**Module I**

**INTRODUCTION TO ACCOUNTING**

**Introduction**

Today accounting is treated as language of business and an instrument of administration and commerce. Business man wants to know- how much profit he has earned from his business? It is impossible for any business man to remember all the transactions of his business for a period. It has made him to keep a record of his business transactions in books of accounts. Originally accounting was introduced as an aid to human memory to have a permanent and systematic record of business transactions that would help a business man to know easily and readily his profit and financial position. Financial information found in accounting records is useful to owners and the managers for planning, decision making and controlling the activities of business. Number of outsiders (investors, shareholders, banks and financial institutions, creditors, customers, employees, govt., public, academicians, etc) is interested in the activities of a business.

**Meaning and Definition**

Accounting is an information system which receives data, process and gives it in the form of information for planning and decision making. It is an art as well as science of recording, classifying and summarizing of business transactions which are of financial character and expressed in terms of money.

1. “Accounting is the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by users of the information” (**American Accounting Association**).

2. “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” (**American Institute of Certified Public Accountants**)

3. “Accounting as the science of recording and classifying business transactions and events, primarily of financial character and art of making significant summaries, analyses and interpretations of those transactions and events and communicating the results to persons who must make decisions or form judgments” (**Smith and Ashburne**)

**OBJECTIVES OF ACCOUNTING**

Accounting has many objectives. They are as follows:

1. **Ascertaining the profit or loss of business**: to ascertain the profit or loss of the business for an accounting period by preparing profit and loss account.
2. **Knowing the sources of revenue and the items of expense**: to know how the profit is earned or the loss is incurred i.e. to know the various sources of revenue and various items of expenses which have resulted in profit or loss.
3. **Ascertainment of the financial position of the business**: to ascertain the true financial position (the assets, liabilities and owners capital) of the business at the end of every accounting year by preparing the balance sheet or position statement.
4. **Ascertaining the amount due to the business and the amount due from the business**: to ascertain the amounts due to the business from its debtors and the amounts due from the business to its creditors.
5. **Ensuring effective control over the performance of the business**: accounting reveals the actual performance of business in terms of cost of production, sale, profit and loss, and book values of assets and liabilities. It facilitates the comparison actual performance with planned performance or the previous year performance. The causes responsible for poor performance can be identified and efforts can be made to remove such unfavourable causes. In case of better performance, factors responsible for better performance can be identified and those can be reinforced. Thus accounting ensures effective control over the performance of business.
6. **Protection of the properties of the business**: by keeping proper records of the various properties of the business and providing up-to-date information about the properties to the management. It helps the management to exercise proper control over the use of the properties of the business. It is for this reason the accounting is called the eyes and ears of the business.
7. **Prevention of errors and frauds**: to prevent errors and frauds by facilitating their quick detection and correction and by introducing suitable measures for their prevention in future.
8. **Satisfying legal requirements**: various laws like the Companies Act 1956, Income Tax Act, the Sales Tax Act etc. require a business concern to maintain necessary financial records and submit the required financial statements to the Government.
9. **Making financial information available to various group of persons:** accounting communicates the financial results and other valuable information to various groups of persons, such as owners, the lenders, the creditors, employees, potential investors consumers. So accounting is regarded as the mouth and the language of the business.

**Features of Accounting**

1. **Recording** – it is concerned with recording transaction of financial character in a systematic manner. It is originally done in a book called Journal. Business transactions are divided in to two; external and internal. External events involve a transfer or exchange of something of value between two or more entities. Eg. Payment of rent to landlord
2. **Classifying** – it is concerned with systematic analysis of recorded data with a view to bring transactions or entries of similar nature to one place. The work of classification is done in the book known as ledger. In ledger financial transactions of similar nature are brought under one page is called Account.
3. **Summarising** – it is the presentation of the classified data in a manner understandable and useful to internal users like different levels of management and external users. It involves the preparation of an income statement showing profit or loss and position statement showing the assets and liabilities.
4. **Analysis and interpretation** – the financial data recorded is analysed and interpreted in such a manner that the end users can make a meaningful judgment about financial condition of business.
5. **Communication** – after proper analysis the accounting information has to be communicated in a proper form to the proper person. This is done through preparation and distribution of accounting reports such as ratios, graphs diagrams etc.

**Limitations of Accounting**

Accounting is not free from limitations:

1. In accounting only monetary transactions are recorded. Non monetary transactions are not treated in accounting. Therefore, accounting does not provide complete information on all the activities of a business.
2. Accounting records do not give exact information. They give only approximate information. This is because, in accounting, sometimes estimates are used.
3. Accounting figures may be manipulated, as desired by the owners or by the management.
4. Balance sheet prepared does not show the present value of the business, as the assets and liabilities are shown in the balance sheet at cost or book values and not at market values.
5. In the balance sheet, values less assets i.e. fictitious assets are shown. As a result, the balance sheet does not show the real financial position of the business.
6. In financial statements only material items are disclosed in detail. Insignificant items are ignored or not disclosed properly.
7. Accounting fails to supply timely information to the owners and management, as the summarised financial information are presented only at the end of the financial year.
8. Accounting methods or systems are static and not flexible.
9. Accounting records are the records of past or historical events. So they are not much relevant in present situation.
10. Sometimes Accounts are influenced by the personal judgement of the accountant. So accounting records are subjective.

**Basic Accounting terminology**

1. **Capital (owner’s capital):** it refers to the investment made by the owner of business in the form of cash or money’s worth (goods, machinery etc.). On the other hand, it is the amount of money or money’s worth invested or introduced by the proprietor in to his business at the time of the commencement of business. Capital is also defined as the owner’s equity i.e. owner’s claim against the assets of the business. It can also be defined as the excess of the total assets of a business over its total liabilities at any particular time in case of an existing business.
2. **Drawings:** drawings refer to cash or goods or any other assets withdrawn by the proprietor from his business for his personal, private or domestic use. It also includes the personal, private or domestic expenses of the proprietor paid by the business. Drawings will reduce the owner’s equity in the business.
3. **Assets:** the term asset is derived from the French word ‘assez’ which means enough. So assets mean enough or sufficient economic resources owned by a business concern for carrying on the business. “Assets are valuable resources owned by a business which are acquired at a measurable money cost” (Robert N. Anthony). Assets are also defined as the properties and possessions owned by a business which benefit future period or periods. In simple terms assets are the properties and things of value owned by the business. They help for generating income. Assets may be fixed or current. Fixed assets are those assets held for a longer period and are not meant for resale. E.g. land and building, machineries etc. assets which are held for a shorter period are known as current assets. E.g. cash in hand and bank, closing stock, debtors etc.
4. **Liabilities:** the term liability is derived from the French word ‘lier’ which means to bind.Liabilities mean claims of outsiders against a business concern which bind the business concern to others. It also termed as outsider’s equity. It denotes the amounts which a business owes to others either for money borrowed or for goods and assets purchased credit or for services rendered. E.g. loans and advances borrowed, bank loan, bank overdraft, bills payable etc.
5. **Debtor:** a debtor is a person who owes money to the business. He owes money to the business because he has received some benefit from the business. A debtor constitutes an asset of the business. Generally such Owings come out of goods or services purchased from the business on credit.
6. **Creditor:** a creditor is person to whom the business owes money. The business owes money to him because he has given some benefit to the business. A creditor constitutes liability for the business. The business owes money on account of goods supplied or services rendered by them on credit.
7. **Accounts receivable**: it refers to the amount due to a business from customers or debtors to whom goods were sold on credit or services were rendered on credit. It includes amount due from debtors as well as on account of bills receivables. A bill is a document issued by the debtor to pay for the value owing by him. Such a document is called bills receivable.
8. **Accounts payable**: it refers to the amount owed by the business to creditors from whom goods were purchased on credit or services were received on credit. Accounts payable is the total of creditors and bills payable of the business.
9. **Entry**: the record of a transaction in a book of accounts is known as an entry. The term entry refers to the record of a transaction made for the first time i.e. a record of transaction in the books of original entry.
10. **Revenue:** revenue or income is the earnings of a business from the sale of goods or from the rendering of services to customers during an accounting period. It is related to the day to day operations of the business and of recurring in nature. Revenue represents the amount a business earns through sale of its products or services to customers. Thus sale is the major revenue of the business. Other items of revenue are rent received, interest received, dividend received etc.
11. **Expenditure:** it refers to the amount of money spent or the amount of an obligation or liability incurred or the amount of a property transferred for the acquisition of an asset or for the payment of a service. Expenditure may be expired cost or expense or unexpired cost or asset. If the benefit of expenditure is limited to just one accounting year, it is treated as expense or revenue expense. In case the benefit of expenditure extends to more than one accounting year, it is treated as unexpired cost or capital expenditure. Simply expense mean the amount spent for earning revenue.
12. **Loss:** it refers to money or money’s worth given up without getting any benefit in return. Loss occurs accidently or involuntarily by fire, theft, accident etc. It is the excess of expenses over revenues.
13. **Profit / Gain:** it is the excess of revenue over expenses in an accounting year and represents increase in net asset or owner’s equity. Gain refers to revenue which is not generated through routine or regular business activities. E.g. profit sale of fixed asset.
14. **Stock:** the goods available with the business for sale on a particular date are termed as stock. It varies with every transaction of purchase and sale. The value of goods unsold at the end of an accounting year is known as closing stock. It is also called inventory.
15. **Debit:** the term *debit* (Dr.) is derived from the Latin word ‘**debere**’ which means that what is due. The term debit means the amount owed by or due from an account or charged to an account for the benefit received by that account. It means the benefit received by an account. In accounting, the term debit may be used in three ways: used as noun – it is termed as debit which means an entry on the debit side or left hand side of an account. Used as an adjective – it is termed debit side which means left hand side of an account. Used as a verb – it is termed to debit which means to make an entry in the debit side of an account.
16. **Credit:** the term credit (Cr.) is derived from the Latin word ‘**credere*’*** which means trust or belief. The term credit means the amount owed to an account for the benefit given by that account in the belief that its value will be returned at a later date. It can be used in three ways: as a noun- it means an entry on the credit side or right hand side of an account. Used as an adjective – it termed credit side which means right hand side of an account. Used as a verb it is termed to credit which to make an entry on the credit side.
17. **Account:** an account means a summarised record of all the transactions relating to a particular person, thing or service which has taken place during a given period showing their net effect.

**Book-Keeping**

1. “Book-keeping is the art of recording business transaction in a systematic manner”(A.H. Rosenkampff)
2. “Book-keeping is the art of recording in the books of account the monetary aspect of commercial and financial transactions” (Northcot)
3. “book-keeping as the science and art of correctly recording in books of accounts all those business transactions that result in the transfer of money or money’s worth” (R.N. Carter)
4. Book-keeping is the process of recording business transactions in appropriate books of accounts in a systematic manner so as to ascertain the profit or loss and the financial position of the business.

**Essential Features of Book-keeping**

1. It is the recording of only business transactions.
2. It is the recording of only the monetary or financial aspects of business transactions.
3. It is the recording of business transactions in terms of money.
4. It is the recording of business transactions in the books of account in a systematic manner in accordance with accounting principles.
5. It covers certain aspects .i.e. identifying business transactions, measuring those transactions in terms of money, recording those transactions in the books of original entry and posting the entries to the concerned ledger.

**Distinction between Book-keeping and Accounting**

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| **Book-keeping** | **Accounting** |
| * It is just the process of recording transaction in the books of accounts | * It comprises the recording of business transactions, preparations of financial statements and analysis and interpretation of financial statements |
| * It is the first stage of maintenance of books of account. | * It is the second stage of maintenance of books of accounts. |
| * It just maintains information about a business in the books of accounts. | * It summarises and analyses and interprets the information maintained in the books of account. So it can be said that accounting begins where book-keeping ends. |
| * It does not produce financial statements like P/L account and the Balance Sheet. | * It is mainly concerned with the preparation of financial statements. |
| * It represents the art aspect of recording business transactions. | * It represents science aspect of recording business transactions. |
| * The work of boo-keeping is of routine and clerical in nature. | * The work of accounting is of technical and complicated in nature. |
| * It is entrusted to junior staff of the accounts department called the accounts clerks. | * It is entrusted to senior staff of the accounts department called accountants. |

**Accountancy**

Accountancy is a discipline or a body of knowledge or a subject of study which explains the art and principle of recording business transactions. It is the science of recording which explains why books of accounts should be maintained, how to maintain the books of accounts, how to prepare financial statements, how to interpret the financial statements, and how to communicate the results to the end users. In short, accountancy is a science prescribing the principles or rules governing the recording, summarising and analysing business transactions.

**Definition**

**“**Accountancy is the theory and practice of accounting**” (*Eric Kohler*)**

**“**The discipline which analyses the art and principle of recording of all monetary transactions is known as accountancy**” (*F.W. Pixley*)**

**Features**

1. It is a discipline.
2. It is a science, prescribing the principles and rules of accounting.
3. It is also concerned with designing of the systems for accounting.
4. It includes both book-keeping and accounting.
5. It is a theoretical study as well as a practical work.

**Double Entry System of Accounting**

Double entry system of book-keeping refers to the system of accounting under which both the aspects of every transaction are recorded in the books of accounts. For every business transaction, there are two contracting parties and exchange of equal values or benefits i.e. the receiving aspect and giving aspect. The receiving and giving aspects of a transaction concerning each of the contracting parties affect two items or accounts in opposite directions or side. Two or double entries of equal values have to be made in two different accounts in opposite sides in the books of each of the contracting parties for recording a transaction completely. It is known as double entry system of accounting. It will be done in accordance with the **rules for debit and credit** which vary according to the type of accounts.

**Principle of Double entry System**

1. The double entry system is based on the universally accepted accounting principle duel aspect concept.
2. There must be two parties to each transaction, one party receiving the benefit of the transaction and the other party giving the benefit of transaction.
3. Both the aspects of the transaction should be recorded in the books of each party.
4. Each transaction is recorded simultaneously on the debit side of one account and credit side of another account.
5. The debit side of an account is intended to record the benefit received by the account and credit side is intended to record the benefits given by the account.
6. Both personal aspect and impersonal aspects are recorded under the double-entry system of accounting.
7. Since one aspect is debited and other aspect is credited, the total of debits given to all the accounts must always be equal to the total of credits given to all accounts. It will help in checking the arithmetical accuracy of transactions in the books of accounts.

**Advantages of Double-entry System**

1. It provides a complete record of all business transactions, as it records both the aspects of each and every transaction.
2. It provides not only complete but also authentic record of all transactions of a concern.
3. It is possible to prepare trial balance to check the arithmetical accuracy of books of accounts. Thus, opportunities for errors and frauds can be reduced to minimum.
4. It is possible to prepare Profit and Loss account as it maintains the nominal account.
5. It is possible to prepare Balance Sheet to ascertain financial position as it discloses assets and liabilities.
6. Since personal accounts are maintained amounts receivable from debtors and amount owed to creditors can be known readily.
7. It becomes easy for business concern to satisfy income tax and sales tax authorities.

**Limitations of Double –Entry System**

It suffers from the following limitations:

1. It is a complicated and difficult system.
2. The system involves the maintenance of a number of account books. So it is costly.
3. The system requires strict adherence to the principles or rules of accountancy. As such a person without adequate knowledge of the principles of accountancy cannot maintain accounts under the system.
4. Even this system does not disclose all the errors committed in the books of accounts.

**Classification of Accounts**

1. **As per Traditional or English Approach:** every business deals with other persons, firms or companies. A concern may buy goods from other parties or sell goods to other parties on credit. It may borrow money from other parties or lend money to other parties. A business concern has certain properties or assets such as goods, cash, furniture, buildings etc. a business may incur certain expenses, such as salaries, rent, advertisement, stationery, etc. and may earn some incomes, such as commission, interest etc. in the course of business. In the light of the above discussion, it is clear that every business has three classes of transactions, viz., transactions relating to persons (**Personal Accounts**), transactions relating to Assets (**Real Accounts**), transactions relating to expenses and incomes(**Nominal Accounts**)
2. **Personal Accounts:** these are accounts of persons with whom a concern carries on business. A personal account may be: *(****a) natural personal accounts*** – accounts of human beings e.g. Ram’ Account, Devi’s Account etc. ***(b) artificial persons accounts* –** these are the accounts of legal or artificial persons account i.e. accounts of partnership firms, companies, clubs, banks, government institutions, schools, colleges etc. e.g. St. Thomas College’s Account, income tax Departments Account, etc. ***(c)representative personal accounts –*** these accounts are called representative personal accounts as they represent certain persons behind them i.e. accrued expenses account, outstanding expenses, prepaid expenses, accrued incomes account, outstanding incomes account and income received in advance account etc. in this connection it is noted that if any prefix or suffix , say, outstanding, unpaid, accrued, owing, due, unexpired, prepaid etc. is added to nominal account, that account becomes a representative personal account.
3. **Real Accounts:** these are accounts of properties, assets or things owned by a concern and in and with which the business is carried on. Real accounts may be: ***(a) accounts of tangible assets*** – accounts which have physical existence and can be seen, touched, felt, bought and sold. E.g. goods account, cash account, furniture account, machinery account, buildings account, land account etc. ***(b)accounts of intangible assets*** – accounts of assets which have no physical existence and cannot be seen, touched, felt etc. but can be bought and sold. E.g. goodwill account, patent right account, copy rights accounts and trademarks account etc.
4. **Nominal accounts:** these are accounts of the expenses and losses which a concern incurs and incomes and gains which a concern earns in the course of its business. These are called nominal accounts, because they do not really exist and cannot be seen or touched. They exist only in names. Nominal accounts may be: ***(a) revenue or income accounts*** – these are accounts of revenues, incomes, gains, or profits such as commission earned, interest received, discount received etc. ***(b) expenses accounts*** – these are accounts of expenses or losses such as salaries paid, rent paid, discount allowed, bad debts etc.

**Rules of Debit and Credit as per English Approach**

1. Personal Account: A person, who enters into a business transaction with a business, either receives some benefit from the business or gives some benefit to the business. As such, the account of the person who receives the benefit of the transaction from the business should be debited and the account of the person who gives benefit of the transaction to the business should be credited.

***Debit the receiver***

***And***

***Credit the giver***

1. Real Account: an asset is a lifeless thing. As such, it cannot receive or give any benefit. It can only come into the business or go out of the business. So the account of asset which comes into the business should be debited, and the account of an asset which goes out of the business should be credited.

***Debit what comes in***

***And***

***Credit what goes out***

1. Nominal Account: nominal accounts may be expenses and losses or incomes and gains for the business. Therefore, account of an expense or loss of the business should be debited and the account of an income or gain of the business should be credited.

***Debit expenses and losses***

***And***

***Credit incomes and gains***

**Rules of Debit and Credit as per American Approach or accounting Equation Approach**

1. Assets:

***Debit increase in an Asset***

***And***

***Credit decrease in an Asset***

2. Liabilities:

***Debit decrease in Liability***

***And***

***Credit increase in Liability***

3. Capital:

***Debit decrease in capital***

***And***

***Credit increase in Capital***

4. Incomes and Gains:

***Debit decrease in an income***

***And***

***Credit increase in an income***

5. Expenses and Losses:

***Debit increase in an expense***

***And***

***Credit decrease in an expense***

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