# DIRECTORATE OF DISTANCE EDUCATION
# UNIVERSITY OF NORTH BENGAL

## BACHELOR OF COMMERCE
## SEMESTER -I

## FINANCIAL ACCOUNTING - I
## DISCIPLINE SPECIFIC COURSE (DSC)-I

# BLOCK-1

**UNIVERSITY OF NORTH BENGAL**
Postal Address:
The Registrar,
University of North Bengal,
Raja Ram mohunpur,
P.O.-N.B.U., Dist.-Darjeeling,
West Bengal, Pin-734013,
India.
Phone: (O) +91 0353-2776331/2699008
Fax: (0353) 2776313, 2699001
Email: regnbu@sancharnet.in; regnbu@nbu.ac.in
Website: www.nbu.ac.in

First Published in 2019

# FOREWORD

The Self Learning Material (SLM) is written with the aim of providing simple and organized study content to all the learners. The SLMs are prepared on the framework of being mutually cohesive, internally consistent and structured as per the university's syllabi. It is a humble attempt to give glimpses of the various approaches and dimensions to the topic of study and to kindle the learner's interest to the subject

We have tried to put together information from various sources into this book that has been written in an engaging style with interesting and relevant examples. It introduces you to the insights of subject concepts and theories and presents them in a way that is easy to understand and comprehend.

We always believe in continuous improvement and would periodically update the content in the very interest of the learners. It may be added that despite enormous efforts and coordination, there is every possibility for some omission or inadequacy in few areas or topics, which would definitely be rectified in future.

We hope you enjoy learning from this book and the experience truly enrich your learning and help you to advance in your career and future endeavours.

# FINANCIAL ACCOUNTING

## BLOCK-1



## BLOCK-2

# BLOCK-1: FINANCIAL ACCOUNTING

## Introduction to the block

The block -I discusses the Introduction to Accounting. It gives an overview of the meaning, definition, and branches of accounting. It also discusses about its functions, users, qualitative characteristics, and concepts and conventions. The concept of double entry system states that every transaction has two effects-debit and credit. The transaction is first recorded in journal and their posting into ledger are done on the basis of double entry system. The block discusses, Indian accounting standards1 and 2 in detail. It gives brief idea about IFRS and the need for convergence of Indian Accounting Standards into IFRS. The International Accounting Standards Committee has evolved various International Accounting Standards which help in harmonizing the accounting policies worldwide. This block deals with process of preparing to presentation of reports. The block comprises four units.

Unit 1 explains other fundamentals of Accounting. It also explains the branches of Accounting and its concepts and conventions.

Unit 2 describes the accounting standards, the need for IFRS, and the functions of accounting standards in detail.

Unit 3 discusses the accounting mechanisms, journal, ledger, cash book and other subsidiary books. It also deals with trial balance, and rectification of errors.

Unit 4 deals with capital and revenue expenditure. It describes measurement of business income. It deals with depreciation and its different methods.

Unit 5 presents the preparation and presentation of final accounts of an enterprise. It deals with trading, Profit and loss account, and balance sheet of an enterprise.

# UNIT-1: THEORETICAL FRAMEWORK

**STRUCTURE**



## 1.0 INTRODUCTION

Today, we live in the age of information surge. Information is available at the finger tips with the help of mobile phones, laptops, computers etc. With the help of these technologies, we collect data, evaluate various alternatives and arrive at final decision in our life. For example, if we want to buy a refrigerator, we collect information regarding different brands, their features, their price, warranty period, after sales service etc., and compare these options with our need and come to a decision which best suits our requirement. To take this decision, we consumed our time and mental work. Similarly, imagine a businessman who is manufacturing, marketing and distributing appliances. He is dealing in crores of rupees and requires timely and accurate information for decision making. He needs different types information from various sources. If he does get right and timely information, he may end up losing his business.

## 1.1 OBJECTIVES

After going through this chapter, the student should know the following

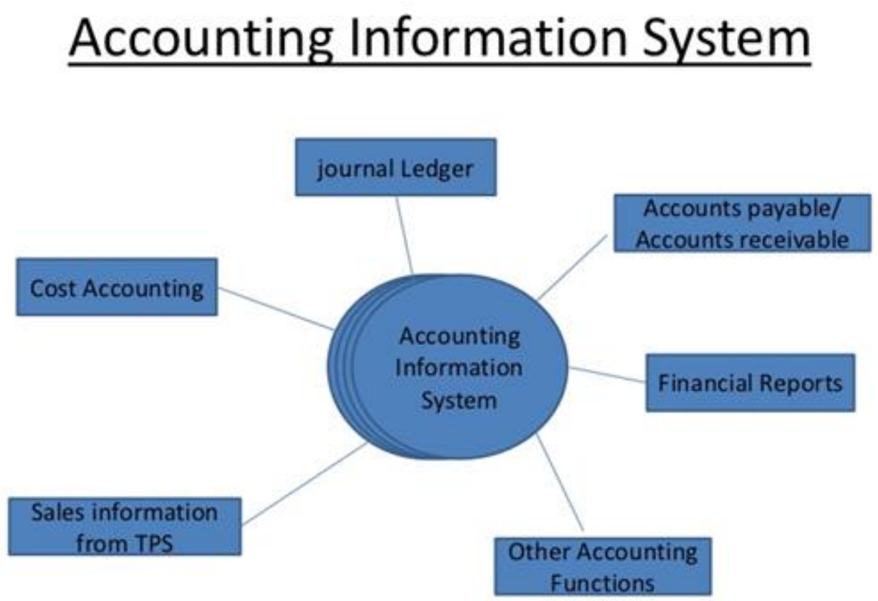
- Meaning and Definition of Accounting Information System
- The users of financial Accounting Information and their needs
- Functions, advantages and limitations of accounting
- Branches of accounting
- Bases of accounting – Cash basis and accrual basis
- Accounting concepts and conventions

## 1.2 ACCOUNTING AS AN INFORMATION SYSTEM

An information system is a process which collects data, processes it into information and distributes information to users. Similarly, Accounting Information System (AIS) collects, accumulates and processes all the financial transactions and produce informational reports that managers' use for decision-making. Today, Accounting Information System is mainly computer oriented. Accounting information is divided into financial accounting information, management accounting information, operating information and tax accounting information. Financial accounting information gives information regarding the financial results and its position at the end of the accounting year to its users like investors, suppliers, creditors etc.

Management accounting information is mainly for internal users of an organization i.e, managers, directors etc. They need adhoc reports and statements to take decisions regarding pricing of the products, sales, and production. AIS supplies all these information to them.

Operating information is required for smooth functioning of the operations. For instance, if the raw material stock is depleting and if AIS is not updated on timely, the production function may stop and the company may incur losses.




Another classification of Accounting Information Systems

Accounting information systems is classified in another class with components of People, Procedures and instructions, data, software, IT infrastructure and internal controls.

1. AIS People

People are end users in AIS. They may include management, accountants, operational level managers, suppliers, distributors, and auditors. AIS help to conglomerate different departments within a company and work together.

For example, when management decides to increase sales goals, production department orders the appropriate amount of inventory notifying the accounting department of accounts payable. When sales target is achieved, salespeople enter customer orders again notifying the accounting department of accounts receivable along with the distribution department wherein the order get assembled in the warehouse, and the shipping department sends it off. Thus, Sales reports, accounting reports and other ad hoc reports are generated at the same time for management for decision-making. Managers can also track production costs, manufacturing costs, distribution costs and so on.

2. Procedures and Instructions

AIS uses both manual and automated methods for collecting, storing, retrieving and processing data. The data comes from both internal sources (e.g., employees) and external sources (vendor's orders). Procedures and instructions are to be coded into AIS software. Employees are to be trained through documentation, manuals and user training programs. To be effective and efficient, procedures and instructions must be followed consistently.

3. AIS Data

AIS uses a database to store data, and a structure such as structured query language (SQL), and a computer language commonly used for databases to interact. The AIS uses various input screens for data entry, and various output formats to generate adhoc reports. All the financial transactions pertaining to the business are to be stored in AIS.

- sales orders
- purchase orders
- vendor invoices
- asset registers
- general ledger
- inventory data
- payroll information
- timekeeping
- tax information

This data is used as base in preparing accounting statements and reports, such as accounts receivable aging, depreciation schedule, reconciliation statements, profit and loss, and balance sheet. Thus, AIS—facilitates business's book-keeping, reporting, analysis, auditing, and decision-making activities.

All non-financial transactions like memos, correspondence, presentations, and manuals are not entered in to AIS as only financial transactions are entered into them. Though these events are critical to company, they do not become part of AIS.

4. AIS Software

Now-a-days, business uses Updated AIS to compete better in the world of business competition. AIS software are the computer programs used to store, retrieve, process, and analyze the company's financial data. Large MNC's are using ready to use application software like SAP, Oracle so that all the departments are integrated in real time. Small businesses use software like Tally, Intuit's QuickBooks or Sage's Sage 50 Accounting etc. These application software reduce burden on the accountant and are system compliant. These software are updated whenever there is change in tax policies or change in tax compliance procedure.

For example, Tally and other softwares have updated their software in compliance with GST (introduced by Government of India) recently. Small to mid-sized businesses use SAP's Business one.

Quality, reliability, and security are key elements of effective AIS software. Managers depend on the information provided by AIS to make decisions for the company. AIS can also be developed in-house with substantial help from end users or can be outsourced to a specialized company. For publicly-traded companies, AIS is structured according to Sarbanes-Oxley regulations in order to establish internal controls and auditing procedures for these companies.

5. IT Infrastructure

AIS needs Information technology infrastructure (hardware) to store the software for operating the accounting information system. Hardware components include computers, processors, internet, servers, printers, surge protectors, routers, storage media, and possibly back-up power supply. Factors like cost-benefit analysis, speed, storage capability, up gradation capability etc., are to be kept in mind while choosing the

Notes

suitable hardware. Ultimately, the hardware selected for AIS must be compatible with the proposed software. Businesses meet hardware and software compatibility requirements is by purchasing a turnkey system or just by outsourcing their requirements to a third party. A good quality AIS includes a plan for maintaining, servicing, replacing and upgrading components of the hardware system, as well as a plan for the disposal of obsolete parts.

6. Internal Controls

The internal controls of AIS are the security measures to protect the accounting information from computer malware, viruses and hackers to unauthorized access as it contains sensitive data. These can be as simple as setting of passwords, biometric identification to firewall protection. AIS contains confidential information like Social Security numbers, payroll information, credit card numbers, and financial information about the organization. All of the data in the AIS should be encrypted, and access to the system should be logged and surveilled.

How an AIS Works In Real Life

We've seen how well-designed AIS allow a business to run smoothly on a day-to-day basis or hinders its operation if the system is poorly designed. The third use for AIS is that, when a business is in trouble, the data in its AIS can be used to uncover the story of what went wrong.

The cases of WorldCom and Lehman Brothers two examples provide that if strong AIS is not built chances of total collapse of the business is present. For example, the main cause of collapse of Lehman Brothers is due to inefficient AIS system .

## 1.3 USERS OF FINANCIAL ACCOUNTING INFORMATION AND THEIR NEEDS

Financial reports are the demonstration to the health of a company. Financial reports are required by both internal and external users of a company.

## INTERNAL USERS OF ACCOUNTING

Internal users are the primary users of accounting. They are:

**Owners/ Management**

Owners need information to assess the well-being of their business. Financial statements provide information to owners about the profitability of the overall business, contribution by each product line, and geographic segments. They are interested to know the return on investment, growth over the years, expenditure and sales, the percentage of risk involved in the business. Such information helps the management to decide whether they should invest any further in the business or they should distribute the profits as dividends to the shareholders.

**Managers**

Managers require AIS to take quick and timely decisions. They require information on sales, closing inventory. They need to allocate resources like, human resources, capital requirements, etc to compete with the competitors Managers with the help of different budgets of various departments, allocate funds to them. For this, he requires, the reserves, further capital requirements and equipment and cash present in the business.

Managers evaluate performance of the business like growth, competitor analysis, market share and industry benchmarks with the help of financial reports. They need to take investment, financial and operational decisions.

**Employees**

Employees are enthused to know how well their company is performing and that effect on their job prospects and bonus payments. Recently, companies have introduced sweat equity where even employees get a share in the profits of the company to boost their productivity and belongingness towards the company. Potential employees are curious regarding the financial health of the company to join the company in the future.

Financing group consists of Shareholders, lenders, supplier or creditors. Public group consists of customers, Government and other tax regulators, and other researchers.

**Investors/Shareholders**

Shareholders are the real risk bearers of company. They are the ultimate owners of the company as they enjoy profits in the form of dividends and capital appreciation when the company is growing or face loss when the company is falling. Therefore, they analyze the financial reports with the help of ratio analysis and take decisions whether to invest in the company or not. They evaluate how well the company is able to allocate the funds generated and earn profits on the capital invested.

**Lenders**

Banks and other financial institutions constitute lenders. Lenders are worried to know how their loans are serviced i.e., whether the company is able to pay the interest on loans taken on time regularly and whether the company is in a position to repay the principal installments .The financial reports reflect the profitability and long-term solvency of the business and assurance for their debt amounts Liquidity, and debt to asset ratio, capital gearing ratio, interest coverage ratio, are the indicators which the lenders watch for. Lenders put conditions like covenants in the structure of capital and exert their influence in the capital structure of the company

**Suppliers**

Similar to lenders, suppliers are interested to know the credit worthiness of its client businesses for which they supply raw materials etc. on credit. Suppliers are interested to know the short-term liquidity position of the company, the current ratio, technical solvency of the company etc. They are worried as how fast the company will repay its debt within the accounting year.

**Customers**

Customers are generally curious about the financial information of the company which they buy the products. They ensure whether the company is facing any legal issues regarding the quality of the product. They ensure whether the company is able to sustain for long-term and steady flow of goods or services in the future. Customers are curious whether the prices will fall or rise according to the industry prices.

**Government**

Assessment of income tax, GST and other tax compliance require a thorough scrutiny of the financial statements of the organization. Government is concerned to know whether the company is able to sustain and the employment generation, whether the company is creating artificial monopolies, or unfair practices regarding the price of the product. It is used to compute national income in macro-economic analysis.

**Tax authorities**

Tax authorities determine whether the income declared by the company is accurate or not by scrutinizing the financial information of the company. Tax authorities cross verify the accounting information of the company with its vendors and lenders to avoid tax evasion.

**Auditors and other research**

Auditors analyze and verify the financial statements whether they represent “True and Fair” view. They give their opinion on the fairness of the financial reports to investors and other users of financial statements.

## 1.4 QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION

Financial statements to be useful to the users should possess certain qualities. These qualities or features help to evaluate the strengths and weaknesses of accounting and is its relevance to effective analysis and decision-making. Five qualitative characteristics form the base of financial statement, out of which two qualitative characteristics are compulsory and remaining four are enhancing.

Primary qualities are Relevance and Adherence to GAAP

**Relevance**

Information should be relevant for decision to be taken by the users of financial reports. Information is said to be relevant when it is on time, fair, and reliable. Relevance of information is affected by its nature and materiality. Information is said to be material worth if its omission or misrepresentation influences the economic decision making

It should have confirmatory value regarding past events and predictive value regarding future events. For example, if the quarter profits of the company are strong, and presenting them in financial reports affect the decision-making of creditors, so that they can extend the credit to the company.

**Adherence to GAAP**

The financial reports are to be prepared keeping in mind their adherence to GAAP and Accounting standards. They should reflect true position of the business. Financial statements should not be window dressed and any losses are to be disclosed to the users.

Secondary qualitative characteristics

1. Verifiability
2. Timeliness
3. Understandability
4. Comparability
5. Consistency
6. Reliability

**Verifiability**

Verifiability is the extent to which information is able to reproduce given the same set of assumptions and procedures. For example, if an accountant is given the purchase price, salvage value, depreciation method, and useful life of machinery, the accountant should be able to generate the current value of the machinery with the same result as in the books of accounts. If they do not match, the information is considered not verifiable.

**Timeliness**

Timeliness implies the how fast, the financial reports are available to users of accounting information. The slower the information, the less useful information is for decision-making. Timeliness is important for accounting users, as they have to compare it with other information. For example, if a company reports its financial statements a year after its accounting period, users of financial statements find it difficult to determine the financial position of the company.

**Understandability**

Users differ in their ability to comprehend the financial reports presented by the organizations. Understandability is the degree to which the users comprehend the information. Complex financial information should be presented in a comprehensive way. Corporate annual reports with significant qualitative information have to be understandable to the average user of financial statements. It is assumed that users have reasonable knowledge of accounting, financial reports and economic activities of organizations. It is common practice for companies to window dress and use a lot of jargon and difficult phrasing in its annual report in order to show better picture

**Comparability**

Comparability is the ability of users to see the similarities or differences in the financial statements of various companies. Financial statements, with consistent accounting standards and policies (goodwill valuation, depreciation method, and inventory valuation) applied throughout each accounting period, enable users to draw insightful inferences about the trends and performance of the company over time. The qualitative characteristics of accounting information are important because they make it easier for both company management and investors to utilize a company's financial statements to make well-informed decisions. Companies need to disclose their accounting methods and policies adopted in the preparation and presentation of financial reports for better comparability for users of financial information.

**Consistency:**

- Accounting information has to be consistent from year to year. Consistency makes accounting information understandable and useful for decision-making by users.: The aim of financial reports is to provide useful information to potential investors, creditors, and other users to make investment, credit, and other decisions. Consistency is closely related to comparability, while comparability enables to compare financial information among entities, consistency enables comparison within an entity over a period of time. Without consistency, comparability is not possible.

<u>Reliability</u>:

Reliability means the extent to which accounting information is faithfully presented and has the following qualities:

It should be unbiased and free from errors

- It should be complete

- It should be neutral:

Occasionally, accountants face uncertainties while entering transactions, in such a situation, they should exercise prudence, in order to maintain reliability of accounting information.

**Check your progress -1**

1. Which of the following are the security measures to protect the accounting information from computer malware, viruses and hackers to unauthorized access in AIS?

a. Procedures and Instruction

b. Internal control systems

c. IT Infrastructure

d. AIS Software

2. Which of the following collects, accumulates and processes all the financial transactions and produce informational reports that managers' use for decision-making?

a. Transaction security systems

b. Accounting Information systems

c. Technology support systems

d. Logistics Management systems.

3. Who among the following are the internal users of financial statements?

a. Management

b. Government

c. Tax authorities

d. Research group.

4. Which of the following is **not** a qualitative characteristic of financial statements?

a. Relevance

b. Understandability

c. Reparability

d. Comparability