Unit 1: Introduction to Accounting System

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1.1. Meaning & Definition of Accounting

Lucas Pacioli is considered to be the Father of modern bookkeeping. The only recording of financial transactions in bookkeeping is not enough to achieve the commercial objective, but also it is important to know the financial result.

It is necessary that the recorded transaction is collected, classified and summarised. This work is done by accounting. After identifying the financial transaction, through the basic accounting process, these are recorded properly in a systematic manner in the books. The meaning of accounting can be made clearer by understanding its process and components.

Some prominent definitions of accounting to help us better understand the meaning of basic accounting.

•*According to the Committee of Terminology of American Institute of Certified Public Account:*" Accounting is the art of recording, classifying 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."

•*According to Bierman and Drebin:*" Accounting may be defined as identifying, measuring, recording and communicating of financial information."

Therefore accounting can be defined as" the process of recording, summarising, reporting and analyzing required financial information relating to the economic events of an organization to the interested users for making decisions."

Components of Basic Accounting

1. Recording

The primary function of accounting is to make records of all transactions that the firm enters into. For the purpose of recording, the accountant maintains a set of books. Their procedures are very systematic. Nowadays, the computer has been deployed to automatically account for transactions as they happen.

2. Summarising

Recording of transactions creates raw data. Sentences of road 8000 of little used to in organization for decision making. Pages and pages of raw data are of little use to an organization for decision making. For this reason, the accountant classifies data into categories.

3. Reporting

Management is answerable to the investors about the company’s state of affairs. The operations that are being financed with the money of owners, it needs to be periodically updated to them. For this reason, there are periodic reports annually summarising the performance of all four quarters which are sent to them.

In the form of financial statements reporting is done. To ensure that there is no misleading financial reporting, these financial statements are also regulated by government bodies.

4. Analyzing

Lastly, accounting entails conducting an analysis of the result. After results have been summarised and reported, a meaningful conclusion needs to be drawn. Management must find out its positive and negative points. Accounting helps in doing so by means of comparison. It is common factors to compare profit, cash, sales, and assets, etc. with each other to analyze the performance of the business.

1.2. Objectives of Accounting

The primary objectives of accounting include systematic maintenance of records of transactions summarising and analysing business reports to assess the financial standing of the business entity. The following are the various objectives of accounting –

- Maintaining systematic financial records
- To estimate and ascertain profits or losses
- Preparing financial reports to assess the financial position
- Auditing of financial reports
- To forecast future payments, expenditures and budgets

Maintaining systematic financial records

One of the most important accounting objectives is that accounting helps the business organisation keep a systematic and accurate record of the day-to-day transactions, which helps to understand the working of the business, payments made, income received, etc.

To estimate and ascertain profits or losses

Recording transactions concerning revenues and expenditures helps us ascertain the profit/ loss at the end of the financial year. Ascertaining profits or losses is important to make payments, making it one of the important objectives of accounting.

Preparing financial reports to assess the financial position

Accounting involves the preparation of a balance sheet which is a record of the assets and liabilities of a business entity. This helps in the analysis of the financial position of the business organisation. Ascertaining profitability can help us understand the strengths and weaknesses of the business organisation and formulate various policies and strategies to correct the weaknesses and improve the organisation's strengths.

Auditing of financial reports

Another objective of accounting is that it helps in understanding the financial position of a company in the form of assets, debts, profits and losses, etc. These records are made available to the auditor, who can then analyse the reports to find any discrepancies and suggest the required corrective reforms. These reports also help the higher authorities formulate plans and make rational decisions.

To forecast future payments, expenditures and budgets

Accounting helps to predict the future profitability of a business entity. This helps plan future payments, debts, expenditures and budgets accordingly. It also helps in distributing funds among different departments of the business organisation based on past allocations and profitability.

Function of Accounting

- Preparation of budget and cash control
- Prevention of errors and fraud
- Basis of evaluation of performance
- Control of fiscal policies of the business

1.3. Concepts and Features of Book Keeping

Bookkeeping is the process of recording your company's financial transactions into organized accounts on a daily basis. It can also refer to the different recording techniques businesses can use. Bookkeeping is an essential part of your accounting process for a few reasons. When you keep transaction records updated, you can generate accurate financial reports that help measure business performance. Detailed records will also be handy in the event of a tax audit.

Before you begin bookkeeping, your business must decide what method you are going to follow. When choosing, consider the volume of daily transactions your business has and the amount of revenue you earn. If you are a small business, a complex bookkeeping method designed for enterprises may cause unnecessary complications. Conversely, less robust methods of bookkeeping will not suffice for large corporations.

Here are some features of bookkeeping:

- **Recording transactions**

Bookkeeping involves recording a business's financial transactions on a daily basis.

- **Rules and regulations**

Bookkeeping records are based on rules and regulations.

- **Financial reports**

Bookkeepers generate financial reports that help businesses track their financial health, make informed decisions, and comply with tax and regulatory requirements.

- **Double-entry bookkeeping**

This method records both sides of a financial transaction, which helps maintain a balance between assets, liabilities, equity, income, and expenses.

- **Payroll**

Bookkeepers can help businesses set up a systematic payroll process by creating a spreadsheet of journal entries.

- **Chart of accounts**

A chart of accounts is included in every business's bookkeeping system, and it sorts transaction data into groups like assets, liabilities, equity, income, and expenses.

- **Budgeting**

Accurate bookkeeping is important for budgeting and forecasting. Businesses can analyze financial statements to identify areas for cost reduction or to invest in to reach their financial goals.

- **Single-entry bookkeeping**

This method involves making one entry for each transaction, and transactions are usually recorded in a cash book.

1.4. Branches of Accounting (Financial, Management, Cost)

Different branches of accounting came into existence with time based on the requirements of stakeholders in different industries. While financial accounting, cost accounting and management accounting are the main branches, there are other accounting branches as well.

Branches of Accounting utilize various accounting practices for monitoring and reporting the financial status of the company. Organizations observe uniformity by following conventions and principles stated in GAAP.

- Management Accounting
- Financial Accounting
- Cost Accounting

1. Management Accounting

Management accounting is also known as managerial accounting. It is a branch of accounting meant for the organisation's internal use. Management uses the information provided by management accountants to make business-related decisions. Since this accounting branch is meant for internal purposes, there is no necessity to follow GAAP rules.

Accountants focus on assessing the finances of the company in a way to increase the company's revenues and profit. They also work towards cost reduction, budget planning, and internal examination through break-even point analysis (BEP) or cost-to-volume profit (CVP). Management accounting functions include forecasting and planning, organizing, performance variances, coordinating, etc.

2. Financial Accounting

In this accounting branch, accountants summarize, analyze and report business-related financial transactions. This involves the preparation of financial statements that are available for public use as well. Stakeholders, government agencies, regulatory authorities, and financial institutions use this information. Since financial accounting deals with documenting information for public use, this branch of accounting follows GAAP and IFRS.

GAAP is for the financial accounting used in every jurisdiction. IFRS governs how transactions and financial events should be reported within financial statements. Through financial accounting, business transactions are recorded systematically and summarized logically for analysis and interpretation.

3. Cost Accounting

It is an accounting branch that recognizes, classifies, allocates, and reports costs as well as compares them with standard costs. The aim of cost accounting is to help management in optimizing business processes based on cost efficiency.

Through cost accounting, management can gain detailed information on cost so that they can manage business operations accordingly. Cost accounting professionals analyze actual costs over budgets on a regular basis to determine monetary actions in the future. Compared with financial accounting, it can be made flexible with guidelines based on the decision of the company’s management.

1.5. Basis of Accounting (Accrual & Cash Basis)

Business transactions are documented in the books of account according to one of two accounting bases:

(i) Cash Basis of Accounting;

(ii) Accrual Basis of Accounting;

Despite the fact that the accrual basis is the most fundamental accounting concept, the cash basis is also used, though in a restricted way. Professionals and non-trading organizations like clubs, schools, and hospitals, for example, employ the cash basis of accounting.

Cash Basis of Accounting

The cash basis of accounting is a method of accounting in which transactions are recorded in the books of account when cash is received and paid. Credit transactions, such as credit purchases and sales, are not recorded in the books of account under this method. When cash is paid or received, they are documented in the books of account. When cash is received, revenue is recognized using the Cash Basis of Accounting. Goods sold on credit, for example, will not be recorded until the sale proceeds are received. Accrued income and income received in advance are not calculated and recorded since revenue is recognized on a cash basis.

Expenses, on the other hand, are only recorded as incurred once they have been paid. If a salary is paid in April for the month of March, for example, it will be recorded in April. Outstanding and prepaid expenditures are not evaluated and recognised since the transaction is recorded when cash is exchanged. The profit or loss of an enterprise for a certain accounting period is the difference between cash revenues and cash payments. The Receipts and Payments Account, which is created for non-trading organizations such as charity institutions, clubs, and schools, is an example of cash-basis accounting.

Accrual Basis of Accounting

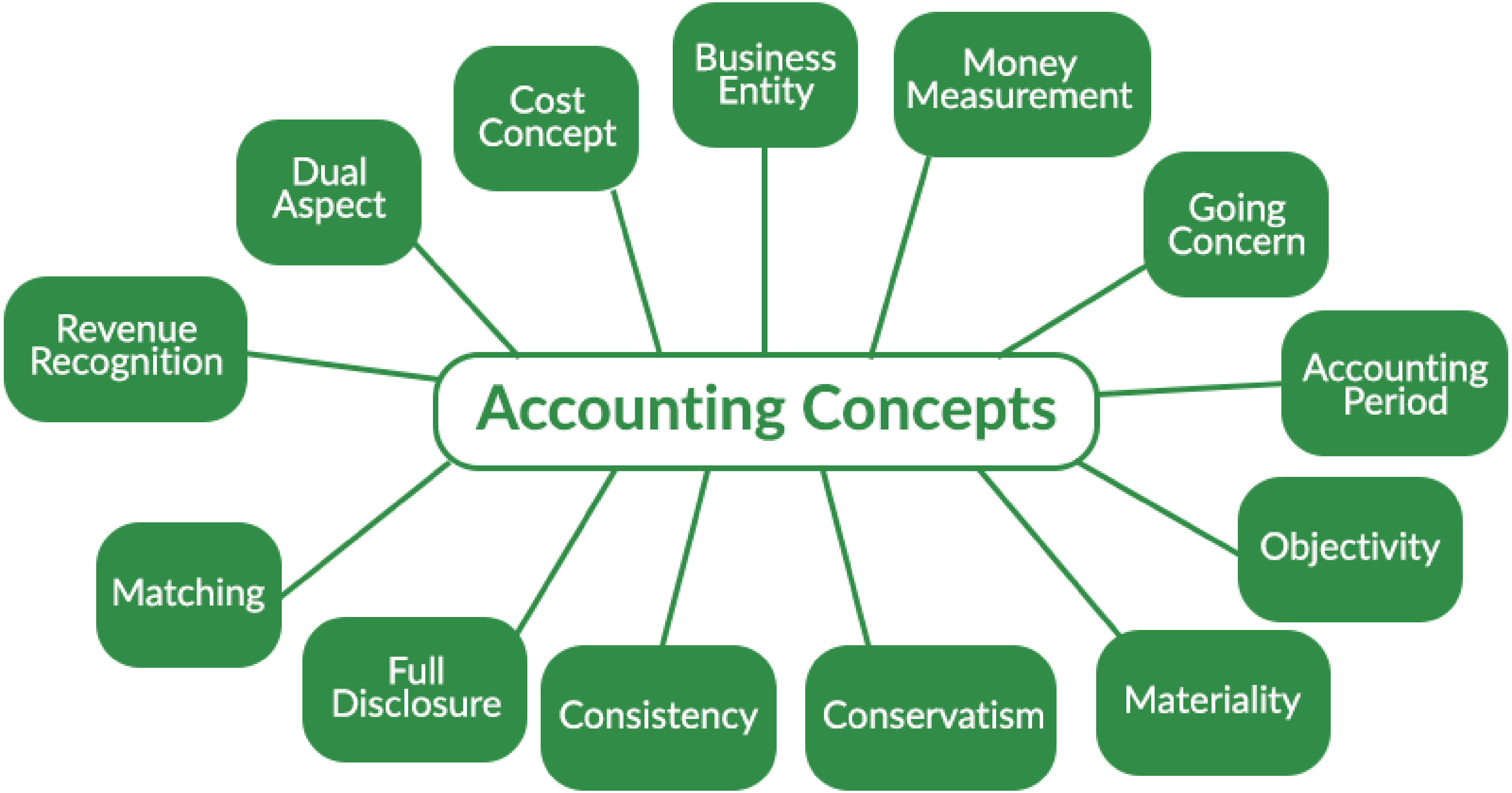
According to the accrual basis of accounting revenue and costs are recorded in the period in which they become due, rather than when they are received or paid, Credit sales, for example, are included in total sales for the period, regardless as to whether money is received or not. Similarly, if a company uses a service but does not pay for it, the expenditure is recorded in the books in the year in which the service is used, not in the year in which the payment is made.

1.6. Accounting Concepts

Theory Base of Accounting consists of accounting concepts, principles, rules, guidelines, and standards that help an individual understand the basics of accounting. These Concepts are developed over time to bring consistency and uniformity to the accounting process.

GAAP or Generally Accepted Accounting Principles are the rules and procedures defined and developed by the Financial Accounting Standards Board (FASB) that an organization has to follow for the proper creation of financial statements consistent with the industry standards. The General Accepted Accounting Principles are also known as **Accounting Concepts**. The primary objective of GAAP is to ensure a basic level of consistency in the accounting statements of an organization. Financial statements prepared with the help of GAAP can be easily used by the external users of the accounts of a company.

There are 13 important Accounting Concepts that are to be followed by companies to prepare true and fair financial statements.


Accounting Concepts
Revenue Recognition
Dual Aspect
Cost Concept
Business Entity
Money Measurement
Going Concern
Accounting Period
Objectivity
Materiality
Conservatism
Consistency
Full Disclosure
Matching

Business Entity Concept

The business entity concept states that the business enterprise is separate from its owner. In simple terms, for accounting purposes, the business and its owners are treated separately. If an owner invests money in the business, it will be treated as a liability for the business. However, if the owner takes out some money from the business for personal use, it will be considered drawings. Therefore, assets and liabilities of a business are the business's assets and liabilities, not the owner's. Hence, the books of accounts include the accounting records from the point of view of the business instead of the owner.

For example, the amount of 1,00,000 in ABC Ltd. by its owner Raj will be considered a liability to the business. The business entity concept applies to partnerships, companies, sole proprietorships, small enterprises, and large enterprises.

Money Measurement Concept

The money measurement concept says that a business should record only those transactions which can be expressed in monetary terms. It means that transactions like purchase and sale of goods, rent payment, expenses payment, earning of revenue, etc., will be recorded in the books of accounts of the firm. However, transactions or happenings, like the research department's creativity, machinery breakdown, etc., will not be recorded in the books of accounts of the firm. Besides, the records of transactions of a firm should not be recorded in physical units, such as 3 acre land, 20 computers, 40 chairs, etc., instead, they should be recorded in monetary terms, such as ₹13 lakh for land, ₹15 lakh for computers, and ₹2 lakh for chairs, etc., in the books of accounts. However, there are two drawbacks of this concept in accounting. Firstly, according to this concept, the accounting of a business is limited to the recording of information that can be expressed in a monetary unit, but does not involve or record essential information that cannot be expressed in monetary units. Secondly, the concept has the limitations of the monetary unit itself.

Going Concern Concept

The going concern concept assumes that an organization would continue its business operations indefinitely. It means that it is assumed that the business will run for a long period of time, and will not liquidate in the foreseeable future. It is one of the most important assumptions or concepts of accounting. It is because the going concern concept provides the firm with the basis to show its assets' value in the balance sheet.

For example, if an organization purchases machinery for ₹1,00,000, it would not be fair to show the full amount of the machinery in one year, as the company will be getting service or production with the help of machinery for several years. Therefore, the going concern concept by assuming that the business will not liquidate in the foreseeable future states that the firm should record the machinery's value for its estimated life span. Let's say, the life span of the said machinery is 10 years. Now, the firm may charge ₹10,000 for 10 years from the profit and loss account.

Accounting Period Concept

The accounting period concept defines the time span at the end of which an organization has to prepare its financial statements to determine whether they have earned profits or incurred losses during a specified time span. It also states the exact position of the firm's assets and liabilities at the end of the specified time span. This information is used by different internal and external users of the organization for various purposes regularly. The financial statements are prepared regularly because it helps them in the decision-making process, and no firm can wait for long to know its results. The normal interval for the preparation of the financial statements is one year. This time interval of one year is known as the accounting period. According to the Companies Act, 2013 and the Income Tax Act, an organization has to prepare its income statements annually. However, in some cases, like the retirement of a partner between the accounting period, etc., the firm can prepare interim financial statements.

Cost Concept

The cost concept of accounting states that an organization should record all of its assets at their purchase price in the books of accounts. This amount also includes any transportation cost, acquisition cost, installation cost, and any other cost spent by the firm for making the asset ready to use. **For example,** Radha Ltd. purchased machinery for ₹60 lakh in July 2021. It has also spent a sum of ₹10,000 on transportation, ₹20,000 on its installation, and ₹15,000 on making it ready to use. The total amount at which the organization will record the value of machinery in the books of account would be ₹60,45,000.

Therefore, the cost concept or historical cost concept states that since the company is not going to sell the assets as per the going concern concept, there is no point in revaluing the assets and showing their current value. Besides, for practical reasons also, the accountants of an organization prefer to report the actual costs to its market values. However, the asset amount listed in the books of accounts of the firm does not indicate the value at which it can sell the asset.

Dual Aspect or Duality Concept

The dual aspect or duality concept is the foundation of any business. The concept describes the basis of recording business transactions in the books of accounts. According to the concept, every transaction of the business has a two-fold effect. Hence, it should record every transaction in two places. In simple words, two accounts will be affected by a single transaction. This concept can be expressed as the Accounting Equation:

Assets = Liabilities + Capital

The accounting equation states that the total of assets of an organization is always equal to the total of its owners' and outsiders' claims. These claims or equity of the firm's owners is also known as Capital or Owner's Equity, and the outsiders' claims are known as Liabilities or Creditors' Equity. **For example,** Rohan started a business by investing a sum of ₹1 crore. This amount will increase the cash (asset side) of the business, and will also increase its capital by the same amount, i.e., ₹1 crore. Therefore, the effect of the transaction will be shown in two accounts, i.e., cash and capital account. The dual concept forms the base of the Double Entry System of Accounting.

Revenue Recognition Concept

The revenue recognition concept, also known as the **realisation concept**, as the name suggests, defines that an organization should record its revenue from business only when it is realised, not when the firm has received the cash. Let us understand the concept with the help of an **example**. Suppose a client pays ₹5,000 in advance for a product. The company will not realise the amount of revenue until its work on the product is complete. Therefore, the firm will initially record the amount as a liability in the unearned revenue account. Once the product has shipped to the client, it will be transferred to the revenue account.

Let us take another **example** of delayed payment. Suppose a company ships its goods amounting to ₹10,000 to its customer on the credit of 30 days. The company will realise the same as soon as the goods have been shipped even though it will receive the amount in the future.

Matching Concept

The matching concept states that an organization should recognize its expenses in the same financial year if the expense is related to the revenue of that year. In simple words, if a firm is earning revenue in an accounting period, even though it incurs the expenses related to that revenue in the next accounting year, the expense will be realized in the same accounting year when the revenue has been realized by the firm.

For example, if a salesman sells goods worth ₹10,00,000 in February 2022 on a 6% commission made in May 2022, the commission expense of 6% will be charged in the accounting year in which the sales have been made, i.e., 2021-2022. A company should keep in mind that the matching concept should be followed only after the realisation concept has been fulfilled.

Full Disclosure Concept

As the name suggests, the full disclosure concept states that an organization should disclose all the facts regarding its financial performance. It is because the information mentioned in the financial statements is used by different internal and external users, like investors, banks, creditors, management, employees, financial institutions, etc., for making financial decisions. Hence, the concept says that all relevant and material facts or figures about an organisation must be disclosed in its financial statements. To fully ensure this concept, an organization has to prepare its Balance Sheet and Profit & Loss Account based on the format provided by the Indian Companies Act 1956. Besides, different regulatory bodies, like SEBI, also make it compulsory for companies to completely disclose the true and fair picture of their state of affairs and profitability.

Consistency Concept

The consistency concept states that there should be consistency or uniformity in the accounting practices and policies followed by an organization. It is because the accounting information provided by an organization through its financial statements would be beneficial only when it allows its users in making a comparison between the statements of different years or with statements of other firms. However, it does not mean that the organization cannot change its accounting policies when necessary. The firm can make required changes in its policies by properly indicating the probable effect of the changes on its financial results. **For example,** if a company's management wants to compare the net profit of the current year with the previous year, it can do so only when the accounting policies followed by the company in both years are the same. **For example,** if a company has used the SLM depreciation method in the previous year and the WDV method of depreciation in the current year; it would not be able to compare the figures.

Conservatism Concept

The conservatism or prudence concept believes in playing safely, while recording the transactions in the book of accounts. According to this concept, an organization should adopt a conscious approach and should not record its profits until they are realised. However, it states that the organization should realise any loss even if the company has not incurred it yet, or if there is a slight possibility of loss to occurring in the future. No matter how pessimist attitude this concept shows, it is essential for an organization to deal with uncertainty and allows them to protect the interest of creditors against any unwanted distribution of its assets.

For example, if an organization feels that a certain debtor will not pay the amount in the future, it should open a Provision for Doubtful Debts Account. Similarly, an organization should not record its increase in the market value of stock until it is sold.

Materiality Concept

The materiality concept suggests that an organization should focus on material facts only. In simple words, an organization should not waste its time on immaterial facts that do not help in determining its income for the period. In order to differentiate a fact as material or immaterial, one should consider its nature and the amount involved. Therefore, a fact will be considered material if the accountant believes that the information can influence the decisions of a user of the financial statements.

For example, the original cost of stationery is insignificant to the users of financial statements. Hence they are not included in the closing stock of the statements and are shown under expenses. Similarly, suppose the company has incurred an expense on the marketing of the firm or its products. In that case, it will be shown in the financial statements as it is a material fact for the users and can change their decisions.

Objectivity Concept

The objectivity concept of accounting states that an organization should record transactions in an objective manner. It means that the recording should be free from any kind of biasness by accountants and other people. Objectivity in the recording of transactions is possible when the transactions of the firm are supported by verifiable vouchers or documents. The purpose of the objectivity concept is that it does not let the firm's management and accountants' opinions impact the financial statements and provide a false image. The concept can be helpful for an organization in creation of its goodwill. Besides, it warns the companies about the penalties if there is any sort of misinterpretation in the financial statements.