

INTRODUCTION TO ACCOUNTING

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Meaning Of Accounting

The main objective of any business is to earn profits. So, it is very important for the business to determine the results of the business at an appropriate interval. For this, it is necessary to record the business transactions and events in a systematic manner. Accounting is the practice of systematically recording, reporting, and analysing the financial transactions conducted by a business

Definition Of Accounting

"Accounting is a process of identifying, measuring, recording, classifying, summarising, analysing, interpreting and communicating the financial business transactions in a useful manner".

Characteristics Or Features Of Accounting

1. Identification of Financial Transactions and Events: A business is full of events, which are both financial and non-financial. Accounting records only those transactions and events which are of financial nature as they bring a change in the resources of a firm. For example, purchase of goods or assets.

2. Measurement of Transactions: Accounting records the transactions only in terms of money. It involves quantifying business transactions into financial terms using monetary unit of the country. In India, rupee is used as a measuring unit. For example, purchase of 10 chairs for ` 12,000 and 100 Kg. of raw material for ` 20,000 will be measured in terms of money, i.e., ` 32,000 will be recorded in the books of accounts.

Note: Any event which cannot be measured in terms of money, is not recorded in the accounting books. For example, events like receiving an order for sale of goods or appointment of an employee are not recorded in the books of accounts.

3. Recording: Accounting involves recording the financial transactions in the books of accounts. It means entering a business transaction in the books of original entry.

- In a small concern with few transactions, recording is done in a book called 'Journal'.
- In a big concern with numerous transactions, the Journal is further sub-divided into various books known as 'Subsidiary Books' such as Cash Book, Purchases Book, Sales

Book, etc.

4. Classifying: Accounting is an art of classifying transactions of the business. Classification is the process of grouping the transactions of one nature at one place, in a separate account, known as 'Ledger'.

- Classification involves entering the transactions from Journal or the Subsidiary Books to ledger. It is also called 'Posting'.
- Ledger contains individual account heads under which all financial transactions of a similar nature are collected. For example, in Hari's Account, all business transactions related to Hari are entered.

5. Summarising: It involves presenting the classified data in a manner which is understandable and useful to the users of accounting statements. This process leads to the preparation of the following statements:

- Trial Balance & Balance Sheet

6. Analysing and Interpreting: In Accounting, the results of the business are analysed and interpreted so that users of financial statements can make a meaningful and sound judgement about the profitability and financial position of the business.

7. Communicating: Accounting involves communicating the financial data to the interested parties through annual and periodic reports. The accounting information must be provided on time so that decisions are taken at the appropriate time.

Accounting Process

Based on the features of accounting, the accounting process is as follows:

1. Identification of Financial Transactions and Events;
2. Measurement of Transactions in terms of money;
3. Recording the financial transactions in Journal or Subsidiary Books;
4. Classifying them through Ledger;
5. Summarising the transactions by preparing Trial Balance, Trading Account and Profit and Loss Account (or Statement of Profit and Loss) and Balance Sheet;
6. Analysing and Interpreting the financial data;
7. Communicating the financial data to the interested parties.

Branches Of Accounting

Economic development and technological improvements have resulted in large-scale business operations. In order to keep pace with the changing business scenario, different branches of accounting have emerged and getting developed over the period of time. The main branches are:

1. Financial Accounting: Financial Accounting is that branch of accounting which involves identifying, measuring, recording, classifying, summarising, analysing, interpreting and communicating the financial transactions. This branch of Accounting is primarily concerned with the systematic maintenance of books of accounts and providing financial information to the users of accounting information.

It aims to:

- Determine Financial Performance, i.e. Profitability of the business by preparing Trading and Profit and Loss Account (or Statement of Profit and Loss); and
- Ascertain Financial Position of the business by preparing Balance Sheet.

Due to inability of Financial Accounting in providing information about cost of products or services, resulted in the development of a specialised branch, known as 'Cost Accounting'.

2. Cost Accounting: Cost Accounting is that branch of accounting which is concerned with the process of accounting and controlling the cost of products manufactured or services rendered by the business enterprise.

It aims to ascertain the cost of product or services in order to enable the management to fix the selling price and exercising controls.

3. Management Accounting: Management Accounting is that part of accounting which is concerned with the decision-making process of the management. Various tools like Ratios and Cash Flow Statements are used for this purpose.

Its main aim is to provide all the relevant information to the management that may be required to take decisions in respect of various aspects of running the business enterprise.

Objectives Of Accounting

The main objectives of accounting are:

1. To maintain a systematic record of business Transactions: The main objective of accounting is to identify the financial transactions and events of the business and to record them into proper books of accounts in a systematic manner.
2. To ascertain Profit or Loss: The next main objective of accounting is to determine the financial performance, i.e. profit earned or loss suffered by the business during a particular period. For this purpose, Trading and Profit and Loss Account or Statement of Profit and Loss Account (by companies) is prepared at the end of each accounting period.
3. To determine Financial Position: Another main objective of accounting is to ascertain the financial position of the business concern. Financial Position can be known from the Balance Sheet, which depicts the position of assets, liabilities and capital of the owners.
4. To provide information to various users: Another objective of accounting is to communicate the accounting information to various interested parties like owners, investors, creditors, employees, government authorities, etc. Such information helps them in making sound decisions about the business entity.
5. To assist the Management: Another objective of accounting is to provide financial information to the management. Management requires it for decision making and for exercising effective control.

Advantages Of Accounting

1. Provides Information about Financial Performance: Accounting helps in providing information about the Financial Performance, i.e. net results of business activities of an accounting period.
2. Provides assistance to Management: Accounting provides information about financial performance and financial position of the business, which is needed by the management for planning and controlling the business.
3. Facilitates Comparative Study: By keeping a systematic record of the business transactions, accounting helps in making comparison.

- It facilitates 'Intra-firm Comparison', i.e. comparison of financial performance of an enterprise for two or more accounting periods.
- It also facilitates 'Inter-firm Comparison', i.e. comparison of financial results of one firm with that of another.

4. Replaces Memory: Accounting helps in maintaining systematic records of the business, which may be referred from time to time. Thus, accounting eliminates the need to remember the transactions.

5. Helps in settlement of Tax Liability: Properly maintained accounting records are helpful in the settlement of various tax liabilities like Income Tax, Sales Tax; VAT, excise duty, etc.

6. Helpful in Raising Loans: Accounting facilitates raising loans from banks or other financial institutions as such institutions grant loan to firm on the basis of appraisal of financial statements of the firm.

7. Evidence in Court: Systematic accounting records provide documentary evidence in the court in case of any dispute.

8. Helps in the Sale of Business: If the business entity is being sold, then the accounting records help to determine the proper purchase price.

9. Helpful in Decision Making: Management has to take a number of decisions at regular intervals. Accounting provides useful information to the management for taking such decisions.

Limitations Of Accounting

1. Accounting is not Fully Exact: Accounting is not completely free from personal bias or judgement.

- Although transactions are recorded on the basis of some documentary evidence, but even then, in some cases, the transactions are recorded on the basis of some estimates.
- For example, estimates for possible bad debts or depreciation on the basis of estimated useful life of an asset.
- In making such estimates, personal judgement is needed. As there is no uniformity for making such estimates, the figures of profit or loss may vary if calculated by different persons.

2. Accounting does not Indicate the Realisable Value: Accounting is 'Historical' in nature, i.e. it records the assets at their original cost (historical cost) less depreciation and does not reflect their current market value. As a result, Balance Sheet does not indicate the amount of cash which the firm may realise by the sale of assets.

3. Ignores Effect of Price Level Changes: Accounting statements are prepared at historical cost (i.e., the original cost). However, value of money is bound to change from time to time. As a result, figures given in the financial statements ignore the price level changes.

Due to this reason, Balance Sheet values of assets are not helpful in estimating the true financial position of the business.

4. Ignores the Qualitative Information: As Accounting is concerned only with the monetary transactions of the business, it ignores the quantitative aspects, like good

labour relations, management's reputation etc

5. Affected by Window Dressing: Window dressing refers to the practice of manipulation of accounts to present a more favourable position of the business than the actual position. For example, treating revenue expenditure as capital expenditure or vice versa. In such a situation, financial statements fail to provide a true and fair view of the financial position of the enterprise.

BOOK KEEPING, ACCOUNTING AND ACCOUNTANCY

The terms 'Book Keeping', 'Accounting' and 'Accountancy' are often considered as synonymous. However, there is a fundamental difference between the three terms.

Book Keeping

Book Keeping is the process of recording the financial transactions and events of a business. It is a part of accounting and involves the following four activities:

1. Identification of Financial Transactions and Events;
2. Measurement of Transactions in terms of money;
3. Recording the financial transactions in Journal or Subsidiary Books;
4. Classifying them through Ledger.

"Book Keeping is the art of recording business transactions in a systematic manner."

Accounting

Accounting is a broad term and it includes Book Keeping. In addition to Book Keeping, it also includes summarising, interpreting and communicating the financial data to the interested parties. Thus, accounting is a wider concept than Book Keeping.

Accountancy

Accountancy refers to systematic knowledge of the principles and the techniques which are applied in accounting. It explains how to maintain the books of accounts, how to summarise them and how to analyse and communicate it to the users.

Difference Between Book Keeping and Accounting

<i>Basis</i>	<i>Book Keeping</i>	<i>Accounting</i>
1. Scope	Book Keeping involves identifying financial transactions, measuring them in terms of money, recording them and classifying them in ledger.	In addition to Book Keeping, Accounting also includes summarising, interpreting and communicating the financial data to the interested parties.
2. Stage	It is a Primary Stage.	It is a Secondary Stage. It begins where book-keeping ends.
3. Nature of Job	The job is routine in nature.	The job is analytical in nature
4. Objective	The main aim is to maintain systematic records of financial transactions.	The main aim is to ascertain the profitability and financial position of the business and to communicate it to the interested parties.
5. Performance	Junior staff performs this function.	Senior staff performs this function.
6. Level of Skills	Book Keeping does not require special skills as the work is mechanical in nature.	It requires specialised skill to analyse and interpret the financial statements.

Accounting and Accountancy a Comparison

Accountancy is a discipline consisting of principles, assumptions, conventions, techniques and concepts, which are to be applied in the process of accounting.

- Accountancy explains how to maintain and accounting actually maintains the business records. Accounting depends on the rules and principles framed by accountancy.
- Thus, accountancy has a wider approach than accounting.

According to Kohler, "Accountancy refers to the entire body of the theory and practice of accounting".

• **Accounting Information** refers to the Financial Statements prepared through the process of Book-Keeping.

• **Types of Accounting Information:** Accounting Information can be categorised as: (i) Income Statement; (ii) Statement of Financial Position; (iii) Cash Flow Statement.

Users of Accounting Information: The users may be categorised into Internal Users and External Users.

Internal Users of Accounting Information

(i) *Owners: They need the accounting information to know the profitability and financial soundness of the business.*

(ii) *Management: Management needs accounting information to take various decisions.*

(iii) *Employees: They use the information to assess the ability of the business to pay higher wages and bonus.*

External Users of Accounting Information

(i) *Banks and Financial Institutions: They need it to ensure safety and recovery of the loan advanced and regularity of the interest amount.*

(ii) *Investors and Potential Investors: They are interested in knowing the earning capacity of the business and safety of the investment.*

(iii) *Creditors: They need accounting information to ascertain financial soundness and creditworthiness of the firm.*

(iv) *Government and their Agencies: Government need accounting information to assess tax liability of the business and to regulate its activities.*

(v) *Researchers: They use accounting information to undertake research.*

(vi) *Consumers: They require accounting information for establishing good accounting control,*

which will reduce cost of production and less price is to be paid by them.

(vii) Public: Public is interested in the accounting information to know the contribution of business towards the welfare of the society.

Qualitative Characteristics of Accounting Information

(i) Reliability: Accounting information must be free from material error and personal biasness and verifiable.

(ii) Relevance: Unnecessary and irrelevant information should not be included in financial statements.

(iii) Understandability: Information should be presented in such a manner that users can easily understand it.

(iv) Comparability: Users should be able to make intra-firm and inter-firm comparison.