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B.Com Honours

Semester I

Calicut University

Fundamentals of Financial Accounting

Course Code: COM1MN103 • Module 1 Notes

1. Accounting Fundamentals: Meaning, Scope, and Users

Accounting is often described as the language of business. It is a systematic process of identifying, measuring, recording, classifying, summarizing, analyzing, interpreting, and communicating financial transactions and events to various interested parties. In a modern economy where commercial activities are highly complex and globalized, financial accounting provides the structural framework to measure business performance, verify financial health, and facilitate decision-making. This module introduces the fundamental accounting concepts, conventions, policies, and standards that form the basis of financial reporting.

Defining Accounting

Prominent professional bodies have defined accounting to reflect its technical and communicative nature:

- **American Institute of Certified Public Accountants (AICPA):** "Accounting is the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of financial character, and interpreting the results thereof."
- **American Accounting Association (AAA):** Defines accounting as "the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by users of the information."

Scope and Branches of Accounting

The scope of accounting has expanded beyond simple record-keeping (bookkeeping) into several specialized branches:

Financial Accounting

The branch focused on recording daily business transactions and preparing periodic financial statements (Income Statement, Balance Sheet) to communicate performance to external users.

Cost & Management Accounting

Cost Accounting identifies, classifies, and controls manufacturing costs. Management Accounting provides internal managers with financial data for planning, budgeting, and control.

Social Responsibility Accounting

The process of identifying, measuring, and reporting the social costs and benefits of an organization's activities (e.g., environmental impact, community benefits).

Human Resource Accounting

A specialized branch that attempts to identify, measure, and report the economic value of human capital (employees) as assets of the enterprise.

Users of Accounting Information

Accounting information is consumed by diverse groups, classified into internal and external users:

Internal Users

- **Management:** Needs financial data to plan operations, monitor budgets, analyze product profitability, and make strategic decisions.
- **Owners/Shareholders:** Monitor the return on their capital, assess profitability, and make decisions regarding reinvestment or disinvestment.
- **Employees:** Assess job security, salary increments, and profit-sharing bonuses based on company performance.

External Users

- **Investors & Creditors:** Assess the financial stability, solvency, and creditworthiness of the firm before lending funds or buying shares.
- **Tax Authorities (e.g., GST, Income Tax Departments):** Verify the accuracy of financial books to determine tax liabilities.
- **Customers & Public:** Assess the business's longevity, stable supply chains, and environmental or ethical contributions to society.

2. Accounting Concepts and Conventions

Accounting books are maintained based on a set of rules and guidelines known as Generally Accepted Accounting Principles (GAAP). These principles are divided into concepts (basic assumptions) and conventions (standard practices).

Fundamental Accounting Concepts

- **Business Entity Concept:** Assumes the business is a distinct legal entity separate from its owners. Personal transactions of the owner are never recorded in the business books.
- **Money Measurement Concept:** Only transactions that can be expressed in monetary terms are recorded (e.g., a manager's skills are ignored, but their salary is recorded).
- **Going Concern Concept:** Assumes the business will continue its operations for an indefinite future period, justifying the recording of assets at cost rather than liquidation value.
- **Accounting Period Concept:** The indefinite life of the business is divided into fixed intervals (typically 12 months) to measure performance and prepare financial statements.
- **Cost Concept (Historical Cost):** Assets are recorded at their original cost of acquisition, ignoring subsequent fluctuations in market value.
- **Dual Aspect Concept:** Every transaction affects at least two accounts (a debit and a credit). Formulated as: **Assets = Liabilities + Capital.**
- **Realization (Revenue Recognition) Concept:** Revenue is recognized only when it is legally earned, i.e., when ownership of goods passes to the buyer, regardless of cash collection.
- **Matching Concept:** Expenses incurred in an accounting period must be matched against the revenues earned during that same period to determine true profits.

Fundamental Accounting Conventions

- **Full Disclosure:** All material financial information must be fully and honestly disclosed in the financial reports or supporting footnotes.
- **Materiality:** Only significant items that could influence a user's decision need to be recorded in detail; minor items can be rounded off or grouped.
- **Consistency:** The accounting policies and methods must remain uniform from year to year to facilitate comparison (e.g., using the same depreciation method).
- **Conservatism (Prudence):** Anticipate no profit, but provide for all possible losses. Assets and incomes must not be overstated, and liabilities must not be understated.

3. Accounting Policies and Standards

Accounting policies represent the specific principles and methods adopted by an enterprise in the preparation and presentation of its financial statements. Because different firms may select different policies (e.g., FIFO vs. Weighted Average cost for inventory valuation), accounting standards are required to ensure uniformity and transparency.

Objectives of Accounting Standards

- **Ensure Uniformity:** Establishing standardized rules across all companies to eliminate variations in financial reporting.
- **Improve Reliability:** Assuring stakeholders that the financial books are prepared based on objective, verified standards.
- **Enhance Comparability:** Allowing investors to compare the performance of different firms in the same industry.
- **Provide Disclosure Guidelines:** Standardizing what information must be disclosed in footnotes to prevent fraud and concealment.

Standard Setting Bodies

In India, Accounting Standards (AS) and Indian Accounting Standards (Ind AS) (which are converged with International Financial Reporting Standards - IFRS) are formulated by the Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India (ICAI) and notified by the Government of India on the recommendation of the National Financial Reporting Authority (NFRA).

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