ACCOUNTING SCOPE DEFINITIONS AND CONCEPT

Notes

LESSON 1 INTRODUCTION TO ACCOUNTING

Contents

1.0 AIMS AND OBJECTIVES

i) To know the Meaning ,Definition and objective of Book- Keeping

ii) To study the objectives, functions, importance and limitations of Accounting

iii) To understand the methods of Accounting, kinds of Accounts and Accounting rules.

iv) To study the difference between Book- keeping and Accounting

v) To study the various branches of Accounting

1.1 INTRODUCTION

In all activities (whether business activities or non-business activities) and in all organizations (whether business organizations like a manufacturing entity or trading entity or non-business organizations like schools, colleges, hospitals, libraries, clubs, temples, political parties) which require money and other economic resources, accounting is required to account for these resources. In other words, wherever money is involved, accounting is required to account for it. Accounting is often called the language of business. The basic function of any language is to serve as a means of communication. Accounting also serves this function.

1.2. MEANING AND DEFINITION OF BOOK- KEEPING

1.2.1 Meaning

Book- keeping includes recording of journal, posting in ledgers and balancing of accounts. All the records before the preparation of trail balance is the whole subject matter of book- keeping. Thus, book- keeping many be defined as the science and art of recording transactions in money or money's worth so accurately and systematically, in a certain set of books, regularly that the true state of businessman's affairs can be correctly ascertained. Here it is important to note that only those transactions related to business are recorded which can be expressed in terms of money.

1.2.2 Definition

"Book- keeping is the art of recording business transactions in a systematic manner". A.H.Rosenkamph.

"Book- keeping is the science and art of correctly recording in books of account all those business transactions that result in the transfer of money or money's worth". R.N.Carter

1.2.3 Objectives of Book- keeping

i) Book- keeping provides a permanent record of each transactions.

ii) Soundness of a firm can be assessed from the records of assets and abilities on a particular date.

iii) Entries related to incomes and expenditures of a concern facilitate to know the profit and loss for a given period.

iv) It enables to prepare a list of customers and suppliers to ascertain the amount to be received or paid.

v) It is a method gives opportunities to review the business policies in the light of the past records.

vi) Amendment of business laws, provision of licenses, assessment of taxes etc., are based on records.

1.3 ACCOUNTING

1.3.1 Meaning of Accounting

Accounting, as an information system is the process of identifying, measuring and communicating the economic information of an organization to its users who need the information for decision making. It identifies transactions and events of a specific entity. A transaction is an exchange in which each participant receives or sacrifices value (e.g. purchase of raw material). An event (whether internal or external) is a happening of consequence to an entity (e.g. use of raw material for production). An entity means an economic unit that performs economic activities.

1.3.2 Definition of Accounting

American Institute of Certified Public Accountants (AICPA) which defines accounting as "the 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 the results thereof".

1.3.3 Objective of Accounting

Objective of accounting may differ from business to business depending upon their specific requirements. However, the following are the general objectives of accounting.

i) To keeping systematic record: It is very difficult to remember all the business transactions that take place. Accounting serves this purpose of record keeping by promptly recording all the business transactions in the books of account.

ii) To ascertain the results of the operation: Accounting helps in ascertaining result i.e., profit earned or loss suffered in business during a particular period. For this purpose, a business entity prepares either a Trading and Profit and Loss account or an Income and Expenditure account which shows the profit or loss of the business by matching the items of revenue and expenditure of the some period.

iii) To ascertain the financial position of the business: In addition to profit, a businessman must know his financial position i.e., availability of cash, position of assets and liabilities etc. This helps the businessman to know his financial strength. Financial statements are barometers of health of a business entity.

iv) To portray the liquidity position: Financial reporting should provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, cash dividends and other distributions of resources by the enterprise to owners and about other factors that may affect an enterprise's liquidity and solvency.

v) To protect business properties: Accounting provides upto date information about the various assets that the firm possesses and the liabilities the firm owes, so that nobody can claim a payment which is not due to him.

vi) To facilitate rational decision – making: Accounting records and financial statements provide financial information which help the business in making rational decisions about the steps to be taken in respect of various aspects of business.

vii) To satisfy the requirements of law: Entities such as companies, societies, public trusts are compulsorily required to maintain accounts as per the law governing their operations such as the Companies Act, Societies Act, and Public Trust Act etc. Maintenance of accounts is also compulsory under the Sales Tax Act and Income Tax Act.

1.3.4 Importance of Accounting

i) Owners: The owners provide funds or capital for the organization. They possess curiosity in knowing whether the business is being conducted on sound lines or not and whether the capital is being employed properly or not. Owners, being businessmen, always keep an eye on the returns from the investment. Comparing the accounts of various years helps in getting good pieces of information.

ii) Management: The management of the business is greatly interested in knowing the position of the firm. The accounts are the basis, the management can study the merits and demerits of the business activity. Thus, the management is interested in financial accounting to find whether the business carried on is profitable or not. The financial accounting is the "eyes and ears of management and facilitates in drawing future course of action, further expansion etc."

iii) Creditors: Creditors are the persons who supply goods on credit, or bankers or lenders of money. It is usual that these groups are interested to know the financial soundness before granting credit. The progress and prosperity of the firm, two which credits are extended, are largely watched by creditors from the point of view of security and further credit. Profit and Loss Account and Balance Sheet are nerve centres to know the soundness of the firm.

iv) Employees: Payment of bonus depends upon the size of profit earned by the firm. The more important point is that the workers expect regular income for the bread. The demand for wage rise, bonus, better working conditions etc. depend upon the profitability of the firm and in turn depends upon financial position. For these reasons, this group is interested in accounting.

v) Investors: The prospective investors, who want to invest their money in a firm, of course wish to see the progress and prosperity of the firm, before investing their amount, by going through the financial statements of the firm. This is to safeguard the investment. For this, this group is eager to go through the accounting which enables them to know the safety of investment.

vi) Government: Government keeps a close watch on the firms which yield good amount of profits. The state and central Governments are interested in the financial statements to know the earnings for the purpose of taxation. To compile national accounting is essential.

vii) Consumers: These groups are interested in getting the goods at reduced price. Therefore, they wish to know the establishment of a proper accounting control,

which in turn will reduce to cost of production, in turn less price to be paid by the consumers. Researchers are also interested in accounting for interpretation.

viii) Research Scholars: Accounting information, being a mirror of the financial performance of a business organization, is of immense value to the research scholar who wants to make a study into the financial operations of a particular firm. To make a study into the financial operations of a particular firm, the research scholar needs detailed accounting information relating to purchases, sales, expenses, cost of materials used, current assets, current liabilities, fixed assets, long-term liabilities and share-holders funds which is available in the accounting record maintained by the firm.

Check Your Progress 1

List out five objectives of Accounting.

Notes: (a) Write your answer in the space given below.

(b) Check your answer with the ones given at the end of this Lesson (pp. 13).

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1.3.5 Functions of Accounting

i) Record Keeping Function: The primary function of accounting relates to recording, classification and summary of financial transactions-journalisation, posting, and preparation of final statements. These facilitate to know operating results and financial positions. The purpose of this function is to report regularly to the interested parties by means of financial statements. Thus accounting performs historical function i.e., attention on the past performance of a business; and this facilitates decision making programme for future activities.

ii) Managerial Function: Decision making programme is greatly assisted by accounting. The managerial function and decision making programmes, without accounting, may mislead. The day-to-day operations are compared with some pre-determined standard. The variations of actual operations with pre-determined standards and their analysis is possible only with the help of accounting.

iii) Legal Requirement function: Auditing is compulsory in case of registered firms. Auditing is not possible without accounting. Thus accounting becomes compulsory to comply with legal requirements. Accounting is a base and with its help various returns, documents, statements etc., are prepared.

iv) Language of Business: Accounting is the language of business. Various transactions are communicated through accounting. There are many parties-owners, creditors, government, employees etc., who are interested in knowing the results of the

firm and this can be communicated only through accounting. The accounting shows a real and true position of the firm or the business.

1.3.6 Advantages of Accounting

The following are the advantages of accounting to a business:

i) It helps in having complete record of business transactions.

ii) It gives information about the profit or loss made by the business at the close of a year and its financial conditions. The basic function of accounting is to supply meaningful information about the financial activities of the business to the owners and the managers.

iii) It provides useful information form making economic decisions,

iv) It facilitates comparative study of current year's profit, sales, expenses etc., with those of the previous years.

v) It supplies information useful in judging the management's ability to utilise enterprise resources effectively in achieving primary enterprise goals.

vi) It provides users with factual and interpretive information about transactions and other events which are useful for predicting, comparing and evaluation the enterprise's earning power.

vii) It helps in complying with certain legal formalities like filing of income-tax and sales-tax returns. If the accounts are properly maintained, the assessment of taxes is greatly facilitated.

1.3.7 Limitations of Accounting

i) Accounting is historical in nature: It does not reflect the current financial position or worth of a business.

ii) Transactions of non-monetary mature do not find place in accounting. Accounting is limited to monetary transactions only. It excludes qualitative elements like management, reputation, employee morale, labour strike etc.

iii) Facts recorded in financial statements are greatly influenced by accounting conventions and personal judgements of the Accountant or Management. Valuation of inventory, provision for doubtful debts and assumption about useful life of an asset may, therefore, differ from one business house to another.

iv) Accounting principles are not static or unchanging-alternative accounting procedures are often equally acceptable. Therefore, accounting statements do not always present comparable data

v) Cost concept is found in accounting. Price changes are not considered. Money value is bound to change often from time to time. This is a strong limitation of accounting.

vi) Accounting statements do not show the impact of inflation.

vii) The accounting statements do not reflect those increase in net asset values that are not considered realized.

1.4 Methods of Accounting

Business transactions are recorded in two different ways.

1.4.1 Single Entry

1.4.2 Double Entry

1.4.1. Single Entry: It is incomplete system of recording business transactions. The business organization maintains only cash book and personal accounts of debtors and creditors. So the complete recording of transactions cannot be made and trail balance cannot be prepared.

1.4.2 Double Entry: It this system every business transaction is having a two fold effect of benefits giving and benefit receiving aspects. The recording is made on the basis of both these aspects. Double Entry is an accounting system that records the effects of transactions and other events in atleast two accounts with equal debits and credits.

1.4.3 Steps involved in Double entry system

(a) Preparation of Journal: Journal is called the book of original entry. It records the effect of all transactions for the first time. Here the job of recording takes place.

(b) Preparation of Ledger: Ledger is the collection of all accounts used by a business. Here the grouping of accounts is performed. Journal is posted to ledger.

(c) Trial Balance preparation: Summarizing. It is a summary of ledge balances prepared in the form of a list.

(d) Preparation of Final Account: At the end of the accounting period to know the achievements of the organization and its financial state of affairs, the final accounts are prepared.

1.4.4 Advantages of Double Entry System

i) Scientific system: This system is the only scientific system of recording business transactions in a set of accounting records. It helps to attain the objectives of accounting.

ii) Complete record of transactions: This system maintains a complete record of all business transactions.

iii) A check on the accuracy of accounts: By use of this system the accuracy of accounting book can be established through the device called a Trail balance.

iv) Ascertainment of profit or loss: The profit earned or loss suffered during a period can be ascertained together with details by the preparation of Profit and Loss Account.

v) Knowledge of the financial position of the business: The financial position of the firm can be ascertained at the end of each period, through the preparation of balance sheet.

vi) Full details for purposes of control: This system permits accounts to be prepared or kept in as much detail as necessary and, therefore, affords significant information for purposes of control etc.

vii) Comparative study is possible: Results of one year may be compared with those of the precious year and reasons for the change may be ascertained.

viii) Helps management in decision making: The management may be also to obtain good information for its work, specially for making decisions.

ix) No scope for fraud: The firm is saved from frauds and misappropriations since full information about all assets and liabilities will be available.

1.5 Meaning of Debit and Credit

The term 'debit' is supposed to have derived from 'debit' and the term 'credit' from 'creditable'. For convenience 'Dr' is used for debit and 'Cr' is used for credit. Recording of transactions require a thorough understanding of the rules of debit and credit relating to accounts. Both debit and credit may represent either increase or decrease, depending upon the nature of account.

1.6 Types of Accounting

Types of Accounts

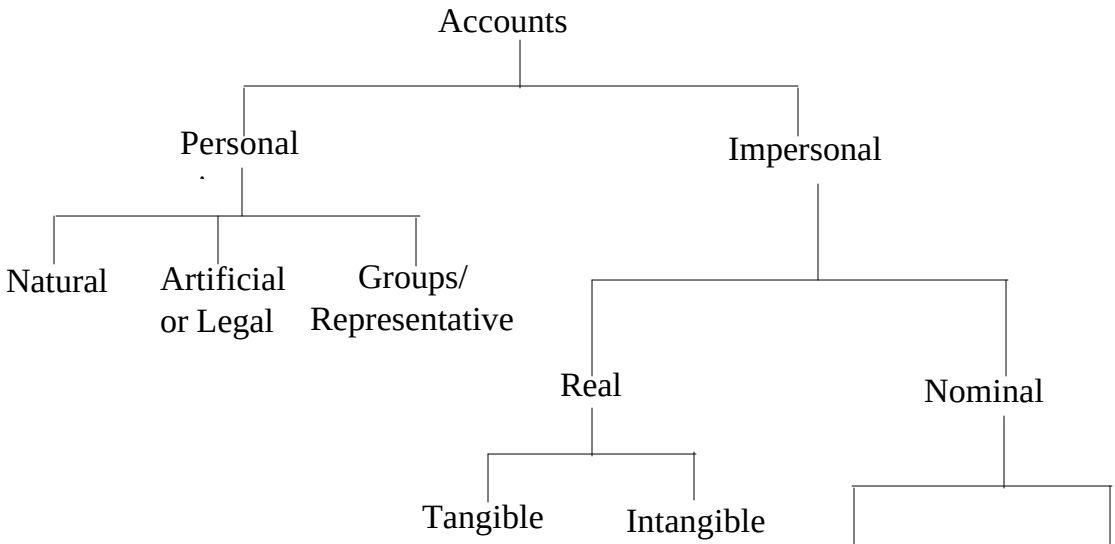
The object of book-keeping is to keep a complete record of all the transactions that place in the business. To achieve this object, business transactions have been classified into three categories:

(i) Transactions relating to persons.

(ii) Transactions relating to properties and assets

(iii) Transactions relating to incomes and expenses.

The accounts falling under the first heading are known as 'personal Accounts'. The accounts falling under the second heading are known as 'Real Accounts', The accounts falling under the third heading are called 'Nominal Accounts'. The accounts can also be classified as personal and impersonal. The following chart will show the various types of accounts:



1.6.1 Personal Accounts: Accounts recording transactions with a person or group of persons are known as personal accounts. These accounts are necessary, in particular, to record credit transactions. Personal accounts are of the following types:

(a) Natural persons: An account recording transactions with an individual human being is termed as a natural persons' personal account. eg., Kamal's account, Mala's account, Sharma's accounts. Both males and females are included in it

(b) Artificial or legal persons: An account recording financial transactions with an artificial person created by law or otherwise is termed as an artificial person, personal account, e.g. Firms' accounts, limited companies' accounts, educational institutions' accounts, Co-operative society account.

(c) Groups/Representative personal Accounts: An account indirectly representing a person or persons is known as representative personal account. When accounts are of a similar nature and their number is large, it is better tot group them under one head and open a representative personal accounts. e.g., prepaid insurance, outstanding salaries, rent, wages etc.

When a person starts a business, he is known as proprietor. This proprietor is represented by capital account for all that he invests in business and by drawings accounts for all that which he withdraws from business. So, capital accounts and drawings account are also personal accounts.

The rule for personal accounts is: **Debit the receiver**

Credit the giver

1.6.2 Real Accounts

Accounts relating to properties or assets are known as 'Real Accounts', A separate account is maintained for each asset e.g., Cash Machinery, Building, etc., Real accounts can be further classified into tangible and intangible.

(a) Tangible Real Accounts: These accounts represent assets and properties which can be seen, touched, felt, measured, purchased and sold. e.g. Machinery account Cash account, Furniture account, stock account etc.

(b) Intangible Real Accounts: These accounts represent assets and properties which cannot be seen, touched or felt but they can be measured in terms of money. e.g., Goodwill accounts, patents account, Trademarks account, Copyrights account, etc.

The rule for Real accounts is: **Debit what comes in**

Credit what goes out

1.6.3 Nominal Accounts

Accounts relating to income, revenue, gain expenses and losses are termed as nominal accounts. These accounts are also known as fictitious accounts as they do not represent any tangible asset. A separate account is maintained for each head or

expense or loss and gain or income. Wages account, Rent account Commission account, Interest received account are some examples of nominal account

The rule for Nominal accounts is: **Debit all expenses and losses**

Credit all incomes and gains

1.7 DISTINCTION BETWEEN BOOK-KEEPING AND ACCOUNTING

The difference between book-keeping and accounting can be summarized in a tabular from as under:

Basis of difference	**Book-keeping**	**Accounting**
Transactions	Recording of transactions in books of original entry.	To examine these recorded transactions in order to find out their accuracy.
Posting	To make posting in ledger	To examine this posting in order to ascertain its accuracy.
Total and Balance	To make total of the amount in journal and accounts of ledger. To ascertain balance in all the accounts.	To prepare trial balance with the help of balances of ledger accounts.
Income Statement and Balance Sheet	Preparation of trading, Profit & loss account and balance sheet is not book keeping	Preparation of trading, profits and loss account and balance sheet is included in it.
Rectification of errors	These are not included in book-keeping	These are included in accounting.
Special skill and knowledge	It does not require any special skill and knowledge as in advanced countries this work is done by machines.	It requires special skill and knowledge.
Liability	A book-keeper is not liable for accountancy work.	An accountant is liable for the work of book-keeper.

1.8 BRANCHES OF ACCOUNTING

The changing business scenario over the centuries gave rise to specialized branches of accounting which could cater to the changing requirements. The branches of accounting are;

i) Financial accounting;

ii) Cost accounting; and

iii) Management accounting.

Now, let us understand these terms.

1.8.1 Financial Accounting

The accounting system concerned only with the financial state of affairs and financial results of operations is known as Financial Accounting. It is the original from of accounting. It is mainly concerned with the preparation of financial statements for the use of outsiders like creditors, debenture holders, investors and financial institutions. The financial statements i.e., the profit and loss account and the balance sheet, show them the manner in which operations of the business have been conducted during a specified period.

1.8.2 Cost Accounting

In view of the limitations of financial accounting in respect of information relating to the cost of individual products, cost accounting was developed. It is that branch of accounting which is concerned with the accumulation and assignment of historical costs to units of product and department, primarily for the purpose of valuation of stock and measurement of profits. Cost accounting seeks to ascertain the cost of unit produced and sold or the services rendered by the business unit with a view to exercising control over these costs to assess profitability and efficiency of the enterprise. It generally relates to the future and involves an estimation of future costs to be incurred. The process of cost accounting based on the data provided by the financial accounting.

1.8.3 Management Accounting

It is an accounting for the management i.e., accounting which provides necessary information to the management for discharging its functions. According to the Anglo-American Council on productivity, “Management accounting is the presentation of accounting information is such a way as to assist management in the creation of policy and the day-to-day operation of an undertaking.” It covers all arrangements and combinations or adjustments of the orthodox information to provide the Chief Executive with the information from which he can control the business e.g. Information about funds, costs, profits etc. Management accounting is not only confined to the area of cost accounting but also covers other areas (such as capital expenditure decisions, capital structure decisions, and dividend decisions) as well.

1.9 Let us Sum Ups

Accounting plays a vital role in the field of commerce and business. One should know the basic purpose of accounting, its merits, kinds of accounting and rules of accounting. By studying this lesion one can understand the above said things and need of double entry system. The next lesion will deal with principles of accounting.

1.10 Lesson-End Activities.

1. Define Accounting.
2 Explain the primary objectives of accounting?
3. What is Double entry system?
4. What is meaning of Debit and Credit?
5. Explain the different methods of accounting.
6. Explain the various types of accounts.
7. Discuss the limitations of accounting.
8. Distinguish between book-keeping and accounting.
9. Explain the accounting rules.

1.11 Check your Progress

1. Your answer may include any five of the following.

   1. To keeping systematic record
   2. To ascertain the results of the operation
   3. To ascertain the financial position of the business
   4. To portray the liquidity position
   5. To product business properties

1.12 Points for Discussion

1. Explain the accounting rules.
2. Discuss the objectives; functions; importance and limitations of accounting.

1.13 References

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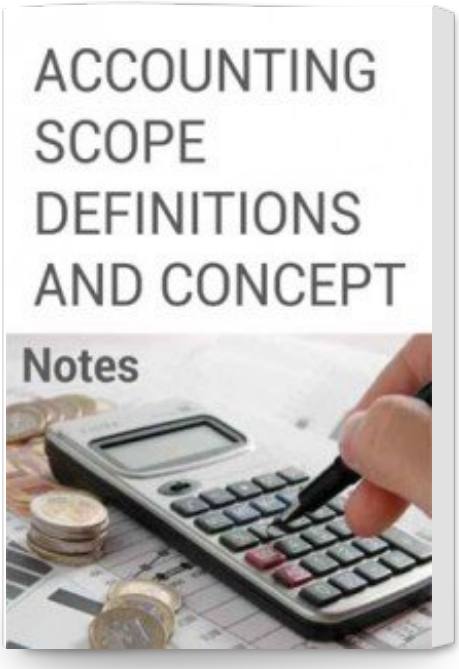
LESSON – 2 PRINCIPLES OF ACCOUNTING

Contents:

Accounting Scope, Definitions and Concept Notes



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