INTRODUCTION TO ACCOUNTING

Meaning and Definition :

Accounting may be defined as **Sciences** well as an **Art** of recording pecuniary transaction (transaction relating to money or money's worth) of a business in a set of books in a regular and systematic manner. It is also called science as it is based on certain principles and the accounting is based on 'principles so it is called science.

It is called Art because it has to written in particular Performa's and has to be written systematically so it is called both 'Science and Art'. Thus

''Accounting can be define as an art of recording ,classifying and summarising in a significant manner and in terms of money, transaction and events which are ,in part at least ,of a financial character, and interpreting the results thereof.'' **–By American Institute of certified Public accountants.**

Objectives and Functions:

1. **To keep systematic record of business transaction**:-The main objective of a accounting is to keep complete record of business transaction helps to avoid the possibility of omission and frauds, for this purpose all the business transaction are first of all recorded in journal or subsidiary books and then posted into ledger.
2. **To calculate Profit &Loss:** The second main objective of accounting is to ascertain the net profit earned or loss suffered on account of business transaction during a particular period. For this purpose trading and profit and loss account of the business is prepared at the end of each accounting period .If the amount of revenue exceeds the expenditure incurred in earning that revenue ,there is said in to be a profit. In case the expenditure exceeds the revenue, there is said to be loss.
3. **To Ascertain the financial position of the business:** The business man must also know the financial health of the business .For this purpose ,after preparing the profit & loss account a statement called balance sheets is prepared which shows the assets and their values on the one hand and the liabilities and capital on the other hand. A balance sheet is actually a screen picture of the financial position of the business. At one glance one would know the following by looking at the balance sheet:
   - How much the business has to recover from debtors?
   - How much the business has to pay to creditors?
   - How much the business has in the form of (Cash in hand, Cash in bank, closing stock and fixed assets?
4. **To provide information to various parties:** Another main objective is to communicate the accounting information to various interested parties owner, investors, creditors, banks employees and government authorities etc. The information helps them in taking sound and judicious decision about the business entity.

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Advantage:

Accounting offers the following advantage:

1. **Helpful in management of business:** Management needs a lot of information for the efficient running of the business. All such information is provided by the accounting which helps the management in the following:-
   A. Helpful in planning.
   B. Helpful in decision making.
   C. Helpful in controlling.
2. **Provide complete and systematic record:** Business transaction has grown in sizes and complexity and it is not possible to remember each and every transaction. Accounting keeps a prompt and systematic record of all the transaction and summarizes them in order to provide a true picture of the activities of the business entity.
3. **Information regarding profit & loss:** Accounting reports the net result of business activities of an accounting period .The profit & loss account prepared at the end of each accounting period discloses the net profit earned or loss suffered during that period. The information regarding profit is of great use to the owners and various other interested parties.
4. **Information regarding financial position:** Accounting reports the financial position of the business by preparing a balance sheet at the end of each accounting period. Balance sheet discloses the position of assets and their values on the one hand and liabilities and capital on the other hand.
5. **Enable comparative study:** By keeping a systematic record helps the owners to compare one year's costs, expenses, sales and profit etc. with those of the other year. Such a comparison provides useful information on the basis of which important decision can be taken more judiously.
6. **Helpful in Assessment of tax liability:** Properly maintain records will be of great help when the firm is assessed to income tax or sales tax. Such records when audited are trusted by the taxation authorities.
7. **Evidence in legal matters:** Properly maintain accounts, supported by authenticated documents are accepted by the courts as firm evidence.
8. **Facilitates sale of business:** If a business entity is being sold the accounting information an be utilised to determine the proper purchase price.
9. **Helpful in raising loans:** Accounting information is of great help while raising loans from banks or other financial institution .Such institution before sanctioning loan screen various financial statement of the firm as final account, fund flow statement, cash flow statement etc.

Limitation:

1. **Influence by personal judgement:** Different persons are bound to have different opinion in respect of such things and hence it will result in ascertainment of different figure of profit or loss of business by different persons. Hence the figure of profit cannot be taken as an exact figure. E.g. it is extremely difficult to predict with any degree of accuracy the actual use life of assets which is needed for calculating depreciation.
2. **Based on accounting concepts and convention:** Accounts are prepared on the basis of a number of accounting concepts and convention. Hence the profitability and the financial position disclosed by it may not be realistic.

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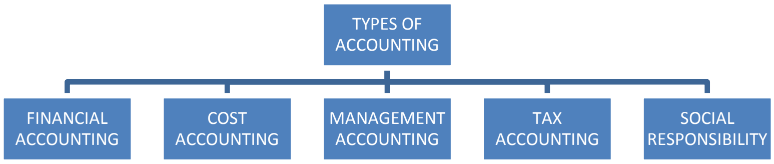
3. **Incomplete information:** Accounting statements provide only the incomplete information because the actual profit or loss of a business can be known only when the business is closed down.
4. **Omissions of qualitative information:** Accounts contain only that information which can be expressed in terms of money .Qualitative aspect of business units omitted from the books at all, as these cannot be expressed in monetary terms.
5. **Based on historical cost:** Accounts are prepared on the basis of the historical costs (i.e. the original costs) and as such the figures given in financial statement do not show the effect of change in price level.
6. **Affect by window dressing:** Window dressing refers to the practice of manipulating accounts, so that the financial statement may disclose a more favourable position than the actual position.eg the purchase made at the end of the year may not be recorded or the closing stock may be overvalued. Hence, correct decision cannot be taken on the basis of such financial statement.
7. **Unsuitable for forecasting:** Financial accounts are only a record of past events. Continuous changes take place in the demand of the product, policies adopted by the firms, the position of competition etc. As such financial analysis based on past events may not be much use for forecasting.

Types and Classification :



TYPES OF ACCOUNTS:

1) **Financial Accounting:** The main purpose of this branch of accounting is to record the business transaction in a systematic manner, to ascertain the profit or loss of the accounting by preparing a profit and loss account and to present the financial position of the business by preparing a balance sheet. This branch of accounting provides information required by the management and various interested parties
2) **Cost Accounting:** The main purpose of cost accounting is to ascertain the total cost and per unit cost of goods produced and serviced rendered by a business .It also estimates the cost in advance and helps the management in exercising strict control over cost.
3) **Management Accounting:** The main purpose of management accounting is to present the accounting information in such a way as to assist the management in planning and controlling the operation of a business. The management accountant uses various techniques and concepts to make the accounting data more useful for managerial decision making .These techniques include ratio analysis budgetary control, fund flow statement, cash flow statement.
4) **Tax Accounting:** The branch of accounting which is used for tax purpose is called Tax accounting. Income tax and sales tax are computed on the basis of this accounting.

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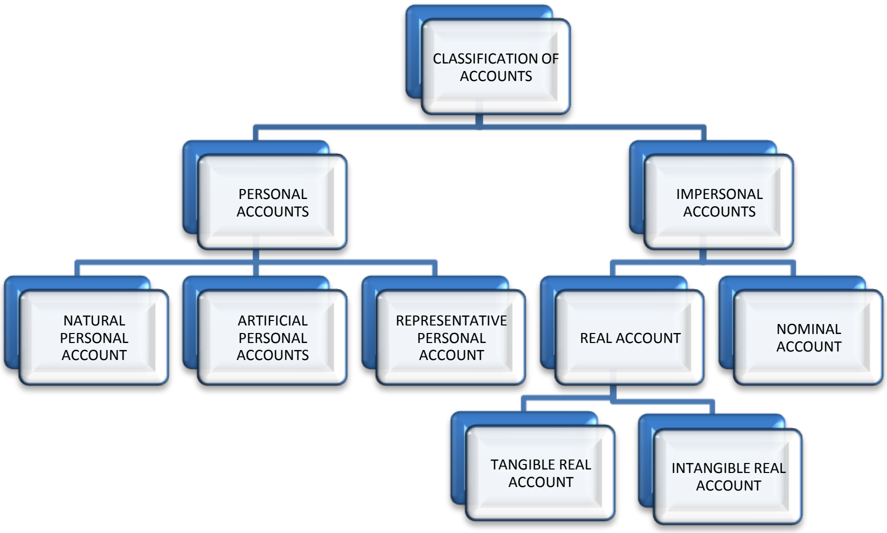
5) **Social Responsibility Accounting:** The society provides the infra structure and the facilities without which business cannot operate at all .Hence the business also has a responsibility to the society.

CLASSIFICATION OF ACCOUNTS:



I. **PERSONAL ACCOUNTS:** The accounts which relate to an individual, firm, company or an institution are called personal accounts.**eg.** Account of Mohan, Account of DCM limited, Account of Delhi University, Bank account, Capital account of proprietor, Drawings of proprietor etc.
RULE: "Debit the Receiver, Credit the Giver".
E.g. Paid Rs 1000 to Hari.
Object: To ascertain as to how much amount a personal account owes to the business.

1. **Natural Personal Accounts**: Account of Natural Person means accounts of Human Beings. **E.g.** Mohan's account, Sohan's account, Proprietor's capital accounts, Proprietor's Drawing account.
2. **Artificial Personal Accounts:** These accounts do not have physical existence as human beings but they work as personal accounts .The person created by law is called legal or artificial personal. **E.g.** any firm accounts, any limited companies account, any institution's accounts and any banks accounts.
3. **Representative Personal Accounts:** When an account represents a particular person or group of persons, it is termed as representative personal accounts. **E.g.** if the salaries for the month of December are not paid to the employees ,the amount payable to these employees will be added and put under one common title. Salaries Outstanding Accounts: these account represents the account of all the persons to whom salaries have to be paid.

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Prepaid Insurance account (Prepaid insurance is the portion of an insurance premium that has been paid in advance and has not expired as of the date of the balance sheet.)
Accrued Interest Account (Accrued interest is the amount of loan interest that has already occurred, but has not yet been paid to the lender by the borrower)
Unearned Commission Account. (The commission which is outstanding the service for which you have been paid but you haven't rendered yet!!)

II. **IMPERSONAL ACCOUNTS:** When the transaction recording does not affect particular persons but affect business is known as impersonal accounts. It can be Real or Nominal Account.

1. **Real Account:** The account of all those things whose value can be measured in terms of money and which are the properties of the business are termed as Real Accounts.
   E.g. Cash Account, Furniture Account, Machinery Account, Building Account, Goodwill Account etc. **RULE:** "**Debit What Comes In, Credit What Goes Out"**
   E.g. Furniture for Rs 5000 has been purchased for cash.
   Object: This account represents the value of various properties owned by a business in terms of money.
   A. **Tangible Real Account:** Tangible real accounts are the accounts of those things which can be touched, felt, measured, purchased, sold etc. **E.g.** Cash account, Stock account, Furniture account, Land Account, Building Account.
   B. **Intangible Real Account:** Intangible Real Account is account which cannot be touched but of course their value can be measured in terms of money. **E.g.** Goodwill account, Patents accounts, Trade market Account, Copyrights accounts.
2. **Nominal Account:** These accounts include the accounts of all Expenses and Losses and Income and Gains.
   RULE: "Debit all Expenses & losses, Credit all Income & Gains".
   E.g. (Relating to Expenses**):** Salaries Paid, Rent Paid, Discount allowed, Bad Debts etc.
   (Relating to Incomes**):** Commission Received, Interest Received, Discount Received
   Object: These accounts are opened simply to explain the nature of need for which cash has been paid. It provides information regarding the following.
   - Amount spent on various heads in a particular period.
   - Income received on various heads in a particular period.

Principles of accounting:

The principles can be classified mainly into three categories:

1) **Basic assumption or concepts:** These assumptions provide a foundation for accounting process .No enterprises can prepare its financial statement without considering these basic assumption or concepts. On the basis of this basic assumption, accounting profession has developed principles that guide how transaction should be recorded and reported. Following may be treated as basic assumption or concepts.

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A. **Business entity assumption**: According to this assumption, the accounting for a business or organization is kept separate from the personal affairs of its owner, or from any other business or organization. This means that the owner of a business should not place any personal assets on the business balance sheet. The balance sheet of the business must reflect the financial position of the business alone. Also, when transactions of the business are recorded, any personal expenditures of the owner are charged to the owner and are not allowed to affect the operating results of the business.

B) **Money measurement assumption**: Only those transaction and events are recorded in accountancy which is capable of being expressed in terms of money.

C) **Going concern concept:** As per this assumption it is assumed that the business will continue to exist for a long period in the future. The transaction is recorded in the books of the business on the assumption that it is a continuing enterprise. It is on this assumption that that we recorded fixed assets at their original cost and depreciation is charged on their assets without reference to their market value.

2) **Basic principle:** On the basis of the assumption discussed above, certain principles have been developed that guide how transaction should be recorded and reported. These basic accounting principles are as follows.

   A. **Duality Principle:** According to this principles, every business transaction is recorded as having a dual aspect in other words, every affects at least two accounts. If one account is debited, any other account must be credited .The system of recording transaction based on this principle is called a ''Double entry system.''
   Assets=Liabilities +Capital
   B. **Verifiability and objectivity of evidence principle:** The principle means that all accounting transaction that are recorded in the books of account should be evidenced and supported by business document are cash memos, invoice, vouchers etc.
   C. **Historical cost Principles:** According to this principles an assets is ordinarily recorded in the books of account at the price at which it was acquired.
   D. **Principle of full discloser:** The principle requires that all significant information relating to the economic affairs of the enterprise should be complete disclosed.

3) **Modifying Principles**: There are certain accounting principles which can be slightly modified by different accountant according to the situation and requirements of the business. This is done in order to make the financial statement more relevant and reliable. These principles are as follows:

   A. **Principle of Timeliness:** The principle requires that the financial statement should be prepared quickly at the end of the accounting period and made external users at the earliest possible time.

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B. **Principle of Materiality: This** principle is an exception to the principles of full discloser. As such it is termed as modifying principles. According to these principles, items having an insignificant effect or being irrelevant to the users need not be disclosed. These unimportant items are either left out or merged with other items, otherwise accounting statement will be unnecessarily overburdened.

C. **Principle of consistency:** This principle states that accounting principle and methods should remain consistent from one year to another. These should not be changed from year to year.

D. **Principle of conservatism:** According to this principle, all anticipated losses should be recorded in the books of accounts, but all anticipated or unrealized gains should be ignored.

Systems of accounting :

The systems of recording transaction in the books of accounts are two types.

1 Double Entry System **2 Single Entry System**

1 **Double Entry System:** Double entry is an almost universally used system of business record keeping. It is a system of recording business transaction which recognises that each transaction has a dual aspect. It is so named because the principle of double entry book keeping are based upon every transaction having two aspect or two parts, i.e. two account are always affected by each transaction. Under this system, each transaction is seen as a flow of value from one account to another. The receiving account is debited with the amount and the giving account is credited. Therefore, every debit has an equal and offsetting credit.

If only two accounts are affected (as in the purchase of building for cash), one account, building is debited and the other account, cash is credit for the same amount. If more than two accounts are affected by a transaction, the sum of the debit entries must be equal to the sum of the credit entries.

It is therefore, necessary to decide for each transaction, the following:

a) Which are the two accounts involved ,and
b) Whether the entries to those accounts are debit or credit.

Applying the principles of double entry will result in the amount being debited to an account being equal to the amount being credited to another account. The rule of double entry system can be explained in terms of the basic accountings equation. **Liabilities + Capital = Assets.**

2 Single Entry System: Single Entry system of recording transaction in the books of accounts may be defined as an incomplete Double Entry System, In this system, all transaction are not recorded on double entry basis. As regards some transaction ,both aspect of the transaction are recorded , as regards others , either one aspect is recorded or not recorded at all. Instead of maintaining all the accounts ,only Personal Accounts and Cash Book are maintained under this system. The account maintained under this system are incomplete and unsystematic and , therefore. not reliable. The single entry system also known as **Accounts From Incomplete Records.**

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Generally Accepted Accounting Principles (GAAP) :

GAAP (stands for "generally accepted accounting principles," a collection of commonly followed accounting rules and standards for financial reporting.

The purpose of GAAP is to ensure that financial reporting is transparent and consistent from one organization to another.

In the present days no business can remain secretive because various people such as investors ,public employees ,creditors, shareholders ,government organisation, directors etc are interested to know the affairs of the business .It is necessary for accountant to develop some concepts which are regarded as fundamental of accounting. Thus the need for GAAP arises for two reasons, to be logical and consistent in recording the transaction and to confirm to the established practice and procedures.

Four Generally Accepted Accounting Principles.

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