Chapter 16 discusses the meaning, classification and various methods of costing, and the scope, objectives and advantages of Cost Accounting to the management, the creditors and the Government. Chapter 17 illustrates the idea of marginal costing and its difference from absorption costing. It also describes various methods used in calculating the break-even point, P/V ratio, and in the construction of break-even chart. Chapter 18 covers standard costing systems, cost variance analysis, and the classification of various variances such as basic material, labour, sales and overhead. Chapter 19 includes budgeting and budgetary control, the preparation of various types of budgets, and zero base budgeting.

Chapter 20 explains the meaning, features, advantages and procedures of job and process costing. Chapter 21 describes the meaning, steps involved, advantages and disadvantages of activity-based costing (ABC) approach, its difference from the traditional costing system, and its uses in manufacturing and service organisations. Chapter 22 elaborates on target costing, its meaning and principles, and the various procedures of installation of the system. It also explains about the cost-reduction process, known as Kaizen costing. Chapter 23 discusses responsibility accounting, its meaning and the essential features, steps involved, the responsibility centres such as cost, profit and investment centres, and transfer pricing. Chapter 24 explains, in detail, about human resources accounting, its meaning, the concept, objectives, advantages, the various methods, and its significance.

I wish to express my thanks to my friends and colleagues who have provided the inspiration, valuable assistance and cooperation to complete this project. Many thanks to my husband Appus and my son Kithu for providing support and understanding. I am thankful to my Publishers M/s Prentice-Hall of India, New Delhi for their constant encouragement and support.

Suggestions for improvement of this book will be highly appreciated.

Jelsy Joseph Kuppapally

CHAPTER 1

Accounting Preliminaries

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- Understanding the development of accounting.
- Learn meaning of accounting.
- Identify the objectives of accounting.
- Identify the end users of accounting.

1.1 INTRODUCTION

Accounting is as old as civilisation. It was the key to important phases of history and the most important professions such as economics and business. Accountants were, in a large measure, responsible for the development of money and banking, and the **double entry bookkeeping** that fuelled the Italian Renaissance saved many Industrial Revolution protagonists and entrepreneurs from bankruptcy. Accounting helped develop the confidence in capital markets which was instrumented in the evolution of Western capitalism, capital markets and the information revolution that is presently transforming the global economy.

In 1494, Luca Pacioli (1447–1517), an Italian Franciscan monk and mathematician, published the book *Summa de Arithmetica, Geometrica, Proportioni et Proportionalite*. It was a summary of the existing mathematical knowledge of the time and contained a section on "Details of Accounting and Recording" which described **bookkeeping** as used in Venice. This book was the first complete description of double entry bookkeeping. The profit or loss was entered into the capital account to balance the balance sheet. The *Summa* was published throughout Europe. It became the most widely read book in Italy on mathematics and firmly established Pacioli as the "Father of Accounting".

1.2 DEFINITIONS

In 1941, the Committee on Terminology of the American Institute of Certified Public Accountants (AICPA) described 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".

In 1966, The American Accounting Association (AAA) defined accounting as:

"The process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by users of the information".

The above definitions bring out many functions and features of accounting as described in the following sections.

1.3 FUNCTIONS OF ACCOUNTING

Recording

This is the basic function of accounting. It is done in the book of **journal**. This book may be further classified into various subsidiary books, such as purchases book, sales book, purchases returns book, sales returns book, bills receivable book, bills payable book, cash book, and the Journal proper. The number of subsidiary books to be maintained will be according to the nature and the size of business.

Classifying

Classification deals with the systematic analysis of the recorded data with a view to group entries of the same nature at one place. The work of classification is done in the book termed **ledger**. This book contains different account heads, under which all financial transactions of similar nature are collected. Any item which is recorded in the Journal is classified under separate heads in the ledger. This helps in finding out the total expenditure incurred under the different account heads.

Summarising

After classifying the data, summarised in such a way that it is understandable and useful to various users of accounting statements.

Financial transaction or events

Transaction or events, which is, at least in part, of a financial character, is recorded in the books of accounts. Any matter of conduct of the managers or of the employees will not be entered in the book of accounts.

Analysis, interpretation and communication

The recorded financial data are analysed, interpreted and communicated to different categories of people so that appropriate decisions can be taken at the right time.

1.4 ACCOUNTING AS INFORMATION SYSTEM

Accounting is the language of business. It is an information system. The accounting system processes business transactions to provide information to various interested parties. There are external and internal users of accounting information system of a firm. The external users are those people who do not have direct access to the books of accounts, e.g., investors, lenders and so on. Managing directors, marketing managers, production managers, materials managers, financial controllers, and government are examples of internal users of accounting information. A typical accounting information system is illustrated in Fig. 1.1.

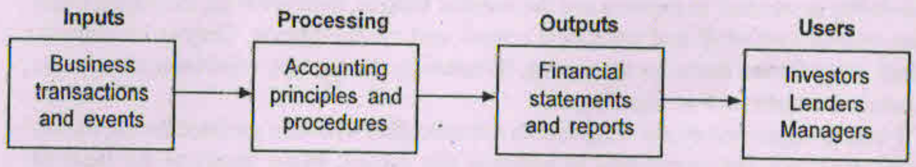

FIG. 1.1 The Accounting Information System.

1.5 USERS OF ACCOUNTING INFORMATION

The basic objective of accounting is to provide information, which is useful for persons inside and outside an organisation.

1.5.1 Internal Users

Owners/investors

They are the major recipients of the financial statements of business enterprises. As providers of risk capital, the individual and institutional investors (such as insurance companies and mutual funds) are accountable to the risks inherent in, and returns provided by, their investments. They need information to decide which investments to buy, retain, or sell, and the timing of the purchases or sales of those investments. They also need information to assess management performance and the ability of the enterprise to pay dividends. As the present investors are legally entitled to receive periodic financial reports, the potential investors are also interested in financial information.

Management

In addition to preparing financial information for use by others, the managers also use the information in many of their own decisions. Management needs information for planning and controlling operations, for making special decisions, and for formulating major plans and policies. Since management is responsible for reporting enterprise performance to owners and others, it monitors the key financial indicators which will appear in financial reports. Further, management studies the competition and seeks to make financial comparisons of its performance against competitors' performance. Sometimes, remuneration of managers is related to reported profits or other accounting-based measures.

Employees

They are interested in information about the enterprise as well as its general operations, stability, and profitability. Present employees clearly have an interest in the financial affairs of the enterprise that employs them since it is the main source of their income. Potential employees may also like to know about the financial affairs of the enterprise and past employees have a valid interest in the information to the extent that their pensions are dependent upon the future prospects of the enterprise. Trade unions have a stake in the financial reports of enterprises with whom they are engaged in wage negotiations.

1.5.2 External Users

Lenders

Lenders, such as banks and debenture-holders, need to know about the financial stability of a business that approaches them for funds. They are interested in information that enables them to determine whether their loans, and the related interest, will be paid when due. Banks use credit evaluation benchmarks based on information derived from financial statements when determining the amount of the loan, interest rate, repayment period and security. They also use the information for monitoring the financial condition of borrowers.

Suppliers and other trade creditors

Present and potential suppliers are interested in the enterprise as an outlet for their products or services and, if the enterprise is a major customer, they would like to assess the future scenario. They are keen to obtain information that enables them to determine whether amounts owed to them will be paid when due. Trade creditors are likely to be interested in an enterprise over a shorter period than lenders unless they are dependent upon the continuation of the enterprise as a major customer.

Government and regulatory agencies

The three levels of government—Central, state and local authorities—are interested in the allocation of resources and the activities of enterprises. They also require information in order to regulate the business practices of enterprises, determine taxation policies, and provide a basis for national income and similar statistics. The Ministry of Finance and the Department of Company Affairs are among those in the Government of India that take a keen interest in the financial affairs of business enterprises. Government or quasi-government regulatory bodies,

such as the Securities and Exchange Board of India (SEBI) and the Insurance Regulatory and Development Authority (IRDA), and others, such as stock exchanges, have a legitimate interest in financial reports of publicly held enterprises to ensure the efficient operation of capital markets.

Customers

Present, potential and past customers are interested in the financial affairs of an enterprise to decide how much business to do with it, and to assess its ability to service the product or to honour warranty agreements. Major customers are considerate of how far they can rely on the enterprise as a source of supply.

The public

Financial statements assist the public by providing information about the trends and recent developments in the prosperity of an enterprise and the range of its activities. Political parties, public affairs groups, consumer groups and environmental protection groups also have a general interest in the affairs of business enterprises.

Research scholars

Being a mirror of the financial performance of a business organization, financial statements are of immense value to a researcher who wants to study the financial operations of a particular firm.

1.6 BOOKKEEPING

1.6.1 Definitions

Bookkeeping has been defined by various authorities. Some of them are as follows:

Bookkeeping is the art of recording business transaction in a systematic manner.

—A.H. Rosenkampff

Bookkeeping is the art of recording in the books of account the monetary aspect of commercial and financial transactions.

—Northcott

Bookkeeping is the science and art of correctly recording in books of account all those business transaction that result in the transfer of money or money's worth.

—R.N. Carter

In a nutshell, bookkeeping is the art and science of recording business transactions in a set of books.

1.6.2 Distinction between Bookkeeping and Accounting

Bookkeeping is recording of the financial transaction of a business in a systematic manner so that information on any point may be quickly obtained, whereas Accounting primarily involves in the design of the system of records, the preparation of reports, classifying and summarising the recorded data and communicating the results to the persons who are interested in the final accounts. A bookkeeper is responsible for keeping all the finance records of a business, but accountants often review the work of bookkeepers.

1.6.3 Advantages

The following are the advantages of bookkeeping:

1. It helps in knowing what are the expenses and gains of a business. This enables to ascertain the profits or losses and thereby watch the progress of the business.
2. It helps in ascertaining the exact financial position of the business at any given date.
3. A systematic written-up of account book serves as a permanent record of business transactions.
4. It assists in easily locating the errors and frauds that have taken place and taking steps to prevent them.
5. The recorded facts provide the management with sufficient information for proper management of the business.
6. It will be a great assistance to the manager for the assessment of income tax and sales tax.

1.6.4 Objectives

The objectives of bookkeeping are to:

1. maintain a permanent record of all business transactions;
2. ascertain the result of the business during a particular period of time;
3. know the financial position on any particular date;
4. keep control over expenses for minimising it;
5. have information for legal and tax purposes;
6. know the reason leading to net profits or net losses;
7. keep record of expenses and losses;
8. evaluate the performance by making comparison with other similar business;
9. know the amount owed by the business to the creditors; and
10. know the amount owed to a frim by the customers.

1.6.5 Explanations of Certain Items Used in Bookkeeping

Business transactions

The term 'business transaction' refers to any business dealing or event which has a value measurable in terms of money and which involves transfer of money or money's worth

between the business and others. The capital introduced by the proprietor, the amount withdrawn by the proprietor, purchase of goods on cash or credit, selling of goods for cash or credit, receipt of money from a debtor, payment to a creditor, borrowing of loan from bank or payment of a loan, payment of salaries, rent, telephone charges, and receipt of incomes such as discount, rent and interest are examples of business transactions.

However, receiving a price list, placing an order with the supplier, receipt of an order, or appointment for an employee does not come under the purview of business transactions because they do not involve any transfer of money or money's worth between the business and others. Similariy, the proprietors' private income from their property or other sources cannot constitute in business transactions.

There are three types of transactions:

(i) ***Cash transactions:*** It refers to any transaction which involves immediate payment or receipt of cash, e.g., purchase of goods for cash, sale of goods for cash, and payment of expenses or receipt of incomes.

(ii) ***Credit transactions:*** A credit transaction is one in which payment or receipt of money is postponed for a future date. Here, the name of the party is mentioned (with or without the word 'credit'). Purchased furniture from Mohan on credit, sold goods to Rajeev on credit, and salary unpaid, are some examples of credit transactions.

(iii) ***Barter transactions:*** If a transaction affects neither cash nor a person nor an institution, it is called a barter transaction. In this, goods are exchanged for goods.

Goods

These refer to commodities, articles, products or things which a trader deals with. In other words, goods mean commodities, which are purchased for re-sale, e.g., for a furniture dealer, furniture items such as table and chair are his goods, and for a machinery dealer, machine, tools and equipments are his goods.

Purchases

These are the goods purchased by a business.

Sales

The goods sold by business are called sales.

Purchase returns or return outwards

The goods returned by the business to its suppliers, which were purchased earlier from them, are called *purchase returns* or *return outwards*.

Sales returns or return inwards

The goods returned to a business by its customers, which were sold earlier to them, are called *sales returns* or *return inwards*.

Stock

Goods lying with a business as unsold on any given date are called stock.

Opening stock

Goods lying with a business as unsold at the beginning of any given period are called opening stock.

Closing stock

Goods lying with the business at the end of the accounting period is called closing stock.

Assets

These are the material things or possessions or properties of the business, including the amounts due to it by others. It includes physical or real properties, called *tangible assets* such as land and building, plant and machinery, furniture, vehicles, stock of goods and cash, owned by a business; rights in certain things, called *intangible assets*, such as goodwill, patents, and trade marks, possessed by the business; and amounts due to the business from others, e.g., sundry debtors, bills receivables, prepaid expenses, and accrued income.

Liabilities

These denote the amount which a business owes to others either for the money borrowed or for the goods or assets purchased on credit or for the services rendered. Creditors, bills payable, bank loan, and outstanding salaries are some examples.

Capital

It refers to the money or money's worth introduced or invested by the proprietor in the business. It is the amount of owners' claim against the assets. It is also called *owners' equity*.

Drawings

It is the value of cash or goods withdrawn by the proprietor from the business for his personal or domestic use.

Debtor

A debtor is a person who owes money to the business as he has received some benefit from the business. He constitutes an asset for the business.

Creditor

A creditor is a person to whom the business owes money, as he has given some benefit to the business. He constitutes some liability for the business.

Equity

All claims against a firm are called *equity*. It denotes liability. The claim of outsiders is called **creditors' equity** and claim of the proprietors is called owners' equity.

Solvent and insolvent

A trader is said to be solvent when he is able to pay his liabilities in full, and when not, he is called insolvent.

1.7 OBJECTIVES OF ACCOUNTING

The following are the main objectives of accounting:

1. *To keep systematic records:* Accounting keeps a systematic record of all financial transactions, since human memory cannot keep track of all transactions on any given day.
2. *To protect business properties:* Proper accounting protects properties from unwanted and unjustified use. At the same time, this information will help the proprietor in assuring that the fund he raised or invested in the business is not unnecessarily kept idle. This is on account of supplying the information to the manager or the proprietor regarding:
   (i) The amounts of the proprietors' fund invested in the business.
   (ii) The amount invested in the form of fixed or current assets.
   (iii) The payment the business has to pay to others.
   (iv) The amount to be recovered from others.
3. *To ascertain profit or loss:* Accounting helps to prepare the income statement, which records and compares all revenue and expenses for a particular period. If the amount of revenue for the period is more than the expenditure, the resulting figure is profit and, if the expenditure exceeds the revenue, the resulting figure is loss.
4. *To ascertain the financial position of the business*: Financial statements exhibit the position of the business on a particular date. Position statement, which is also known as **Balance Sheet**, is a statement of assets and liabilities of the business on a particular date. It serves as a barometer for ascertaining the financial health of the business.
5. *To facilitate rational decision making:* Financial statement is submitted to the board of directors, managers, and to those people who have directly or indirectly interested in it to analyse and interpret it and take timely decisions.

1.8 BRANCHES OF ACCOUNTING

In order to satisfy the needs of the different people interested in the accounting information, various branches of accounting have developed. They are as follows:

1.8.1 Financial Accounting

This is the original form of accounting. The main purpose of this form of accounting is to record transactions in the books of accounts in such a way that the financial statements can be prepared, and the profit for the period and position of the firm on particular date can be analysed and interpreted by those who are interested to know the financial results of the firm.

1.8.2 Cost Accounting

It has developed on account of the *factory system* and due to complexities of modern business. This process starts with recording of expenditure and ends with preparation of statistical data. With the help of this system, the cost of products or services can be ascertained and controlled. Cost accounting provides data under different elements, for different functions of management. It is helpful in evaluating performance through various techniques, such as budgetary control, standard costing and marginal costing.

1.8.3 Management Accounting

This is of recent origin. It is the study of managerial aspects. It relates to the use of accounting data collected with the help of financial and cost accounting methods for the purpose of policy formulation, planning, control and decision making by the management.

1.9 LIMITATIONS OF ACCOUNTING

L.W. Hawkins aptly said that "the ordinary trading account is a locked house for most valuable information." Modern business has become so competitive and complex that financial statements prepared by financial accounting fall short of management's requirements of information for decision-making. It is due to these limitations that cost accounting and management accounting have developed.

The following are the limitations of financial accounting:

1. *Monetary nature:* Accounting records only those transactions which are measured in terms of money. The items, for example, product quality, government policy, competitive strategies and so on, though will have direct bearing on the business, will not be recorded in the books of accounts.
2. *Historical data:* Financial accounting records only those transactions which have occurred. It does not record future transactions. Financial statement, also, is prepared at the end of a particular period, considering all those transactions occurred during that year. Management planning and decisions are future-oriented, hence they require information about the future. Financial accounting fails to provide this information.
3. *Preparation of accounts:* Accounting provides information for a particular period, for the entire firm. Financial accounting does not record financial data unit-wise,

product-wise or process-wise. So, it is difficult for the management to know the unit cost or the total cost of a product.
4. *Actual cost alone is recorded:* Accounting transactions are recorded at the cost in the books. Since price level changes are not accommodated in this account, the price comparison of various years becomes difficult.
5. *Fails to help price fixation:* Since financial accounts record historical data, the cost of production can be ascertained only after the costs are incurred; so the prices of the products cannot be fixed in advance. Submission of quotations or tenders is very difficult since accurate prices cannot be determined with the help of financial statements.
6. *Not useful in cost control:* In financial accounting, cost figures are available only after it has occurred. The cost control process involves constant comparison of predetermined cost with actual cost. If costs are incurred and information is available, subsequently, nothing can be done to control them. Financial accounts fail to reveal whether the costs incurred are high or low.

1.10 DOUBLE ENTRY SYSTEM

In India, there is adequate evidence of the systematic accounting methods used in the ancient period. Kautilya's famous *Arthasasthra* not only relates politics to economics, but it also explains the art of account keeping. The Italian philosopher and mathematican Luca Pacioli, in his book *Summa*, makes an important step in keeping records under the double entry system. By stating the principles of double entry bookkeeping, this book laid the foundation of modern double entry bookkeeping.

The **double entry system** is that system which recognises and records both the aspects of transactions. For every business transaction, there are two contracting parties. For each transaction involves exchange of equal values or benefits. In each transaction, there is someone to receive and someone to give the benefit of equal value.

1.10.1 Advantages

1. The accuracy can be tested through the preparation of Trial Balance.
2. Income statement can be prepared to ascertain the profit or loss for a particular period.
3. With the help of Balance Sheet, the financial position can be ascertained.
4. Ready information is available at any time, which is useful for decision making.
5. The double entry system satisfies tax and government authorities.