# UGC-NET

## COMMERCE

NATIONAL TESTING AGENCY (NTA)

**PAPER – 2 || VOLUME – 2**

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## UNIT – 4

## Accounting and Auditing


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# UNIT – IV

# #Accounting Concepts, Principles and Basic Terms

## Definition and introduction

* The worldview of accounting and accountants may certainly involve some unhelpful characters poring over formidable figures stacked up in indecipherable columns.
* However, a short and sweet description of accounting does exist:
* Accounting is the language of business efficiently communicated by well-organised and honest professionals called accountants.
* A more academic definition of accounting is given by the American Accounting Association:
* The process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information.
* The American Institute of Certified Public Accountants defines accounting as:
* The art of recording, classifying, summarising 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.
* Accounting not only records financial transactions and conveys the financial position of a business enterprise; it also analyses and reports the information in documents called "financial statements."
* Recording every financial transaction is important to a business organisation and its creditors and investors. Accounting uses a formalised and regulated system that follows standardised principles and procedures.
* The job of accounting is done by professionals who have educational degrees acquired after years of study. While a small business may have an accountant or a bookkeeper to record money transactions, a large corporation has an accounts department, which supplies information to:
* who guide the company.
* Managers Investors who want to know how the business is doing.
* Analysts and brokerage firms dealing with the company's stock.
* The government, which decides how much tax should be collected from the company.

# Accounting Principles

* Obviously, if each business organisation conveys its information in its own way, we will have a babel of unusable financial data.
* Personal systems of accounting may have worked in the days when most companies were owned by sole proprietors or partners, but they do not anymore, in this era of joint stock companies.
* These companies have thousands of stakeholders who have invested millions, and they need a uniform, standardised system of accounting by which companies can be compared on the basis of their performance and value.
* Therefore, accounting principles based on certain concepts, convention, and tradition have been evolved by accounting authorities and regulators and are followed internationally.
* These principles, which serve as the rules for accounting for financial transactions and preparing financial statements, are known as the "*Generally Accepted Accounting Principles*," or GAAP.
* The application of the principles by accountants ensures that financial statements are both informative and reliable.
* It ensures that common practices and conventions are followed, and that the common rules and procedures are complied with. This observance of accounting principles has helped developed a widely understood grammar and vocabulary for recording financial statements.
* However, it should be said that just as there may be variations in the usage of a language by two people living in two continents, there may be minor differences in the application of accounting rules and procedures depending on the accountant.
* For example, two accountants may choose two equally correct methods for recording a particular transaction based on their own professional judgement and knowledge.
* Accounting principles are accepted as such if they are (1) objective; (2) usable in practical situations; (3) reliable; (4) feasible (they can be applied without incurring high costs); and (5) comprehensible to those with a basic knowledge of finance.
* Accounting principles involve both accounting concepts and accounting conventions. Here are brief explanations.

## Accounting Concepts

1. Business entity concept: A business and its owner should be treated separately as far as their financial transactions are concerned.
2. Money measurement concept: Only business transactions that can be expressed in terms of money are recorded in accounting, though records of other types of transactions may be kept separately.
3. Dual aspect concept: For every credit, a corresponding debit is made. The recording of a transaction is complete only with this dual aspect.
4. Going concern concept: In accounting, a business is expected to continue for a fairly long time and carry out its commitments and obligations. This assumes that the business will not be forced to stop functioning and liquidate its assets at "fire-sale" prices.
5. Cost concept: The fixed assets of a business are recorded on the basis of their original cost in the first year of accounting. Subsequently, these assets are recorded minus depreciation. No rise or fall in market price is taken into account. The concept applies only to fixed assets.
6. Accounting year concept: Each business chooses a specific time period to complete a cycle of the accounting process—for example, monthly, quarterly, or annually—as per a fiscal or a calendar year.
7. Matching concept: This principle dictates that for every entry of revenue recorded in a given accounting period, an equal expense entry has to be recorded for correctly calculating profit or loss in a given period.
8. Realisation concept: According to this concept, profit is recognised only when it is earned. An advance or fee paid is not considered a profit until the goods or services have been delivered to the buyer.

## Accounting Conventions

There are four main conventions in practice in accounting: conservatism; consistency; full disclosure; and materiality.

* Conservatism is the convention by which, when two values of a transaction are available, the lower-value transaction is recorded. By this convention, profit should never be overestimated, and there should always be a provision for losses.
* Consistency prescribes the use of the same accounting principles from one period of an accounting cycle to the next, so that the same standards are applied to calculate profit and loss.

* Materiality means that all material facts should be recorded in accounting. Accountants should record important data and leave out insignificant information.
* Full disclosure entails the revelation of all information, both favourable and detrimental to a business enterprise, and which are of material value to creditors and debtors.

## Basic Accounting Terms

Here is a quick look at some important accounting terms.

### Accounting equation:

* The accounting equation, the basis for the double-entry system (see below), is written as follows:
* Assets = Liabilities + Stakeholders' equity
* This means that all the assets owned by a company have been financed from loans from creditors and from equity from investors. "Assets" here stands for cash, account receivables, inventory, etc., that a company possesses.

### Accounting methods:

Companies choose between two methods—cash accounting or accrual accounting. Under cash basis accounting, preferred by small businesses, all revenues and expenditures at the time when payments are actually received or sent are recorded. Under accrual basis accounting, income is recorded when earned and expenses are recorded when incurred.

Account receivable: The sum of money owed by your customers after goods or services have been delivered and/or used.

Account payable: The amount of money you owe creditors, suppliers, etc., in return for goods and/or services they have delivered.

Accrual accounting: See "accounting methods."

<u>Assets (fixed and current)</u>: Current assets are assets that will be used within one year. For example, cash, inventory, and accounts receivable (see above). Fixed assets (non-current) may provide benefits to a company for more than one year-for example, land and machinery.

<u>Balance sheet</u>: A financial report that provides a gist of a company's assets and liabilities and owner's equity at a given time.

<u>Capital</u>: A financial asset and its value, such as cash and goods. Working capital is current assets minus current liabilities.

<u>Cash accounting</u>: See "accounting methods."

<u>Cash flow statement</u>: The cash flow statement of a business shows the balance between the amount of cash earned and the cash expenditure incurred.

<u>Credit and debit</u>: A credit is an accounting entry that either increases a liability or equity account, or decreases an asset or expense account. It is entered on the right in an accounting entry. A debit is an accounting entry that either increases an asset or expense account, or decreases a liability or equity account. It is entered on the left in an accounting entry.

<u>Double-entry bookkeeping</u>: Under double-entry bookkeeping, every transaction is recorded in at least two accounts—as a credit in one account and as a debit in another.

For example, an automobile repair shop that collects Rs. 10,000 in cash from a customer enters this amount in the revenue credit side and also in the cash debit side. If the customer had been given credit, "account receivable" (see above) would have been used instead of "cash." (Also see "single-entry bookkeeping," below.)

<u>Financial statement</u>: A financial statement is a document that reveals the financial transactions of a business or a person. The three most important financial statements for businesses are the balance sheet, cash flow statement, and profit and loss statement (all three listed here alphabetically).

<u>General ledger</u>: A complete record of financial transactions over the life of a company.