made on the basis of both these aspects. Double Entry is an accounting system that records the effects of transactions and other events in at least two accounts with equal debits and credits.
2.5 Theories of Accounting

“Theory is a cohesive set of hypothetical, conceptual and pragmatic principles forming a general frame of reference for a field of inquiry.” – American Accounting Associations

When applied to accounting theory sets broad principles that (1) provide a generic frame of reference by which accounting practice and be evaluated (2) Guide the development of new practices and procedures.

“A theory is a systematic statement of the rules and principles which underlie or govern a set of phenomena. A theory may be viewed as a frame work permitting the organisation of ideas, the explanation of phenomena and the prediction of future behaviour”.-Kenneth S.Most.

According to Choi and Muller theory is

(a) An integrated group of fundamental principles underlying a science or its practical applications.

(b) Abstract knowledge of any art as opposed to the practice of it.

(c) A closely reasoned set of propositions derived from and supported by established evidence and intended to serve as explanation for a group of phenomena.

(d) An arrangement of results or a body of theorems presenting a systematic view of some subject.

Kohler has defined theory as “a set of propositions including and theorems which together with definitions and formal and informal rules of inference is oriented towards the explanation of a body of facts or treatment of a class of concrete or abstract operations. In a well defined fields, the support of a theory derives from two considerations (a) its logical structure with respect to consistency, redundancy of propositions, as well as its
deductive potential. (b) The manner in which propositions dependent on the theory (axioms and theorems) may be placed in correspondence with data incorporated in facts. Relative to rules of measurement, testing of hypothesis or more generally accepted rules of evidence.”

The above definition when applied to accounting theory should be read with the following qualifications

(i) Theory does not apply all accounting practice

(ii) The body of facts being explained by accounting theory can be assumed to be either

(a) The financial facts as presented in accounting statements

(b) The concepts implied in the presentation of accounting statements.

(c) The economic relationship of firms with other firms, individuals and the economy as measured and summarised in accounting statements

Hendriksen has defined accounting theory as “Logical reasoning in the form of a set of broad principles that (1) provide a general frame of references by which accounting practices can be evaluated and (2) guide the development of new practices and procedures. Accounting theory may also be used to explain existing practices to obtain a better understanding of them. But its most important goal of accounting theory should be to provide a coherent set of logical principles that form the general frame of reference for the evaluation and development of accounting practices.

The role of accounting theory is to state the principles and methodology of accounting. But they cannot be completely divorced from practice. Accounting theory is expected to explain the present practices and to predict them. Prediction of accounting practice means theory can predict unobserved
accounting phenomena. Unobserved accounting phenomena may include phenomenon that has happened but not observed Accounting theory may be formulated on the basis of empirical evidence and practices or on the basis of hypothetical and imaginary interpretations.

2.5(a) Decision Theory

Decision theory which is partly descriptive in character. It explains how decisions are made in actual practice. It is normative also since it explains as to how decisions ought to be made. Decisions are made when a logical selection is made out of the various alternatives available to solve a specific problem situation. Information is required at every stage of the decision making process. The quality of decision depends on the quality of information supplied and the improvements in the use of the information. The purpose of accounting is to supply relevant and useful information to the various decision makers to enable them to take rational decisions. Decisions may be taken through the process of model building by the decision makers. The duty of the accountant is to provide information for such model building.

2.5(b) Measurement Theory

Rational decision making depends on the use of information which is significant and relevant Measurement Theory is concerned with the evaluation of data so that its significance is correctly stated. Accountant has to devise means to measure and present the accounting information in a manner that it presents the truth. The information required may relate to past, present or future. The objectives to which the measured information will be put to use should be clear so that appropriate measurement techniques could be employed. Another important consideration is the standard of
measurement to be used. In accounting measurement money is the standard of measurement.

2.5(c) Information Theory

The information theory considers information as an organizational resource which could be put to the most economical use. Information enables an organisation to put its other resources to the best possible use. There are certain costs associated with the production of information such as collecting and processing data and distributing the information thereby collected.

The total cost of producing information increases in direct proportion to the information produced and distributed. The argument is that since the cost of producing information increases in proportion to the information produced, the production of information should be kept at the minimum. Another factor to be considered is the marginal cost of the information generated and its marginal utility. The amount of information to be produced should be restricted to the point at which marginal utility is equal to the marginal cost. Another important consideration is the value of the information generated. The value of information lies in its relevance to the decisions to be made. The value of the information supplied could be assessed by finding out how far the supplied information reduces the uncertainty in the decisions taken. In the end information theory states that cost-benefit analysis of the information generated are the consideration in supplying information to the users of such information.

2.6 Approaches to Accounting Theory

Once the objectives of accounting are established, then the approaches to accounting theory must be selected in order to derive logically conceived accounting principles. Once it is established that the objective of financial
reporting is to provide useful information to stockholders and others to predict the future operations of the entity, it leads to the development of an operating concept of income to the enterprise and to the stockholders.

Some of widely used approaches to accounting theory are

2.6(a) The Deductive Approach.

Under this method one starts with the accounting objectives and postulates and then derives logical principles which provide bases for practical applications. The principles of practical application and rules are derived from logical reasoning.

The deductive approach to accounting theory involves the under mentioned steps

(i) Formulation of objectives of financial reporting

(ii) Statement of postulates

(iii) Set of constraints to guide the reasoning process

(iv) Specifying the frame work on which the ideas can be expressed and summarised.

(v) Developing the definitions

(vi) Formulation of principles and policies derived from the logic.

(vii) The application of the principles to specify situations and the establishment of methods and rules.

2.6(b) The Inductive Approach

The inductive method involves making detailed observations of a phenomena and then drawing generalized principles. Few items are observed
in minute details and then general conclusions which are applicable to entire universe is drawn. The observations may be confirmed or rejected on further observation and experimentation. In accounting the inductive process involves making observations of financial data and if recurring relationship is found, certain general principles and conclusions are arrived at.

2.6(c) Common Law Approach

Common law approach also known as pragmatic approach is concerned with the development of ideas that are in agreement with the real world and which are useful in realistic situations. When applied to accounting theory pragmatic approach selects the accounting concepts and methods based on its utility the users.

Any principle, concept or method is useful provided it helps to accomplish the objectives of various uses of the information derived from accounting. If a theory fails to fulfill the immediate practical use, it is not good theory.

2.6(d) The Ethical Approach

According to the proponents of this approach accounting theory should put emphasis on the concepts of justice, truth and fairness. According to D.R.Scott the basis for the determination of accounting practices is the basic principles underlying social organisations. He has stated that accounting procedure must provide equitable treatment to all interested parties. Financial reports should present a true and accurate statement without misrepresentation and accounting data should be unbiased and impartial. Further accounting principles should be subjected to continuo’s revision to incorporate changes taking place due to changing conditions. Thus accounting statements should be prepared with fairness, justice and
impartiality considering the interest of all parties and not giving preference to any one group.

2.6(e) Communication Approach

Advocates of this approach recognize interesting relationship between communication and accounting. They claim that accounting may be viewed as an integrated system of the communication process, it involves the decision regarding what information should be gathered and disseminated and how it should be communicated. The type of information needed by the users of accounting reports should be observed and the ability of the users to interpret the information communicated should be determined.

2.6(f) Behavioral Approach

According to this approach accounting has close resemblance with other social sciences like psychology, sociology, economics etc which studied social behavior. As per this theorist of accounting is a means of providing information for proper decision making by firms, individuals and Government. The accountants are concerned with the reaction of the receivers of the accounting information. If certain procedures are conceptually strong what leads erroneous behaviour should be closely scrutinized. But if certain methods and procedures are used as a matter of expediency but leads to good behaviour and decision, they may be useful and adopted. The behavioral approach is concerned with how accounting data is used rather than with the logical development of the reports.

2.6(g) Sociological Approach

Sociological approach is very much similar to behavioral approach. It judges the effects of the accounting information provided to the users. But the emphasis on the broader sociological effect than its immediate effect on the
user. It is a welfare approach. It considers the welfare of the society as a whole. The objective of accounting is to report the effects of business operations on all related groups in the society whether they use the information so provided or not.

2.6(h) Events Approach

According to G.H.Sorger “The events approach in accounting theory implies that the purpose of accounting is to provide information about relevant economic events that might be useful in a variety of possible models”.

The duty of the accountant is to provide information regarding events which he thinks useful and it is for the user to pick out the information useful for his decision making purpose. The events approach suggests supply of a lot of information in the financial reports. All characteristics of events in addition to the money values involved should be disclosed.

According to O.Johnson. “In order for interested persons (shareholders, employees, manager, suppliers, customers, government agencies and charitable institutions) to better forecast the future of social organisations (household, business, government and philanthropies) the most relevant attributes (characteristics) of the crucial events (internal environment and transactional) which affect the organisations are aggregated (temporally and sectionally) for periodic publication free of inferential bias.”

2.6(i) Value Approach

The Value approach assumes that the user needs are known and accounting should provide inputs to the user so as to assist him in the construction of useful decision models. The input values may vary from user to user and is not optimal for all users. Under the value approach the balance
sheet indicates the financial position of the enterprise at a particular point of time, the income statement the financial performance of the business firm for a given period of time and the fund flow statement the changes in the working capital of the business entity. The value approach considers how far a particular transaction is able to influence the decision making process of the user and reporting the transaction accordingly. The emphasis on the value of the transaction than on the event.

2.6(j) Predictive Approach

The basic objective of accounting is to provide information to various users so as to enable them to make predictions. The predictive approach states that method of accounting should be followed which will help the users in predicting future events. Predictions are possible by analysis and interpretation of accounting information. The information supplied should be relevant to the purpose at hand. It helps in evaluating current accounting practices, alternative methods of accounting and empirically test the utility of the accounting information supplied.
2.7 Methodology of Accounting

The methodologies employed in accounting theory usually are Positive Methodology and Normative Methodology which are as follow.

2.7 (a) Positive Methodology

Positive Methodology is concerned with explaining accounting practices. Watts and Zimmerman has given the following with regard to positive theory.

“By itself theory, as we describe it, yields no prescription for accounting practice. It is concerned with explaining accounting practice. It is designed to explain and predict which firms will and which will not use a particular method of valuing assets, but it says nothing as to which method a firm should use.”

According to the proponents of the positive theory the objective of accounting theory is to explain and predict accounting practice and not tell the accountants to select what procedures they ought to use. Positive Accounting helps to make predictions regarding the behavior of business entities in relation to the selection of accounting policies and how they will react to the accounting standards prescribed by the standard setting bodies. Positive methodology involves lot of chances for opportunistic behavior on the part of the accountants. They may select a method which is most convenient to them and consistency may be lacking. In this regard William R.Scott has commended

“The optimal set of accounting policies for the firm then represents the best tradeoff between tightly prescribing accounting policies so as to minimise contracting costs under current circumstances and giving managers flexibility to change accounting policies in the face of changing
circumstances, including resulting costs of opportunistic behavior. PAT (positive accounting theory) emphasis the need for empirical investigation to determine just what these accounting policies are and how they vary from firm to firm depending on its organizational structure. Ultimately the objective of the theory is to understand and predict accounting policies choices across different firms”

2.7(b) Normative Methodology

Normative Methodology explains as to what accounting ‘should be’ rather than what ‘it is’. Since the basic objective of accounting is to provide information to various users, accounting theories should prescribe what information should be supplied, so that the objective of accounting are better fulfilled. The increased role Government, standard setting bodies and regulators has increased the importance of normative accounting theories.

Accounting Point of View

APB has described accounting as a service activity. But the crucial question is to serve whom or whose interest? It is to be from whose point of view? Many theories and explanations have been advanced in this regard. Some such explanations are that accounting is to serve the interest of the following parties.

Proprietor

From the very beginning accounting was based on the “purpose of the firm, the nature of the capital and the meaning of the accounts from the owner’s view point.”- Michael Chatfield .The proprietor is the centre of all attention in accounting .All accounting concepts, procedures and rules are made with his interest in mind. Accounting entries are passed from the point
of view of the proprietor. This is the case even in the case of a corporate entity where the stakeholders seek to increase their wealth.

The accounting equation $A - L = P$ demonstrates the essence of the proprietorship point of view. ‘P’ represents the net worth of the business. Assets belong to the proprietor and liabilities are his obligations. The objective of accounting is to ascertain the net worth of the business. The attempt of the business is to increase the net worth of the proprietor. Profit which is derived from revenue and expenses increases the net worth of the proprietor. Revenue and expenses are the subsidiary accounts of ‘P’. Revenue is the increase in proprietorship and expenses are decreases in it. William Vater (“Corporate Stock Equities” in Morton Backer (ed) Modern Accounting Theory, Prentice Hall 1966 p.251) explains “The theory of double entry is based on the idea that expenses and revenue accounts have the same algebraic characteristics as ‘net worth’ i.e., accounts tending to increase net worth are increased by credits ,accounts tending to decrease net worth are handled in reverse order.”

**Entity**

With the advent of companies as the popular form of business organisations the proprietary point of view was found to be insufficient to explain for whom accounting is being done. Thus evolved the entity point of view. A corporation is a separate entity with its own identity .This has nothing to do with the separate entity concept used in accounting which is applicable to all forms of business organisations.

As per the advocates of this thinking accounting is done for the entity and not for the proprietors. This could be applied to all entities whether sole proprietorship, partnerships, companies and to non-profit organisations.
Accounting transactions are classified and analysed from the point of view of the entity.

Paton has stated It is the ‘business’ whose financial history the book keeper and accountant are trying to record and analyse. The books of accounts are the record of ‘the business’; the periodic statements of operations and financial condition are the reports of ‘the business’.

An entity is not a person and it cannot act on its own. But it is real and has got its own existence and personality. There are two views of entity itself. According to the first view the business firm is operating for the benefit of the equity holders, those who provide funds to the entity. The entity is expected to account to the equity holders the status and consequences of their investment. The second view is that the entity itself is in business and it is striving to protect it own interest. The entity gives accounting information to equity holders to meet statutory requirements and to keep better relations with them.

The accounting equation is

\[
\text{Assets} = \text{Equities}
\]

Net worth is of no consequences under entity concept since the entity is the focus of attention and not the proprietor. Equities represent rights or claims on the assets of the entity which includes creditor ship equities and ownership equities. The assets belong to the entity and liabilities are its obligations. All equities are to be met out of the assets of the entity, even though ownership equities may have only

**Residual claims**

Under the entity concept the income statement is important because equity holders are interested to know the result of their investment and the
firm is in existence to make profit. Income is change in net assets rather than change in capital. Revenue is the inflow of assets due to the activities of the entity and expenses are the outflow of the assets due to the same reasons. In case of profitable operations the net assets will show an increase and in case of loss a decrease. Revenue brings in more assets and expenses diminish them.

According to Paton and Littleton “Accounting theory, therefore, should explain the concepts of revenue and expenses in terms of enterprise asset changes rather than an increases or decreases in proprietor’s or stakeholder’s equities.”

**Fund**

William Watter is the proponent of this viewpoint. The proprietary theory is from the point of view of the proprietor and the entity from the point of view of the entity. Vatter has objected to both these due to the reason the personal outlook leads to specific interpretations and methods of valuation. The weakness in these personalized bases for accounting is that the content of accounting reports will tend to be affected by personal analogies and issues will be decided not by considering the nature of the problem but upon some extension of personality. Personal points of view do not lead to objectivity in accounting information.

A fund is a unit of operations, a centre of interest, with specified purposes or set of activities consisting of assets and equities. It is free from personalized thinking and attitudes about valuations or the form and content of the financial statements which is associated with theory of personalization like proprietorship and entity.
The accounting equation is

\[ \text{Assets} = \text{Restrictions on Assets} \]

The balance sheet is considered an “inventory statement” of assets and the restrictions applicable to them (liabilities). Revenues represent an increase in assets of the fund and are free of restrictions. But they are subjected to final restrictions applicable to residual equity. Expenses represent the release of services for designated purposes mentioned in the objectives of the fund.

Commander

Louis Goldberg in his ‘An Inquiry into the Nature of Accounting (AAA 1965) has stated that the focus of accounting should be an effective economic control of the resources. People act on behalf of entities and decisions are made by specific individuals or group of individuals. The process and procedures of accounting are carried out by people. According to him ‘it is difficult to conceive how many aspects of accounting can be devoid entirely from all personal implications’. Attention should be paid to the function of control which could be done by specific people only. The point of view of people who have the power to deploy the resources should be taken. A person who has the power to deploy resources is the ‘commander’. Thus the sole proprietors, partners in a partnership are commanders. But in the case of a corporation the shareholders have no say in the deployment of the resources. It is in the hands of a hierarchy of commanders, the professional managers. Accounting functions are carried out for and on behalf of the commanders. Financial statements are reports by commanders to commanders. Accounting records are kept, financial statements are prepared and reports are analysed by the people on behalf of people for the benefit of the people. Accounting procedures are undertaken on behalf of the top commander.
The balance sheet shows the sources from which the commander has received resources and how he has applied the resources. The balance sheet is a statement of a accountability and stewardship rather than that of ownership. The income statement is a report of the result of the activities undertaken by the commander with the resources at his command.

**Investor**

Since the objective of accounting is to provide information to the suppliers of capital Staubus states that accounting should take the point of view of investors. The accounting equation under the investor theory is

\[
\text{Assets} = \text{Specific Equities} + \text{Residual Equity}
\]

Specific equities include liabilities and preferred stock. The residual equity is the common equity. When common equity is wiped out preferred stock steps into the shoes of common equity. Investors need information to predict the future cash receipts of the entity to ascertain their chances of receiving cash in the form of dividend. According to Staubus the future cash receipts depends on the firm’s monetary capacity to disburse cash, the management’s willingness to pay investors and the legal priority of the investors claim. Financial statements can shed light on the ability and willingness of the entity to disburse cash. Because of the focus of this view is on the investors the importance of cash flow increases.

**Enterprise**

Sauojanen Waino Sauojanen, “Accounting Theory and Large Corporations” based the theory of Peter Drucker that the large corporation is an institution with social responsibilities formulated the enterprise theory. The enterprise being a social institution, its decisions affect various people like stockholders, employees, creditors, customers and the general public.
The enterprise theory is broader in concept since it takes a total view of the parties affected by its actions. Suojanen argues that management is there not only to protect the interest of the stockholders but also those of all other stakeholders. The management strives for the growth and survival of the enterprise, thereby

Protecting the interest of all stakeholders. The enterprise is duty bound to protect the interest of all stakeholders by proper utilization of resources like money, human resources and materials at its disposal. The enterprise point of view is the forerunner of the social accounting concept.

2.8 Accounting Research:

David Flint and John C Shaw in their article Accounting Research from the perspective of practice in Essays in British Accounting Research edited by Michael Broom which and Antony Hopwood has given the following objectives of research in accounting.

a) To enable better understanding

(i) Of what accounting is, that is of the means of creating and communicating information.

(ii) of what accounting is about, that is, of those resources and activities which are the subject of accounting information, of those issues of control or decision about which accounting information is concerned and of those individuals or interest groups who are involved; and

(iii) Of what and how external influences affect accounting, contributing to the development of a meta-theory of accounting.

b) To put existing practice into historical perspective and current context, identifying social expectations, the legal constraints and the cultural factors
which together with the organizational and behavioral influences have brought that practice to its present state by pragmatic development.

c) To isolate those areas or instances of practice in which this unsystematic development has resulted in misinterpretation of needs, inconsistency, illogicality or lack of soundness and failures to take advantage of or to apply new knowledge or new technology, to recognize the need for change or to perceive emergent new expectations, new influences or new organizational structures; and not least

d) To gain an early perception of emergent new applications for accounting practices and to recognize the applicability of new knowledge in other fields to existing accounting practice by analysis and interpretation of the trends in the environmental factors to which reference has already been made.

2.9 Accounting Process:

Accounting as an information system is the process of identifying, measuring and communicating the economic information of an organization to its users who need the information for making decision. It identifies the transactions and events of a specific entity. The transaction is an exchange in which each participant receives or scarifies value. An event is a happening of consequence to an entity. An entity means an economic unit that performs economic activities. Accounting measures transaction and events in terms of a common measurement unit i.e. the ruling currency of a country. Communication is preceded by an accounting cycle through which the identified and measured transactions and events pass.

An accounting cycle is a complete sequence beginning with the recording of the transactions and ending with the preparation of the final accounts.
Figure 2.2: Accounting Process Cycle

The process of accounting, depicting how information flows from the source documents up to the stage where final accounts are prepared, can be shown from above chart.

Accounting is the process of identifying, measuring, recording, classifying, summarizing, analyzing, interpreting and communicating the financial transactions and events.

Accounting helps in keeping systematic records to ascertain financial performance and financial position of the entity and to communicate the relevant financial information to the interested user groups. Transactions and events recorded by suitable account heading are analyzed in terms of debit and credit, and thus assets become equal to equity and liabilities. Accounts are classified as personal, real, and nominal types. Transactions and events are first journalized, then posted to suitable ledgers accounts and all accounts are balanced at the end of the accounting period. Generally balances of the
nominal accounts are transfer to profit and loss account for determination of profit or loss and balance of personal and real accounts are carried to balance sheet.

In the first phase, the data collected i.e. gathering of information from internally or externally prepared documents that describe a transaction and its monetary value. In the second phase, the transactions and events are analyzed into debit and credit and entered primarily in journal. Journal is also called subsidiary book. In a business organization different type of journals are maintained for different types of transactions and events. On the basis of the entries made in the journal, accounts are prepared in the ledger. The ledger is also called principal book because finally only ledger accounts balance are considered for the purpose of accounting analysis. So it is necessary at the journalisation stage to decide the major heads of accounts. Transactional analysis should be made accordingly. The principal assets accounts of a business are land, building, plant and machinery, cash, bank etc. The principal liabilities accounts in a business are bank loan, sundry creditor etc. The principal expense accounts are purchase, wages, salary, rent, electricity and printing & stationary, postage & telegrams, interest, depreciation, discount, commission, bad-debt etc. The principal income accounts are sales, fees, commission, discount earned, interest earned etc. It is important to keep in mind that heads of account should be treated to communicate the accounting information in a meaningful manner to the users of accounts. There is no standard classification account. Every enterprise makes this classification to suit its purposes.

After posting the accounts in the ledger, a statement is prepared to check if the sum of debit balances is equal to the sum of credit balance at a particular point of time. In fact balances are trialed in the statement to assess whether the fundamental accounting equation is satisfied or not. This is called trial balance.
In the last phase of accounting cycle, Profit and Loss account is prepared for an accounting period. The accounting period is generally of twelve months. Also a Balance Sheet is prepared as at the end of the accounting period. Profit and Loss account is prepared to find out the profit made or loss sustained in a particular accounting period through transactions and events. Balance Sheet is prepared to explain the financial position of the reporting entity at the end of the accounting period. Profit and Loss account and Balance Sheet are called final account.

2.9(a) Source Documents:

Source documents represent all documents in business which contains financial records and act as evidence of the transactions which have taken place. It involves gathering of information from internally or externally prepared documents that describe a transaction and its monetary value. Such documents are called 'source documents', e.g., invoices raised in favour of customers, material receipt report for merchandise received, etc.

2.9(b) Journalisation:

The second stage in the accounting process is journalisation. Journal is the book of primary entry. It is the 'Book of Original Entry' because it is the book in which transactions is originally recorded. "A journal is a book of account in which business transactions are recorded in their two-fold aspect for the first time, in the order of their happenings." An entry made in the journal is called a 'Journal Entry'.

The process of recording a transaction in the journal is called 'Journalising'. While journalising the transaction a detailed description of the transaction is given in this record, which is called 'Narration'. This gives the information about the transaction to the reader. When there are more than two accounts are involved in a transaction and the transaction is recorded by
means of a single journal entry instead of passing several journal entries, such single journal entry is termed as 'Compound Journal Entry'.

The various steps to be followed in journalising the business transaction are given as under:

a. Ascertaining what accounts are involved in a transaction.
b. Ascertaining what is the nature of accounts involved.
c. Ascertaining which rule of debit credit is applicable for each of the accounts involved.
d. Ascertaining which account is to be debited and which is to be credited,
e. Record the date of transaction in the 'Date column',
f. Write the name of the account to be debited very close to the left hand side along with the abbreviation 'Dr' on the same line against the name of the account in 'particular column' and the amount debited to be in the 'Debit Amount Column' against the name of the account,
g. Write the name of the account to be credited very close to the left hand side along with the abbreviation 'Cr' on the same line against the name of the account in 'particular column' and the amount debited to be in the 'Credit Amount Column' against the name of the account.
h. Write 'Narration' within brackets in the next line in 'particular column',
i. Draw a line across the entire 'particular column' to separate one journal entry from the other.

There are various types of journal:

a. Purchase Day Book: To record transactions relating to credit purchase;
b. Sales Day Book: To record transactions relating to credit sales;
c. Purchase Return Book: To record transactions relating to purchases return;
d. Sales Return Book: To record transactions relating to sales return;
e. Cash Book: To record cash, bank, and discount transactions;

f. Journal Proper: To record other transactions for which no specific journal is maintained.

Before one can journalise transactions, one must think on the basis of the rules, the effect of the transactions on assets, liabilities, expenses, gain etc. of the firm. In accordance with the effects, the account to be debited or credited will be determined. Then the entry will be made in the journal.

2.9(c) Ledger Posting and Balance:

A ledger is the principle book which contains all the accounts to which the transactions recorded in the books of original entry are transferred. As the ledger is the ultimate destination of all transactions, it is called 'Book of Final Entry'. It is considered as a permanent record and is frequently referred to. A ledger may keep in form of bound books, loose leaf sheet, floppy diskette or any other like device.

The journal tells us the accountants to be debit and credited the amount involved. The amount is written on the left-hand side of the account to be debited. In the particulars column, the name of the account is written preceded by the word, "To". The amount is written on the right-hand side of the account to be credited in the particulars column, the name of the other account concerned is written preceded by the word "By".

Posting is the process of transactions recorded in the books of original entry to the concerned accounts opened in the ledger. It may be daily, weekly, fortnightly or monthly according to the convenience and requirements of the business. It is necessary to post all journal entries into various accounts in the ledger because posting helps us to know the effect of various transactions during a given period on a particular account. Posting in the ledger account is considered complete only when both the debit and credit aspects of all journal entries have been posted.
A journal entry, by means of which the balances of various assets, liabilities and capital appearing in the balance sheet of the previous accounting period are brought in the books of the current accounting period, is known as 'Opening Entry'. While passing an opening entry, all assets accounts are debited and all liabilities accounts are credited and net worth is credited to Proprietor's Capital Account or Partners' Capital Account. The procedure of posting an opening entry is the same as in the case of an ordinary journal entry except that in case of an account which has been debited the words 'To Balance b/d' are recorded in the 'Particular column' on the debit side and in case of an account which has been credited, the words 'By Balance b/d' are recorded in the 'Particular column' on the credit side. Balance of an accounting is the difference between the total of debit items and total of credit items appearing in an account. It signifies the net effect of all transactions posted to that account during a given period. It may be debit balance or a credit balance or a nil balance depending upon whether the debit or the credit total is higher. Normally, personal accounts, real accounts are balanced. Nominal account are not usually balanced but closed by transfer to trading, and profit and loss account.

Balance an account is necessary to ascertain the effect of all transactions posted to that account during a given period.

2.9(d) Trial Balance:

A trial Balance is a statement which shows either the balances or total amounts of debit items and credit items of all the accounts in the ledger and is prepared on a particular date and not for a particular period.

To check on the accuracy of recording, posting and balancing, a list of ledger account titles and their respective balances is prepared, which is known as 'Trial balance'. The debit and credit balance are arranged so as to appear in separate column. Each column is totaled and two totals are
compared for the verification of equality. A failure to attain this equally signals an error in the recording process. A trial balance should be prepared whenever the accountant feels that it would be useful to test the quality of debits and credits; can be daily, monthly, etc.

After posting the accounts in the ledger, a statement is prepared to show the debit and credit balances. It may also be prepared by listing each and every account and entering in separate columns the totals of the debit and credit sides. Whichever way it is prepared, the totals of the two columns should agree. An agreement indicates reasonably accuracy of the accounting work. If the two sides do not agree, then this is simply an arithmetic error(s). This follows the fact that under the Double Entry System, the amount written on the debit side of various accounts is always equal to the amount entered on the credit side of other account and vice versa. Hence the total of the debit sides must be equal to the totals of the credit sides. Once this agreement is established, there is reasonable confidence that the accounting work is free from clerical errors, though it is not proof of cent per cent accuracy because some errors of principle and compensating may still remain.

2.9(e) Final Accounts:

Final accounts comprise of profit and loss account and balance sheet. Profit and loss account shows the performance of the reporting entity during the accounting period and balance sheet gives the financial position of the reporting entity at the end of the accounting period.

The principal function of final statements of account is to exhibit true and fairly the profitability and position of the business to which they relate. In order that these may be properly drawn up, it is essential that a proper record of transactions entered into by the business during the period of account should maintain.
2.10 Bases of Accounting System:

a. Cash Basis of Accounting.

b. Accrual Basis of Accounting.

c. Hybrid Basis of Accounting.

2.10 (a) Cash Basis:

Cash basis of accounting is called 'Receipts bases. Under this method, recording of transactions of revenues and cost and assets and liabilities are reflected in accounts in the period in which actual receipts or actual payments are made. For Example: 'Receipts and payments Accounts' in case of non-trading concerns.

2.10 (b) Accrual basis:

Accrual basis is also called as 'Mercantile' basis of accounting. Revenues, costs, assets and liabilities are reflected in accounts in the period in which they accrue. Accrual basis includes considerations relating to outstanding, prepaid, accrued due and received in advance. Thus, under accrual basis of accounting net income for a period is the results of matching of revenue realized in the period and costs expired during the period.

2.10 (c) Hybrid Basis of Accounting:

Hybrid basis of accounting is also called 'Mixed Basis Accounting'. In this system both cash and accrued accounting systems are followed. Income is recorded on cash basis whereas expenses are recorded on accrual basis. The net income is ascertained by matching expenses on accrual basis with income on cash basis. When all expenses are taken into account, there is reduction in taxable income and therefore the system is popular among professionals as doctors, lawyers, chartered accountants, consultants, etc.
2.11 Accounting Standards:
  
  ➢ **Introduction:**

  Accounting as a language of businesses communicates the financial results of an enterprise to various stakeholders by means of financial statements. If the financial accounting process is not properly regulated, there is possibility of financial statements being misleading, tendentious and providing a distorted picture of the business, rather than the true state of affairs. In order to ensure transparency, consistency, comparability, adequacy and reliability of financial reporting, it is essential to standardize the accounting principles and policies. Accounting standards provide framework and standard accounting policies so that the financial statements of different enterprises become comparable.

  ➢ **Meaning and Definitions:**

  Accounting standards are the policy documents issued by the recognized expert accounting relations to various aspects of recognition, measurement, treatment, presentation and disclosure accounting transactions and events in the financial statements. The purpose of the accounting standards is to standardize the diverse accounting policies with view to eliminate to the extent possible the incomparability of the financial statements information within and on the firm.

  The accounting standards deal with the issues of :-

  **a.** Recognition of events and transactions in the financial statements;
  
  **b.** Measurement of these transactions and events;
  
  **c.** Presentation of these transactions and events in the financial statements in a manner that is meaningful and the understandable to the reader; and
  
  **d.** The disclosure requirements which should be there to enable the public large and the stakeholders and the potential investors in particular, to get
insight into what these financial statements are trying to reflect and thereby facilitating them to take prudent and informed business decision.

According to Michael Bromwich, "Accounting standards are uniform rules for financial reporting applicable either to all or to certain class of entity promulgated by what is perceived of as predominantly an element of the accounting community specially created for this purpose. Standards letters can be seen as seeking to prescribe an accounting treatment from the available set of methods for treating one or more accounting problems. Other policy statements by the profession will be referred to as recommendations."

According to Kohler's dictionary, "Accounting standard is: (1) A code of conduct imposed on accountants by custom law or professional body; and (2) accounting principle."

Accounting standards are a principle that governs current accounting practice and that is used as a reference to determine the appropriate treatment of complex transactions.

➤ **Features of Accounting Standards:**

i. Accounting standards are regarded as major component in the framework of accounting & reporting principles,

ii. As help individual companies and their managements to justify whatever practices they adopt when produce their financial statements,

iii. Accounting standard is treated as a basis for comparison and judgments.

iv. As are written statements issued from time-to-time by institution of the accounting profession or institution in which it has sufficient involvement.

v. As are universally accepted principles and are known as Generally Accepted Accounting principles (GAAP).
**vi.** As consist of comprehensive and detailed rules to be adopted for accounting treatment of different items before presentation of financial statements.

- **Benefits of Accounting Standards:**
  Most of the AS bodies have been constituted with the prime aim of bringing harmonization in accounting practices among the organization and enterprises in their respective countries of the globe. Accounting standards seek to describe the accounting principles, the valuation techniques and the methods of applying the accounting principles in the preparation and presentation of financial statements do that they may give a true and fair view.

  **i. To improve the Credibility and Reliability Financial Statements:**
  Accounting standards are beneficial to improve the credibility and reliability of financial statement. It is necessary that the financial statements the users use and upon which they rely, present a fair picture of the position and progress of the enterprise.

  **ii. Benefit to Users:**
  For users' viz., proprietor, creditor, holders, investors, banks, financial institutions, chamber of commerce, public, internal management and researchers etc., these accounting standards are throwing bright information about the accounting practices and policies and procedure followed by the various companies of the nation as well as international stage.

  **iii. Government:**
  With the help of these AS government can be able to chalk out plans of the country like five-year plans, able to decide the future course of action for development of the country both financially, socially and economically.
Government can be able to assess the revenue and tax position of the country partially if not fully which will help the authorities to collect the tax-revenue.

iv. Managements: Shareholders, who are away from the business, entrust the management to manage their business in which they are very much interested to have 'true and fair view' or their accounts and they rely much if their company's accounts are prepared in line with AS.

v. Better communication tools: Financial statements prepared as the guidelines of the AS, these are, in fact, became the better communication tool to various parties e.g., shareholders, management, tax collecting authorities, banks, public, investors, etc.

vii Inter-firm comparison: With the aid of AS of one company which can be compared with that of the other company to assess the financial position and performance of the companies with utmost easy and thereby the difficulties can be plugged out and future course of action can be more perfect. With the help of these accounting standards, both inter-firm and intra-firm comparison with the same industry or with the other industry can be compared.

➢ Overview of Accounting Standards in India: In India, the Institute of Chartered Accountants of India (ICAI), being a premier accounting body in the country, took upon itself the leadership role by constituting the Accounting Standards Board (ASB) on 21st April, 1977. The main function of ASB is to formulating accounting standards so that such standards may be established in India by the council of the ICAI. The
council of the Institute of Chartered Accountants of India has, so far issued thirty two accounting standards. However, AS 8 on 'Accounting for Research and Development' has been withdrawn consequent to the issuance of AS 26 on 'Intangible Assets'. Following is the list of Accounting Standards with their respective data of applicability.

1. Disclosure of accounting policies
2. Valuation Of Inventories
3. Cash Flow Statements
4. Contingencies and events Occurring after the Balance sheet Date
5. Net Profit or loss For the period, Prior period items and Changes in accounting Policies
6. Depreciation accounting
7. Construction Contracts
8. Accounting for Research and Development
9. Revenue Recognition
10. Accounting For Fixed Assets
11. The Effect of Changes in Foreign Exchange Rates
12. Accounting For Government Grants
13. Accounting For Investments
14. Accounting For Amalgamation
15. Employee Benefits
16. Borrowing Cost
17. Segment Reporting
18. Related Party Disclosures
19. Accounting For Leases
20. Earnings Per Share
21. Consolidated Financial Statement
22. Accounting For Taxes on Income
A brief review of the above mentioned accounting standards is given below:

1. **Disclosure of Accounting Policies:**
   This standard is related with presentation/disclosure requirements of the significant accounting policies followed in preparing financial statements. The true and fair state of affairs and the financial results of an entity are significantly affected by the accounting policies followed in accounting. The areas in which different accounting policies can followed are accounting for depreciation, revaluation of inventories, valuation of fixed assets etc. the disclosure of the significant accounting policies should form part of the financial statement and any change in the accounting policies which has material effect in the current period or which is reasonably expected to have a material effect in the latter period should be disclosed.

   Accounting Policies refer to specific accounting principles and the method of applying those principles adopted by the enterprises in preparation and presentation of the financial statements.
2. **Valuation of Inventories:**

   AS 2 is measurement related standard and specifies the methods of computation of cost of inventories and the method of determination of the value of inventory to be shown in the financial statements. As per the standard, the cost of inventories should comprise costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition. Inventory is valued by following conservatism principle i.e., at lower of the cost or the market price. The revised standard permits the use of only FIFO or Weighted average cost of inventories where the specific identification of cost of inventories is not possible.

   The objective of this standard is to formulate the method of computation of cost of inventories / stock, determine the value of closing stock / inventory at which the inventory is to be shown in balance sheet until it is not sold and recognized as revenue.

3. **Cash Flow Statements:**

   Cash flow statement is additional information to user of financial statement. This statement exhibits the flow of incoming and outgoing cash. This statement assesses the ability of the enterprise to generate cash and to utilize the cash. This statement is one of the tools for assessing the liquidity and solvency of the enterprise.

   The standard deal with the provision of information about the historical changes in cash and cash equivalents of an enterprise by means of cash flow statement which classifies cash flows during the period into operating, investing and financing activities. The requirement of presentation of cash flow statement would force the management to strive to improve the actual cash flows rather than the profit, which is ultimate goal of any business entity.
4. **Contingencies and Events occurring after the balance sheet date:**

In preparing financial statement of a particular enterprise, accounting is done by following accrual basis of accounting and prudent accounting policies to calculate the profit or loss for the year and to recognize assets and liabilities in balance sheet. While following the prudent accounting policies, the provision is made for all known liabilities and losses even for those liabilities / events, which are probable. Professional judgment is required to classify the likelihood of the future events occurring and, therefore, the question of contingencies and their accounting arises.

Objective of this standard is to prescribe the accounting of contingencies and the events, which take place after the balance sheet date but before approval of balance sheet by Board of Directors. The Accounting Standard deals with Contingencies and Events occurring after the balance sheet date.

5. **Net Profit or Loss for the Period, Prior Period Items and change in Accounting Policies:**

This statement should be applied by an enterprise in presenting profit and loss from ordinary activities, extraordinary items and prior period items in the statement of profit and loss, accounting for changes in accounting estimates, and disclosure of changes in accounting policies. As per AS 5, prior period items are income or expenses which arise in the current period as a result of errors or omission in the preparation of financial statements of one or more prior period.

The objective of this accounting standard is to prescribe the criteria for certain items in the profit and loss account so that comparability of the financial statement can be enhanced. Profit and loss account being a period statement covers the items of the income and expenditure of the particular
period. This accounting standard also deals with change in accounting policy, accounting estimates and extraordinary items.

6. **Depreciation Accounting:**

   It is a measure of wearing out, consumption or other loss of value of a depreciable asset arising from use, passage of time. Depreciation is nothing but distribution of total cost of asset over its useful life. This standard requires that the depreciable amount of depreciable assets should be allocated on a systematic basis to each accounting period during the useful life of the assets and the depreciation method selected should be applied consistently from period to period. If there is a change in the method of providing depreciation, such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed.

7. **Construction Contracts:**

   Accounting for long term construction contracts involves question as to when revenue should be recognized and how to measure the revenue in the books of contractor. As the period of construction contract is long, work of construction starts in one year and is completed in another year or after 4-5 years or so. Therefore question arises how the profit or loss of construction contract by contractor should be determined. There may be following two ways to determine profit or loss on year-to-year basis based on percentage of completion or on completion of the contract.

   The standard prescribes the accounting treatment of revenue and costs associated with construction contracts by laying down the guidelines regarding allocation of contract revenue and contract costs to the accounting period in which the construction work is perform. As per the standard, the gross amount due from and to customers from contract work are shown as assets and liability respectively.
8. **Accounting for Research and Development:**

   This standard stands withdrawn w.e.f. 1st April, 2003 i.e. the date from which AS 26 on intangible assets becomes mandatory.

9. **Revenue Recognition:**

   The standard explains as to when the revenue should be recognized in profit and loss account and also states the circumstances in which revenue recognition can be postponed. Revenue means gross inflow of cash, receivable or other consideration arising in the course of ordinary activities of an enterprise such as the sale of goods, Rendering of Services, and Use of enterprises resources by other yielding interest, dividend and royalties. In other words, revenue is a charge made to customers / clients for goods supplied and services rendered. The revenue arising from construction contracts, hire purchase and lease agreements government grants and subsidies and revenue of insurance companies from insurance contracts are outside the purview of AS 9.

10. **Accounting for Fixed Assets:**

    It is an asset, which is held with intention of being used for the purpose of producing or providing goods and services. Not held for sale in the normal course of business. Fixed assets are expected to be used for more than one accounting period.

11. **The Effects of changes in Foreign Exchange Rates:**

    Effect of Changes in Foreign Exchange Rate shall be applicable in Respect of Accounting Period commencing on or after 01-04-2004 and is mandatory in nature. This accounting Standard applicable to accounting for transaction in Foreign currencies in translating in the Financial Statement Of foreign operation Integral as well as non-integral and also accounting for
forward exchange. Effect of Changes in Foreign Exchange Rate, an enterprise should disclose following aspects:

a. Amount Exchange Difference included in Net profit or Loss;
b. Amount accumulated in foreign exchange translation reserve;
c. Reconciliation of opening and closing balance of Foreign Exchange translation reserve;

12. Accounting for Government Grants:

Government Grants are assistance by the Govt. in the form of cash or kind to an enterprise in return for past or future compliance with certain conditions. Government assistance, which cannot be valued reasonably, is excluded from Govt. grants. Those transactions with Government, which cannot be distinguished from the normal trading transactions of the enterprise, are not considered as Government grants. The standard also describes the treatment of non-monetary government grants; presentation of grants related to specific fixed assets, related to revenue, related to promoters' contribution, treatment for refund of government grants etc.

The enterprises are required to disclose:

- The accounting policies adopted for government grants including the method of presentation in the financial statements;
- The nature of government grants recognized in the financial statements, including non-monetary grants of assets given either at a concessional rate or free of cost.

13. Accounting for Investments:

It is the assets held for earning income by way of dividend, interest and rentals, for capital appreciation or for other benefits. The standard deals with accounting for investments in the financial statements of enterprises and related disclosure requirements. The enterprises are required to disclose the
current investments and long term investments in their financial statements. The cost of investments should include all acquisition costs and on disposal of an investment, the difference between the carrying amount and net disposal proceeds should be charged or credited to profit and loss statement.

14. Accounting for Amalgamation:

AS 14 deals with the accounting for amalgamation and the treatment of any resultant goodwill or reserves and is directed principally to companies although some of its requirements also apply to financial statements of other enterprises. This accounting standard deals with accounting to be made in books of Transferee Company in case of amalgamation. This accounting standard is not applicable to cases of acquisition of shares when one company acquires / purchases the share of another company and the acquired company is not dissolved and its separate entity continues to exist. The standard is applicable when acquired company is dissolved and separate entity ceased exists and purchasing company continues with the business of acquired company.

15. Employee Benefits:

Accounting Standard has been revised by ICAI and is applicable in respect of accounting periods commencing on or after 1st April 2006. The scope of the accounting standard has been enlarged, to include accounting for short-term employee benefits and termination benefits.

16. Borrowing Costs:

Enterprises are borrowing the funds to acquire, build and install the fixed assets and other assets, these assets take time to make them useable or saleable, therefore the enterprises incur the interest to acquire and build these assets. The objective of the Accounting Standard is to prescribe the treatment
of borrowing cost in accounting, whether the cost of borrowing should be included in the cost of assets or not. This standard deal with the issue related to identification of asset which qualifies for capitalization of interest, determination of the period for which interest can be capitalized and determination of the amount that can be capitalized. The amount of borrowing costs eligible for capitalization should be determined in accordance with provision of AS 16 and other borrowing costs should be recognized as expenses in the period in which they are incurred.

17. Segment Reporting:

An enterprise needs in multiple products/services and operates in different geographical areas. Multiple products / services and their operations in different geographical areas are exposed to different risks and returns. Information about multiple products / services and their operation in different geographical areas are called segment information. Such information is used to assess the risk and return of multiple products/services and their operation in different geographical areas. Disclosure of such information is called segment reporting.

This standard requires that the accounting information should be reported on segment basis. AS 17 establishes principles for reporting financial information about different types of products and services an enterprise produces and different geographical areas in which it operates. The standard is more relevant for assessing risks and returns of a diversified or multilocalational enterprise which may not be determinable the aggregated data.

18. Related Party Disclosure:

Sometimes business transactions between related parties lose the feature and character of the arms length transactions. Related party
relationship affects the volume and decision of business of one enterprise for the benefit of the other enterprise. Hence disclosure of related party transaction is essential for proper understanding of financial performance and financial position of enterprise.

19. Accounting for leases:

Lease is an arrangement by which the lesser gives the right to use an asset for given period of time to the lessee on rent. It involves two parties, a lesser and a lessee and an asset which is to be leased. The lesser who owns the asset agrees to allow the lessee to use it for a specified period of time in return of periodic rent payments.

AS 19 prescribes the accounting and disclosure requirements for both finance leases and operating leases in the books of the lesser and lessee. The classification of leased adopted in this standard is based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lesser and the lessee.

20. Earnings Per Share:

Earnings per share (EPS) is a financial ratio that gives the information regarding earning available to each equity share. It is very important financial ratio for assessing the state of market price of share. This accounting standard gives computational methodology for the determination and presentation of earning per share, which will improve the comparison of EPS. The statement is applicable to the enterprise whose equity shares or potential equity shares are listed in stock exchange. The objective of this standard is to describe principles for determination and presentation of earnings per share which will improve comparison of performance among different enterprises for the same period and among the different accounting period for the same enterprise.
21. Consolidated Financial Statements:

AS 21 deals with preparation and presentation of consolidated financial statements with an intention to provide information about the activities of group. Consolidated financial statements are presented by a present to provide financial information about the economic activities of the group as a single economic entity. The objective of this statement is to present financial statements of a parent and its subsidiary as a single economic entity. In other words the holding company and its subsidiaries are treated as one entity for the preparation of these consolidated financial statements. Consolidated profit/loss account and consolidated balance sheet are prepared for disclosing the total profit/loss of the group and total assets and liabilities of the group. As per this accounting standard, the consolidated balance sheet if prepared should be prepared in the manner prescribed by this statement.

22. Accounting for Taxes on Income:

AS 22 seeks to reconcile the taxes on income calculated as per the actual taxes payable on the taxable income as per the provisions applicable to the entity for the time being in force. This standard prescribes the accounting treatment of taxes on income and follows the concept of matching expenses against revenue for the period. This accounting standard prescribes the accounting treatment for taxes on income. Traditionally, amount of tax payable is determined on the profit/loss computed as per income tax laws. According to this accounting standard, tax on income is determined on the principle of accrual concept. According to this concept, tax should be accounted in the period in which corresponding revenue and expenses are accounted. In simple words tax shall be accounted on accrual basis not on liability to pay basis.
23. Accounting for Investments in Associates in consolidated financial statements:

AS 23 describes the principles and procedures for recognizing investments in associates in the consolidated financial statements of the investor. An investor which presents consolidated financial statements should account for investments in associates as per equity method in accordance with this standard but in its separate financial statements, AS 13 will be applicable. The accounting standard was formulated with the objective to set out the principles and procedures for recognizing the investment in associates in the consolidated financial statements of the investor, so that the effect of investment in associates on the financial position of the group is indicated.

24. Discontinuing Operations:

The objective of this standard is to establish principles for reporting information about discontinuing operations, thereby enhancing the ability of users of financial statements to make projections of an enterprise's cash flow, earnings generating capacities, and financial position by segregating information about discontinuing operation from information about continuing operation. The focus of the disclosure of the Information is about the operations which the enterprise plans to discontinue rather than disclosing on the operations which are already discontinued. However, the disclosure about discontinued operation is also covered by this standard.

25. Interim Financial Reporting:

Interim financial reporting is the reporting for periods of less than a year generally for a period of 3 months. As per clause 41 of listing agreement the companies are required to publish the financial results on a quarterly basis. The standard prescribes the minimum contents of an interim financial report and requires that an enterprise which elects to prepare and present an
interim financial report, should comply with this standard. It also lays down the principles for recognition and measurement in complete or condensed financial statements for an interim period.

26. Intangible Assets:

An Intangible Asset is an Identifiable non-monetary Asset without physical substance held for use in the production or supplying of goods or services for rentals to others or for administrative purpose. The standard prescribes the accounting treatment for intangible assets that are not dealt with specifically under other accounting standards, and requires an enterprise to recognize an intangible asset if, and only if, certain criteria are met. The standard specifies how to measure the carrying amount of intangible assets and requires certain disclosures about intangible assets. This standard should be applied by all enterprises in accounting intangible assets, except:

- Intangible assets that are covered by another AS,
- Financial assets,
- Right and expenditure on the exploration for or development of minerals, oil, natural gas and similar non-regenerative resources,
- Intangible assets arising in insurance enterprise from contracts with policy holders,
- Expenditure in respect of termination benefits.

27. Financial Reporting of Interest in joint ventures:

Joint Venture is defined as a contractual arrangement whereby two or more parties carry on an economic activity under 'joint control'. Control is the power to govern the financial and operating policies of an economic activity so as to obtain benefit from it. 'Joint control' is the contractually agreed sharing of control over economic activity.
AS 27 set out principles and procedures for accounting of interest in joint venture and reporting of joint venture assets, liability, income and expenses in the financial statements of venture’s and investors regardless of the structure or forms under which the joint venture activities take place. The standard deal with three broad types of joint venture - jointly controlled operations, jointly controlled assets and jointly controls entities.

28. Impairment of Assets:

The dictionary meaning of 'impairment of asset' is weakening in value of asset. In other words when the value of assets decreases, it may be called impairment of an asset. As per AS-28 asset is said to be impaired when carrying amount of asset is more than its recoverable amount. This standard prescribes the procedures to be applied to ensure that the assets of an enterprise are earned at an amount not exceeding their recoverable amount. The standard also lays down principles for reversal of impairment losses and prescribes certain disclosures in respect of impaired assets. An enterprise is required to assess at each balance sheet date whether there is an indication that an enterprise may be impaired.

29. Provisions, Contingent Liabilities and Contingent Assets:

Objective of this standard is to prescribe the accounting for Provisions, Contingent Liabilities, Contingent Assets, and Provision for restructuring cost.

Provision: It is a liability, which can be measured only by using a substantial degree of estimation.

Liability: A liability is present obligation of the enterprise arising from past events the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.
The another objective of AS 29 is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities and sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount. This standard applies in accounting for provisions and contingent liabilities and contingent assets resulting from financial instruments and insurance enterprises. The standard will not apply to provisions/liabilities resulting from executing controls and those covered under any other standard.

30. Financial Instrument:
Recognition and Measurement, issued by The Council of the Institute of Chartered Accountants of India, comes into effect in respect of Accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years. This Accounting Standard will become mandatory in respect of Accounting periods commencing on or after 1-4-2011 for all commercial, industrial and business Entities except to a Small and Medium-sized Entity. The objective of this Standard is to establish principles for recognizing and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. Requirements for presenting information about financial instruments are in Accounting Standard.

31. Financial Instrument presentation:
The objective of this Standard is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets
and financial liabilities should be offset. The principles in this Standard complement the principles for recognizing and measuring financial assets and financial liabilities in Accounting Standard Financial Instruments.

32. Financial Instruments, Disclosures and Limited revision to accounting standards:

The objective of this Standard is to require entities to provide disclosures in their financial statements that enable users to evaluate:

- The significance of financial instruments for the entity's financial position and performance; and
- The nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.

2.12 Techniques of Inventory Valuation:

![Figure 2.3: Techniques of Inventory Valuation](image-url)
2.12 (a) Historical Cost Methods:

Under the historical cost methods, costs of goods refer to the historical costs of acquisition of goods. There is no unique formula for determination of historical cost of inventories. The different techniques for valuation of inventories are as under:

1. FIFO (First In First Out) Method:

The First In First Out method is based on the assumption that the goods which are received first are issued first. This assumption is made for the purpose of assigning costs and not for the purpose of physical flow of goods. The ending inventory consists of the latest lots and is valued at the price paid for such lots, so that the ending inventory is stated in the balance sheet at a nearer the current market price.

2. LIFO (Last In First Out) Method:

The last in first out method is based on the assumption that the goods which are received last are issued first. This assumption is made for the purposes of assigning costs and not for the purposes of physical flow of goods. The ending inventory consists of the earliest lots and is valued at the price paid for such goods. Under this basis, goods issued are valued at the price paid for the latest lot of goods on hand and which means stock of goods in hand is valued at price paid for the earliest lot of goods.

3. Average Price Method:

Average price for computing value of stock is a very simple approach. The closing stock then valued according to the price ascertained.
4. **Base Stock Method:**

The base stock method proceeds on the assumption that a minimum quantity of inventory must be held at all times in order to carry on business. Inventories up to this quantity are stated at the cost at which the base stock was acquired. Inventories in excess of the base stock are dealt with on some other basis.

5. **Weighted Average Price Method:**

The weighted average method is based on the assumption that each issue of goods consists of a due proportion of the earlier lots and is valued at the weighted average price. Weighted average price is calculated by dividing the total cost of goods in stock by the total quality of goods in stock. This weighted average price is used for pricing all the issue until a new lot is received when a new weighted average price is calculated.

However, it is more logical to compute weighted average price using the quantities purchased in a lots as weights. Under weighted average price method, costs of goods available for sale during the period is aggregated and then divided by number of units available for sale during the period to calculate weighted average price per unit.

2.12 (b) **Non-Historical Costs Methods:**

Non-historical costs methods do not considered the historical cost incurred to acquire the goods. Non-historical cost methods include adjusted selling price method, standard cost method, and latest purchase price method.

1. **Adjusted Selling Price:**

This method is called retail inventory method. It is used widely in retail business or in business where the inventory comprises of items, the individual costs of which are not readily ascertainable. The use of this method is appropriate for measuring inventories of large numbers of rapidly
changing items that have similar margins and for which it is impracticable to
use other costing methods. The costs of inventories are determined by
reducing from the sales value of the inventory the appropriate percentage of
gross margin.

2. Standards Cost:

Standard cost method may be used for convenience if the results
approximate the actual cost. Standard cost take into account normal levels of
consumption of materials and supplies, labour, efficiency and capacity
utilization. They are regularly reviewed and, if necessary, revised in the light
of current conditions.

3. Latest Purchase Price:

As per latest purchase price method the price of inventory is calculated
on the bases of purchase price of latest lot. The price of latest lots is assumed
for all inventories on hand.

2.13 Methods of Depreciation

Generally, the methods for providing depreciation are based on
formulas developed on a study of the behavior of the assets over a period of
years for readily computing the amount of depreciation suffered by different
assets. Each of the methods however should be applied only after carefully
considering the nature of the asset and the conditions under which it is being
used.

2.13(1) Straight Line Method:

Under the straight line method, an equal amount is written off each
year during the working life of the asset so as to reduce the cost of the asst to
nil or to its breakup value at the end thereof. It is thus simple to use and can
be depended upon to give accurate results especially in the case of lease, patents, copyrights and also in the case of plant and machinery, when additions to it are made from time to time, calculation of depreciation on addition to plan and machinery, under the method, can be a complicated affair unless different group of assets are classified separately in the plant register segregated according to the years in which additions are made.

2.13(2) Reducing Balance Method:

Under the system a fixed percentage of the diminishing value of the asset is written off each year so as to reduce the asset to its breakup value at the end of its life, repairs and small renewals being charge to revenue. Under this method, the annual charge for depreciation decreases from year to year so that earlier years suffer to the benefit of later years. Also, under this method the value of the can never be completely extinguished. The advantage of this method is that the total charge to revenue in respect of depreciation and repairs is uniform each year, in the earlier years when the depreciation is high, repairs are negligible, and as repairs increase the burden of depreciation gets lesser and lesser.

2.13(3) Annuity Method:

This is the method of depreciation which also takes into account the element of interest on capital outlay and seeks to write off the value of the asset and the interest lost, over the life of asset. It assumes that the amount laid out in acquiring the asset, if invested would have earned interest which must be reckoned as part of the cost of the asset and the business. Under this method, first the rate of interest to be charged on the asset and the period of its life are settled. On that basis, the amount of depreciation to be annually provided in the accounts is ascertained from the annuity tables. This method
is eminently suitable for writing off the amounts paid for long leases which generally involve a considerable capital outlay.

2.13(4) Sinking Fund Method:

If a large sum of money will be required for the replacement of an asset at the end of its effective life, it may be advisable that the amount of annually provide for depreciation may be placed to the credit of the sinking Fund Account, at the same time equivalent amount may be invested in government securities and debited to Sinking Fund Investment Account. Interest on government securities when received would be reinvested and the amount thereof credited to dinking fund account. When the asset is due for replacement, the securities are sold and the new asset is purchased with the proceeds of their sale.

2.13(5) Machine Hour Rate Method:

Where it is practicable to keep record of the running hours of each machine, depreciation calculated on the basis of hours that a machine is worked is provided in the account. The machine hour rate of depreciation is calculated by estimating the total number of hours that a machine would work during its whole life and the amount for which it would be sold at the end of its useful life.

2.13(6) Depletion Method:

This method is used in case of mines, quarries, etc., containing only a certain quantity of product. The depreciation rate is calculated by dividing the cost of the asset by the estimated quantity of product likely to be available. Annual depreciation will be the quantity extracted multiplied by the rate per unit.
2.13(7) Sum of Year's Digits Method:

Sum of year's digits method is one of the accelerating methods of depreciation which depreciate the asset at higher rate in the earlier years and at lower rate in the later years.

2.14 Financial Statements:

A firm communicates financial information to the users through financial statements and reports. Financial statements contain summarized information of the financial affairs, organized systematically. They are the means to present the firm's financial situation to the users. Preparation of the financial statements is the responsibility of top management. As these statements are used by investors and financial analysts to examine the firm's performance in order to make investment decisions, they should be prepared very carefully and contain as much information as possible.

There are three financial statements prepared by firm for the purpose of provide information to the various users. These statements are Income Statement, Balance Sheet, and Cash Flow Statement.

2.14 (1) Income Statement (Profit and loss account):

➤ Meaning and Definition:

According to the AICPA, "Statement which shows the principal elements the positive and negative, in the derivation of income or loss, the claims against income, and the resulting net income or loss of accounting unit."

Profit and loss account presents the summary of revenues, expenses and net income or net loss of a firm. It serves as a measure of the firm's profitability. Revenues are amounts which the customers pay to the firm providing them goods and services. The firm uses economic resources in providing goods and services to customers. The costs of the economic
resources used to earn revenues during a period of time are called expenses. Thus, to determine net income or net loss, the accounting system matches expenses incurred during the accounting period against revenues earned that period.

All those expenses and losses will be written on the debit side. Incomes and gains, other than sales, will be written on the credit side. It is considerable, according to modern thinking, that the profit and loss account should be prepared in such a manner as will enable the reader to form a correct idea about the profit earned or loss suffered by the firm during the period together with the significant factors. Too many details will prevent a person from knowing properly the factors leading to the profit earned. Therefore, items should be classified according to the various functions such as administration, selling and financing.

➢ Nature of P & L Account:

1. Periodic Account:
   As a periodic account, P & L A/C is prepared at the end of the accounting year.

2. A Flow Account:
   It is description of the flow both inflow and out flow as a result of profits directed activities of the business.

3. A Dynamic Account:
   It discloses information about how the enterprise recourses have changed as a result of business activities during the year.

4. An Absorbent Account:
   All balances of nominal accounts merge with profit and loss account to generate an accounting aggregate called income.

5. An Interim Report:
For each covenant of accounting years, profits are ascertained and disclosed. So, the profit and loss account is a period statement.

6. **A Statement of Allocation:**

   Profit and Loss Account is the process of measuring periodical income involves allocation of the stream of costs and revenue between the present and future.

7. **A Link between Successive Balance Sheets:**

   Profit and Loss Account is the periodic movement in the resources and corresponding obligations of business from one balance sheet to another.

   ➢ **Objectives of P & L Account:**

1. **Determination of Enterprise Results:**

   Income determination is apparently the central point of an entity. Profit and Loss Account represent net profit or net loss by matching of incomes and expenses.

2. **Receptacle Balances:**

   Transferring to profit and loss account closes balance of al nominal accounts. Balances of representative accounts i.e., outstanding accounts, accrual accounts etc. are carried forward to next accounting year. Many related accounts either not go elsewhere or need not be carried forward to the succeeding year.

3. **Matching:**

   In profit and loss account costs of the particular period are match with revenue of the same period.
4. **Managerial Objective:**

   Managerial objectives like pricing decisions, distribution of income, and measurement of internally generated resources.

- **The Elements of P & L A/C:**

1. **Operating Revenue and Non-operating Revenue:**

   All incomes or gains in addition to indirect expenses and losses are shown in the Profit and Loss Account. Generally the following incomes or gains are shown on credit side of the Profit and Loss Account:
   a. Net sales
   b. Rent received
   c. Commission or brokerage or agent's remuneration received
   d. Discount or allowances received
   e. Interest or dividend received
   f. Apprentice premium received
   g. Bad debts recovered
   h. Interest or loan given
   i. Interest on drawing etc.

2. **Operating Expenses & Non-operating Expenses:**

   All operating expenses are shown in the profit and loss account. Generally the following are expenses are debited to profit and loss account:
   a. **Administrative Expenses:**

      There are the expenses incurred in the office for administering the business, e.g. salaries, taxes, rent of office, printing and stationary, postage and telegrams, insurance premium, legal expenses, audit fees, lighting in the office, etc.
b. Selling Expenses:

   Expenses incurred on making sales, or for increasing sales are selling expenses e.g. publicity expenses, commission, salesmen's salaries, traveling expenses, discount allowed, bad debts etc.

c. Distribution Expenses:

   The expenses incurred for dispatching goods from trader or manufacturer to the customer are called distribution expenses. They include carriage outward, delivery van expenses, packing expenses, warehouse expenses, etc.

d. Financial Expenses:

   The expenses incurred for procuring finance for the business are financial expenses. Interest on capital, interest on loan taken or interest on overdraft, bank charges, discount on bills discounted etc.

e. Other Expenses:

   These are all those expenses which reduce the profit of the business. They are debited to Profit and Loss Account e.g. depreciation on assets, charities, losses due to theft, losses due to fire, etc.
2.14 (2) Balance sheet:

➤ Meaning:

Balance Sheet is the most significant financial statement. It indicates the financial condition or the state of affairs of a business at a particular moment of time. Balance sheet contains information about resources and obligations of a business entity and about its owners' interests in the business at a particular point of time.

Balance sheet is a list of assets and liabilities of a business at some specific moment of time. Balance sheet is a statement. It shows the financial position of a business. Balance sheet shows the assets and liabilities grouped properly classified in a specific manner. It is prepared for the last day of accounting period. The accounts that are transferred to the balance sheet are not closed.

➤ Functions of Balance Sheet:

a. Balance sheet is a summary of various assets used in business. It provides information regarding the assets owned by a firm and debt due to outsiders and it also indicates the capital of the owner in the business.

b. Balance sheet serves as a measure of liquidity.

c. Balance sheet serves as a measure of solvency.

➤ Contents of Balance Sheet:

The financial position of an entity as a specified moment of time is shown by a balance sheet. The balance sheets reveal an entity's resource structure and its financial structure. Balance sheet is detailed summary of the basic accounting equation:

\[
\text{Assets} = \text{Liabilities} + \text{Owner's Equity}
\]
Generally, assets and liabilities on a balance sheet may be written on (a) liquidity basis, or (b) fixity basis.

Liquidity basis is that basis where assets and liabilities are arranged according to their reliability and payment preference, e.g., current first, and then non-current assets or fixed assets.

Fixity basis is that basis where assets and liabilities are arranged in order of permanence, e.g., fixed assets first, and then current assets.

The various items of the balance sheet may be grouped as under:

1. **Current Assets:**
   
   All assets which are acquired for reselling or converting during the course of business within an accounting period are to be treated as current assets, e.g., cash and bank balances, account receivable, etc.

2. **Fixed Assets:**

   Fixed assets are those assets which are acquired for the purpose of using them in the conduct of business operations, and are not for reselling to earn profit. These assets are not readily convertible into cash in the normal course of business, e.g., machinery, building, etc.

3. **Intangible Assets:**

   These are those assets which do not have physical existence, and their real value depends upon the earning capacity of the business concern, e.g., goodwill.

4. **Deferred Expenditures:**

   Deferred expenditures are those expenditures which are not incurred repeatedly and do not arise from the present operations. These expenditures contribute income or benefit in future years. Thus, these expenditures are
written off gradually over several years. The amount of such expenditures which is not written off at a point of time is shown as assets in the balance sheet, e.g., preliminary expenditure, debenture discount, etc.

5. Investments:
Investments are business holdings of securities issued by governments or other businesses. Investments may appear as current assets or/and long term investments.

6. Other Assets:
The assets possess a tangible form but are not directly used in the operations of business, e.g., investments in real assets, etc.

7. Current Liabilities:
All short term obligations generally due and payable within one year are current liabilities, e.g., bills payable, creditors, bank overdraft, etc.

8. Net Worth:
Net worth is the amount of funds invested at the risk of the owner's of the business concern. It is arrived at after deducting all outside liabilities, both current and non-current, from total assets of the concern. Net worth equals the capital and retained earnings less net losses, if any of the concern.

2.14 (3) Cash Flow Statements:
An analysis of cash flows is useful for short-run planning. A firm needs sufficient cash to pay debts maturing in the near future, to pay interest and other expenses and to pay dividends to shareholders. The firm can make projections of cash inflows and outflows for the near future to determine the availability of cash. The balance can be matched with the firm's need for cash
during the period, and accordingly, arrangements can be made to meet the deficit or invest the surplus cash temporarily.

A statement of change in financial position cash basis, commonly known as the cash flow statement, summarizes the change in cash position between dates of the two balance sheets. It indicates the sources and uses of cash. The cash flow statement is similar to the funds flow statement except that it focuses attention on cash instead of working capital or funds. Thus, this statement analyses change in non-current accounts as well as current accounts to determine the flow of cash. Cash flow and fund flow statements are addressed to the problem of financial management.

Cash flow statement is important for financial planning purposes. The objective of cash flow statement is to reconcile the opening balance with the closing balance of cash at the end of an accounting period.
Researchers, Scholars, Teachers, Academicians, Students and Practitioners get ideas through reading and life-long process of learning. In the present study also, reference of related literature has been used.

The purpose of referring research papers, articles, and working papers was to understand the gap in various studies carried out in the past as well as to derive supportive evidence for some of the findings of such studies.

There are so many research work done by researcher on Corporate accounting practices but very few works was done in the area of accounting practices done by Wholesalers and Retailers. The focus here is to given that how wholesaler and Retailer are doing the accounting practices in the business. For that various research papers, articles, and related research work were referred.

R.J.Chambers has stated that when accounting is looked upon as a communication system it denotes “the process of encoding observation in the language of the accounting system of manipulating the signs and statements and decoding and transmitting the result”.

Accounting is considered to be a language of the business by means of which business information is communicated to various outside parties. Just like any other medium of communication it should be thoroughly studied and understood.

Anthony and Reece have described accounting as a language in the following terms.

“Accounting resembles a language in that some of its rules are definite, whereas others are not. Accountants differ as how a given event should be
reported just as grammarians differ as to many matters of sentence structure, punctuation and choice of words. Nevertheless just as many practices are poor English (language) many practices are definitely poor accounting. Language evolves and changes in response to the changing needs of society and so does accounting.”

Hendriksen has defined accounting theory as “Logical reasoning in the form of a set of broad principles that provide a general frame of references by which accounting practices can be evaluated and guide the development of new practices and procedure. Accounting theory may also be used to explain existing practices to obtain a better understanding of them. But it’s most important goal of accounting theory should be to provide a coherent set of logical principles that form the general frame of reference for the evaluation and development of accounting practices.

Paton has stated “It is the business whose financial history the bookkeeper and accountant are trying to record and analyse. The books of accounts are the record of the business the periodic statements of operations and financial condition are the reports of the business.”

Louis Goldberg has stated that the focus of accounting should be an effective economic control of the resources. People act on behalf of entities and decisions are made by specific individuals or group of individuals. The process and procedure of accounting are carried out by people.

Chamber has stated in his article blueprint for a theory of accounting that “the basic function of accounting is the provision of information to be used in making rational decisions.”
Carey (1965) developed the theme that emergent profession should recognize the need for research as a means of improving its knowledge and performance.

Hicks (1972) reflected the nature of accounting research taking in practitioners firms as geared to keeping track of what is happening. Much of the theoretical accounting literature seeks to aid decision making by providing valuation which also permit the computation of income measures the determination of such valuation and income measures implies the existence of an accepted accounting framework.

Copeland and Birnberg carried out empirical studies using the controlled environment methods in which cases the experiments is personally administered by researcher or his assistance to overcome the limitation of mail.

Hicks, stated that the research effort largely geared to keeping track of what is happening may result in the perpetuation of existing practices and a tendency to reinforce the apparent validity of existing practices.

S.M.Woosely and J.W.Pattilo examined the main factors that determine the collection, classification and summarization of accounting data. Taking an economists perspective the problems associated with determining a conceptual framework for accounting occur because of the lack of usual type of information generated by accounting process.

Suggestion for classification of accounting research have included basic, applied and usable empirical, formal and philosophical a prior and empirical and fundamental and technical.
Imran Pathan has stated in his dissertation that generally all the wholesalers and retailers are aware about the accounting practices in their business they are regularly check the business position.

Hugar.S.S, Shirslashetti.A.S, have stated in their study articles, Accounting practices in Business:A Study of wholesaler and retailers in Bijapur District that wholesaler and retailers mainly concentrate on selling and buying activity they are not more concentrate on accounting and through their study they suggeste that they should concentrate on accounting so it will help to them for the business decision making.

Klaasen and Schreuder developed the idea of separating tool making a professional responsibility and rule making a political activity. The main contention is that an important source of the present methodological confusion in the field of accounting research is the insufficient understanding and subsequent delineation of the political and actual spheres of accounting.
Reference:


2) Chamber R.J...Blue Print for a Theory of Accounting, Accounting Research No-6 1955 P-125


7) Littleton A.C., Structure of Accounting theory, American Accounting Association 1958 P-132
