CHAPTER-1

INTRODUCTION TO ACCOUNTING

➢ Accounting is the art of recording, classifying and summarising the economic information 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.

➢ Functions of Accounting

1) Identifying: The first step in accounting is to determine what to record, i.e., to identify the financial events which are to be recorded in the books of accounts. It involves observing all business activities and selecting those events or transactions which can be considered as financial transactions

2) Recording: A transaction will be recorded in the books of accounts only it is considered as an economic event and can be measured in terms of money. Once the economic events are identified and measured in economic terms they will be recorded in the books of accounts in monetary terms and in chronological order.

3) Classifying: Once the financial transactions are recorded in journal or subsidiary books, all the financial transactions are classified by grouping the transactions of one nature at one place in a separate room.

4) Summarising: It is concerned with presentation of data and it begins with balance of ledger accounts and the preparation of trial balance with the help of such balances.

5) Communication: The main purpose of accounting is to communicate the financial information the users who analyse them as per their individual requirements. Providing financial information to its users is a regular process.

➢ Objectives of Accounting

1) To keep systematic and complete records of financial transactions in the books of accounts according to specified principles and rules to avoid the possibility of omission and fraud.

2) To ascertain the profit earned or loss incurred during a particular accounting period which further help in knowing the financial performance of a business.

3) To ascertain the financial position of the business by the means of financial statement i.e. balance sheet which shows assets on one side and Capital & Liabilities on the other side.

4) To provide useful accounting information to users like owners, investors, creditors, banks, employees and government authorities etc who analyze them as per their requirements.

5) To provide financial information to the management which help in decision making, budgeting and forecasting.

6) To prevent frauds by maintaining regular and systematic accounting records.

➢ Advantages of Accounting

1) It provides information which is useful to management for making economic decisions.

2) It helps owners to compare one year's results with those of other years to locate the factors which leads to changes.

3) It provides information about the financial position of the business by means of balance sheet which shows assets on one side and Capital & Liabilities on the other side.

4) It helps in keeping systematic and complete records of business transactions in the books of accounts according to specified principles and rules, which is accepted by the Courts as evidence.

5) It helps a firm in the assessment of its correct tax Liabilities such as income tax, sales tax, VAT, excise duty etc.

6) Properly maintained accounts help a business entity in determining its proper purchase price.

➢ Limitations of Accounting

1) It is historical in nature; it does not reflect the current worth of a business. Moreover, the figures given in financial statements ignore the effects of changes in price level.

2) It contains only those informations which can be expressed in terms of money. It ignores qualitative elements such as efficiency of management, quality of staff, customer's satisfactions etc.

3) It may be affected by window dressing i.e. manipulation in accounts to present a more favorable position of a business firm than its actual position.

4) It is not free from personal bias and personal judgment of the people dealing with it. For example, different people have different opinions regarding life of asset for calculating depreciation, provision for doubtful debts etc.

5) It is based on various concepts and conventions which may hamper the disclosure of realistic financial position of a business firm. For example, assets in balance sheet are shown at their cost and not at their market value which could be realised on their sale.

➢ Book Keeping - The Basis of Accounting Book keeping is the record-making phase of accounting which is concerned with the recording of financial transactions and events relating to business in a significant and orderly manner. Book Keeping should not be confused with accounting. Book keeping is the recording phase while accounting is concerned with the summarizing phase of an accounting system. The distinction between the two are as under.

Accounting

1) It is the summarizing phase of an accounting system

2) It is a Secondary Stage which begins where the Book keeping process ends.

3) It is analytical in nature and required special skill or knowledge.

4) It is done by senior staff called accountants.

5) It gives the complete picture of the financial conditions of the business unit.

Book Keeping

1) It is the recording phase of an accounting system.

2) It is a primary stage and basis for accounting.

3) It is routine in nature and does not require any special skill or knowledge

4) It is done by junior staff called bookkeepers

5) It does not give the complete picture of the financial conditions of the business unit.

➢ Types of accounting information Accounting information can be categorized into following:

1) Information relating to profit or loss i.e. income statement, shows the net profit of business operations of a firm during a particular accounting period.

2) Information relating to Financial position i.e. Balance Sheet. It shows assets on one side and Capital & Liabilities on the other side. Schedules and notes forming part of balance sheet and income statement to give details of various items shown in both of them.

➢ Subfields/Branches of Accounting 1) Financial Accounting: It is that subfield/Branch of accounting which is concerned with recording of business transactions of financial nature in a systematic manner, to ascertain the profit or loss of the accounting period and to present the financial position of the business.

2) Cost Accounting: It is that Subfield/Branch of accounting which is concerned with ascertainment of total cost and per unit cost of goods or services produced/ provided by a business firm.

3) Management Accounting: It is that subfield/Branch of accounting which is concerned with presenting the accounting information in such a manner that help the management in planning and controlling the operations of a business and in better decision making.

➢ Qualitative Characteristics of Accounting Information Accounting information is useful for interested users only if it poses the following characteristics:

1) Reliability: Means the information must be based on facts and be verified through source documents by anyone. It must be free from bias and errors.

2) Relevance: To be relevant, information must be available in time and must influence the decisions of users by helping them to form prediction about the outcomes.

3) Understandability: The information should be presented in such a manner that users can understand it well.

4) Comparability: The information should be disclosed in such a manner that it can be compared with previous year's figures of business itself and other firm's data.

➢ Assets Assets are valuable and economic resources of an enterprise useful in its operations. Assets can be broadly classified as:

1) Current Assets: Current Assets are those assets which are held for short period and can be converted into cash within one year. For example: Debtors, stock etc.

2) Non-Current Assets: Non-Current Assets are those assets which are hold for long period and used for normal business operation. For example: Land, Building, Machinery etc. They are further classified into:

a) Tangible Assets: Tangible Assets are those assets which have physical existence and can be seen and touched. For Example: Furniture, Machinery etc.

b) Intangible Assets: Intangible Assets are those assets which have no physical existence and can be felt by operation. For example: Goodwill, Patent, Trade mark etc.

➢ Liabilities Liabilities are obligations or debts that an enterprise has to pay after some time in the future. Liabilities can be classified as:

1) Current Liabilities: Current Liabilities are obligations or debts that are payable within a period of one year. For Example: Creditors, Bill Payable etc.

2) Non-Current Liabilities: Non-Current Liabilities are those obligations or debts that are payable after a period of one year. Example: Bank Loan, Debentures etc.

➢ Receipts A written acknowledgment of having received, or taken into one's possession, a specified amount of money, goods, etc. receipts, the amount or quantity received. the act of receiving or the state of being received. Receipts can be classified as:

1) Revenue Receipts: Revenue Receipts are those receipts which are occurred by normal operation of business like money received by sale of business products.

2) Capital Receipts: Capital Receipts are those receipts which are occurred by other than business operations like money received by sale of fixed assets.

➢ Expenses Costs incurred by a business for earning revenue are known as expenses. For example: Rent, Wages, Salaries, Interest etc.

➢ Expenditure Spending money or incurring a liability for acquiring assets, goods or services is called expenditure. The expenditure is classified as:

1) Revenue Expenditure: It is the amount spent to purchase goods and services that are used during an accounting period is called revenue expenditure. For Example: Rent, interest, etc.

2) Capital Expenditure: If benefit of expenditure is received for more than one year, it is called capital expenditure. Example: Purchase of Machinery.

3) Deferred Revenue Expenditure: There are certain expenditures which are revenue in nature but benefit of which is derived over number of years. For Example: Huge Advertisement Expenditure.

➢ Business Transaction An Economic activity that affects financial position of the business and can be measured in terms of money e.g., expenses etc.

➢ Account Account refers to a summarized record of relevant transactions of particular head at one place. All accounts are divided into two sides. The left side of an account is called debit side and the right side of an account is called credit side.

➢ Capital Amount invested by the owner in the firm is known as capital. It may be brought in the form of cash or assets by the owner.

➢ Drawings The money or goods or both withdrawn by owner from business for personal use, is known as drawings. Example: Purchase of car for wife by withdrawing money from business.

➢ Profit The excess of revenues over its related expenses during an accounting year is profit. Profit = Revenue – Expenses.

➢ Gain A non-recurring profit from events or transactions incidental to business such as sale of fixed assets, appreciation in the value of an asset etc.

➢ Loss The excess of expenses of a period over its related revenues is termed as loss. Loss = Expenses – Revenue.

➢ Goods The products in which the business deal in. The items that are purchased for the purpose of resale and not for use in the business are called goods.

➢ Purchases The term purchased is used only for the goods procured by a business for resale. In case of trading concerns it is purchase of final goods and in manufacturing concern it is purchase of raw materials. Purchases may be cash purchases or credit purchases.

➢ Purchase Return When purchased goods are returned to the suppliers, these are known as purchase return.

➢ Sales Sales are total revenues from goods sold or services provided to customers. Sales may be cash sales or credit sales.

➢ Sales Return When sold goods are returned from customer due to any reason is known as sales return.

➢ Debtors Debtors are persons and/or other entities to whom business has sold goods and services on credit and amount has not received yet. These are assets of the business.

➢ Creditors If the business buys goods/services on credit and amount is still to be paid to the persons and/or other entities, these are called creditors. These are liabilities for the business.

➢ Bill Receivable Bill Receivable is an accounting term of Bill of Exchange. A Bill of Exchange is Bill Receivable for seller at time of credit sale.

➢ Bill Payable Bill Payable is also an accounting term of Bill of Exchange. A Bill of Exchange is Bill Payable for purchaser at time of credit purchase.

➢ Discount Discount is the rebate given by the seller to the buyer. It can be classified as: 1) Trade Discount: The purpose of this discount is to persuade the buyer to buy more goods. It is offered at an agreed percentage of list price at the time of selling goods. This discount is not recorded in the accounting books as it is deducted in the invoice/cash memo.

2) Cash Discount: The objective of providing cash discount is to encourage the debtors to pay the dues promptly. This discount is recorded in the accounting books.

➢ Income Income is a wider term, which includes profit also. Income means increase in the wealth of the enterprise over a period of time.

➢ Stock The goods available with the business for sale on a particular date is known as stock.

➢ Cost Cost refers to expenditures incurred in acquiring manufacturing and processing goods to make it saleable.

➢ Voucher The documentary evidence in support of a transaction is known as voucher. For example, if we buy goods for cash we get cash memo, if we buy goods on credit, we get an invoice, when we make a payment we get a receipt.

➢ Double Entry System of Book-keeping Double Entry System of Book-keeping refers to a system of accounting under which both the aspects (i.e. debit or credit) of every transaction are recorded in the accounts involved. The individual record of person or thing or an item of income or an expense is called an account. Every debit has equal amount of credit. So the total of all debits must be equal to the total of all credits.