INTRODUCTION TO ACCOUNTING

Meaning & Definition of Accounting

Accounting is an information system which receives data inputs, process the same and give its output in the form of information which is useful for decision making. Accounting is also called the language of business.

American Institute of Certified Public Accountants (AICPA) defines "accounting is an art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are in part, at least, of a financial character and interpreting results thereof."

Thus, **accounting is the art of recording, classifying, summarizing, analyzing and interpreting the financial transactions and communicating the results to the interested persons.**

Father of Accounting: Luca Pacioli (Italian Mathematician)

Features of Accounting

1. **Economic events –** It means the business transactions. It may be external or internal:
   a. **External event -** Transfer of something of value between two or more entities. Examples: Payment of wages to employees, Purchase of goods from a supplier, Sale of goods to a customer, Receipt of income by way of commission etc.
   b. **Internal event –** It is an economic event takes place within the organization. Examples: Issue of raw materials from stores to production department, Supply of stationery items to the office, Return of raw materials from production department to stores etc.
2. **Identification, measurement, recording and communication**
   a. **Identification –** It involves the identification of events that are to be recorded in the books. It implies observing and selecting the events that may be recorded.
   b. **Measurement -** Transactions that can be measured in terms of money are only recorded. Eg., Sale of goods, Purchase of goods, Purchase of Machinery etc.
   c. **Recording –** After identification and measurement of economic events, they are recorded in a chronological order.
   d. **Communication –** After the above three stages, the accounting information has to be communicated in a proper form to the management or other users in the form of reports like profit and loss account, balance sheet etc.
3. **Organisation –** It means an entity that stands for performing business activities either for profit or for not-for-profit. It can be a sole proprietorship, partnership, co-operative society, company, Municipal Corporation or any other association of persons.
4. **Interested users of Accounting Information –** Many users need financial information for decision making purposes. These users can be divided into two categories:

   a. Internal Users: It includes Chief Executive, Financial Officer, Vice President, Business Unit Managers, Plant Managers, Store Managers, Line Supervisors, etc.

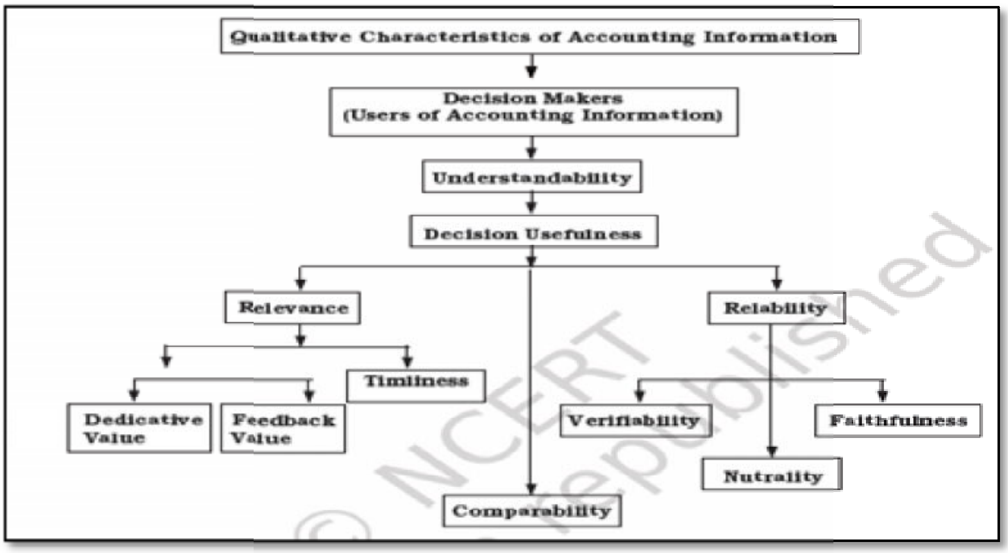
b. External Users: It may include, the present and potential investors (shareholders), Creditors (Banks and other Financial Institutions, Debenture holders and other lenders), Tax Authorities, Regulatory Agencies (Department of Company Affairs, Registrar of Companies, Securities Exchange Board of India), Labour Unions, Trade Associations, Stock Exchanges, Customers etc

Types of accounting information / Branches of Accounting / Accounting Disciplines

1. **Financial Accounting –** It is the original form of accounting, which is used to find out the results of operations (success or failure) and to provide information about the financial position (soundness or weakness) of the business. It is relates to the past period and is expressed in monetary terms.
2. **Management Accounting –** It is concerned with accounting information that is useful to management for decision making. Unlike financial accounting, which produces annual reports mainly for external users, management accounting generates weekly or monthly reports for an organisation's internal users such as departmental managers, chief executive officers etc. It may include the reports of available cash, monthly sales, amount of orders in hand, state of accounts payable and receivables, stock of raw materials etc.
3. **Cost Accounting –** It is the process of accounting for cost, by which costs of products or services are ascertained and controlled.

Qualitative characteristics of accounting information – In order to ensure the objectivity in reporting and validity in the system, accounting information must possess certain qualitative characteristics as shown below:-

1. **Reliability –** Accounting information is considered to be reliable if it is free from bias and faithfully represents the facts.
2. **Relevance –** The information to be relevant, it must be available in time.
3. **Understandability –** It must be understood by those to whom it is communicated.
4. **Comparability –** It means that the accounting reports should be comparable with other firms to identify similarities or differences. To achieve this, the period, the format, unit of measurement etc. should be the same.



Objectives of Accounting

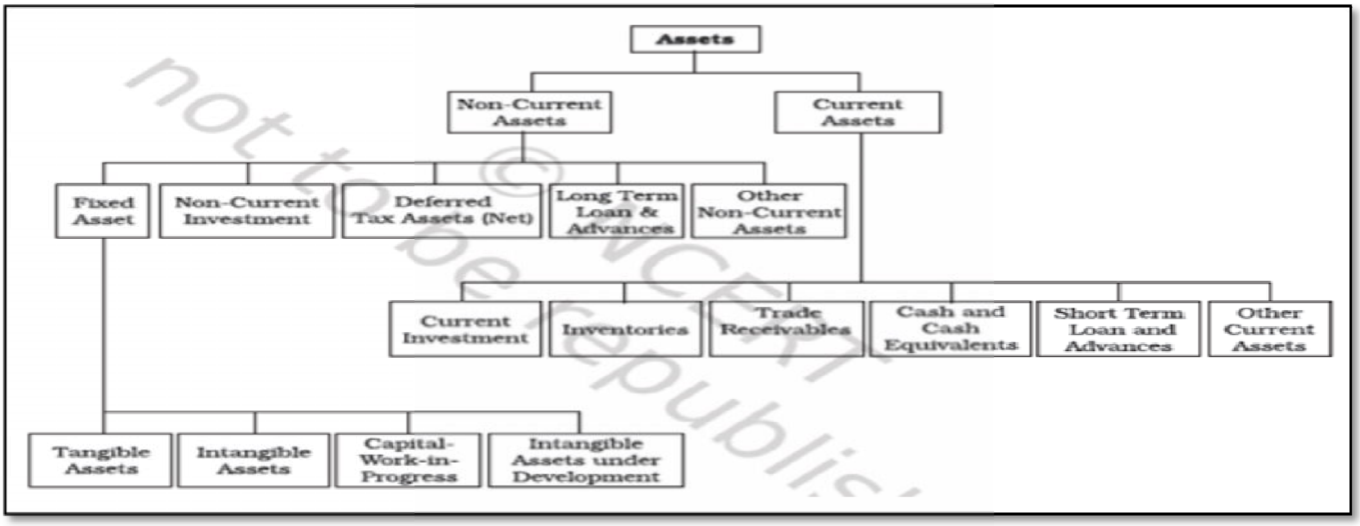
1. **To maintain business records –** Business managers cannot remember every transaction or event that has taken place in their business, hence it is to be recorded, which will be helpful in taking decisions and to find out errors if any in future.
2. **Calculation of profit or loss –** Accounting helps in ascertaining profit or loss to the enterprise by preparing a profit and loss account.
3. **Ascertainment of financial position –** It implied the financial strength of the business in term of assets and liabilities and it is revealed by preparing a balance sheet.
4. **Providing information to users –** The accounting information obtained from records should be communicated to interested parties like owners, creditors, bankers, government, employees etc.

Role of Accounting

Accounting as an information system collects and communicates economic information about an enterprise to a wide variety of interested parties. However, accounting information relates to the past transactions and is quantitative and financial in nature, it does not provide qualitative and non-financial information. These limitations of accounting must be kept in view while making use of the accounting information.

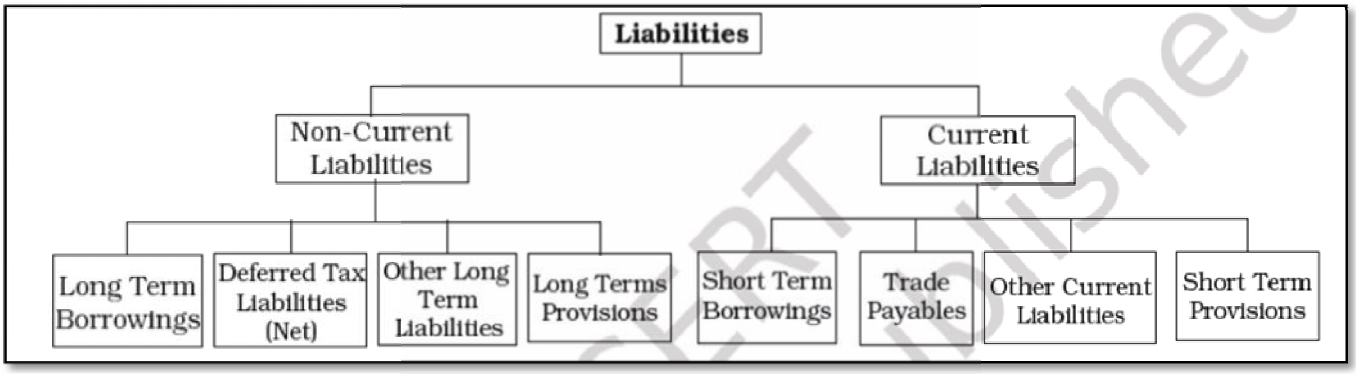
Basic Accounting Terms

1. **Entity –** Entity means a reality that has a definite individual existence. Business entity means a specifically identifiable business enterprise like Super Bazaar, Jewellers, ITC Limited, etc. An accounting system is always devised for a specific business entity (also called accounting entity).
2. **Transaction –** The dealing of a businessman with an external party which can be expressed in monitory terms is called business transactions. In other words, all economic events in a business organization is known as transactions.
3. **Assets –** These are the economic resources or material things or properties of the business including the amounts due from others which can be expressed in monetary terms. It can be broadly classified into two, current assets and non-current assets.



4. **Liabilities –** Liabilities are the obligations which an enterprise owes. It represents the amount payable by the business in future. Liabilities are classified as current and non-current. Eg: Creditors, Bank Loan etc.

Distinction between current and non-current items: 1. Current assets or liabilities are involved in operating cycle. 2. Current assets or liabilities are realised/settled within 12 months. 3. Current items are primarily for trading. 4. Current items are cash or cash equivalent.



5. **Capital –** It is the investment made by the owners for use in the business. It is also called owner's equity.
6. **Sales –** It represents total revenue earned by a business through sale of goods or services to customers. It includes cash sales and credit sales.
7. **Revenues (Income) –** It represents the amount a business earns through the sale of its products or providing services to customers. It also includes earnings like interest received, dividend received, rent received, commission received, discount received etc.
8. **Expenses –** It represents the amount spent to earn revenue. Eg; rent, wages, salaries etc.

9. **Expenditure –** Spending money or incurring a liability for some benefit, service or property received is called expenditure. Purchase of goods, purchase of machinery, purchase of furniture, etc. are examples of expenditure. If the benefit of expenditure is exhausted within a year, it is treated as an expense (also called revenue expenditure). On the other hand, the benefit of expenditure lasts for more than a year; it is treated as an asset (also called capital expenditure) such as purchase of machinery, furniture, etc.
10. **Profit –** It is the excess of revenue over expenses in an accounting year and represents increase in capital.
11. **Gain -** A profit that arises from events or transactions which are incidental to business such as sale of fixed assets, winning a court case, appreciation in the value of an asset etc.
12. **Loss –** It is the excess of expenses over revenue in an accounting year and represents reduction in owners' equity or capital investment.
13. **Discount –** Discount is the deduction in the price of the goods sold. It may be of two types; trade discount and cash discount. Trade discount is the deduction of price at the time of selling goods, whereas cash discount means a deduction in the amount payable by a debtor within a stipulated period.

14. **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 on credit, we get an invoice; when we make a payment we get a receipt and so on.
15. **Goods –** It refers to commodities, products, articles or things in which a trader deals. They refer to commodities which are purchased and are meant for resale. For stationary merchant, stationary articles like pen, pencil books etc. are his goods but for other business, it is an expense. Likewise, for a furniture dealer, furniture items like tables, chairs etc. are his goods, but for others it is an asset. They also include commodities purchased for manufacture and sale. In accounting they are called by different name, such as purchases, sales, purchases returns, sales returns and stock.
16. **Drawings –** It represents the amount of cash or other assets withdrawn by the owner for his personal use.
17. **Purchases –** It is an expense incurred for procurement of **goods** in a business. It includes both cash purchase and credit purchase.
18. **Stock –** It represents the unsold goods at the end of accounting year. It includes unsold goods, raw materials, semi finished goods etc. Stock is also called **inventory**. Inventory at the end of the accounting year is called **closing stock**, while the same at the beginning of the year is called **opening stock**.
19. **Debtors / Accounts receivable –** A **debtor** is a person who owes money to the business as he has received some benefit from the business. The amounts due from different persons are totaled on the close of the accounting period and are shown under the heading **Sundry Debtors or Accounts Receivable** on the asset side of the balance sheet.
20. **Creditors / Accounts payable –** A **creditor** is a person to whom the business owes money as he has given some benefit to the business. The amounts due to various persons are totaled on the close of the accounting period and are shown under the head **Sundry Creditors or Accounts Payable** on the liability side of the balance sheet.

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