Revision Notes

Chapter-1 Introduction to Accounting

Learning Objectives:

After studying this chapter, you should be able to understand:

- Meaning of Accounting
- Accountancy, Accounting and Book-keeping
- Relationship between Accountancy, Accounting and Book-keeping
- Distinguish between Book-keeping and Accounting
- Users of Accounting information
- Advantages and limitations of Accounting.
- Basic Accounting terms
- Double Entry System of Book-keeping

Introduction

According to American Institute of Certified Public Accountants, “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.”

Accounting Principles Board (APB) of AICPA (U.S.A) defined accounting as “Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions.”

In Simple words, accounting is the process of collecting, recording, classifying, summarising and communicating financial information to the users for judgment and decision-making.

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 help owners to compare one year's results with those of other years to locate the factors which leads to changes.
3. It provide 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 help 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 help 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, customers 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.

Book keeping	Accounting
1. It is the recording phase of an accounting system.	1. It is the summarizing phase of an accounting system.
2. It is a primary stage and basis for accounting.	2. It is a Secondary Stage which begins where the Book keeping process ends.
3. It is routine in nature and does not require any special skill or knowledge	3. It is analytical in nature and required special skill or knowledge.
4. It is done by junior staff called book-keepers	4. It is done by senior staff called accountants.
5. It does not give the complete picture of the financial conditions of the business unit.	5. It gives 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.

3. 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.

Interested users/parties of Accountings information's and their Needs
There arenumber of users interested in knowing about the financial soundness and the profitability of the business.

Users	Classification	Information the user want
Internal	1. Owner	Return on their investment, financial health of their company/business.
	2. Management	To evaluate the performance to take various decisions.
External	1. Investors and potential investors	Safety and growth of their investments, future of the business.
	2. Creditors	Assessing the financial capability, ability of the business to pay its debts.
	3. Lenders	Repaying capacity, credit worthiness.
	4. Tax Authorities	Assessment of due taxes, true and fair disclosure of accounting information.
	5. Employees	Profitability to claim higher wages and bonus, whether

		their dues (PF, ESI, etc.) deposited regularly.
	6. Others	Customers, Researchers etc., may seek different information for different reasons.

Qualitative Characteristics of Accounting Information

Accounting information is useful for interested users only if it posses 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.

Basic accounting terms

Business Transaction

An Economic activity that affects financial position of the business and can be measured in terms of money e.g., purchase of goods for use in business.

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.

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

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**: If the benefit of expenditure is received within a year, it 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.

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 purchases 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.

Account : Account refers to a summarised record of relevant transaction of particular head at one place.

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.

Goods and Service Tax (GST) : GST is an indirect tax which is levied on the supply of goods and service.