1. Introduction to Accounting - Preliminaries

Students' Notes:
This area covers the Meaning of "Accounting" and an overview of the Accounting Process and related fields.

1.1 Definition of Accounting

1. As per the **American Institute of Certified Public Accountants (AICPA) –** Accounting is an **art** of recording, classifying and summarizing **transactions and events** which are in part atleast of **financial character,** in a **significant manner** and in terms of **money**, and **interpreting** the results thereof.
2. Accounting also involves **analyzing** and interpreting the **financial transactions** and **communicating** the results to the persons interested in such information.
3. Accounting is considered as an **'Information System',** as the function of Accounting is to provide **quantitative information**, primarily financial in nature about the business organisation.

1.2 Transactions vs Events, Financial vs Non-Financial

1. **Transactions and Events:** In a business or economic scenario –

Business Activities

Transactions	Events	Both Transaction and Event
Transactions – Performance of business Activity	**Events – Result** of Transactions.	**Both Transaction and Event (Refer Note)**
Thumb Rule: Human Effort is involved	**Thumb Rule:** Human Effort not involved. It represents results	**Thumb Rule: Both** Human Effort & results from such effort are involved in a single activity
Example: Purchases, Sales, Expenses paid	**Example:** Profits / Closing Stock are results of purchases & sales	**Example:** Purchase of Fixed Assets on last day of a/cing yr

Note: Both Transaction and Event: Purchase of Fixed Assets on the last day *of the financial year is a transaction, since it is a business activity. It is also an event as a Fixed Asset exists as a result of such purchase.*

Example: Vignesh Traders buys and sells books. During January, the Firm purchased goods for ₹ 1,00,000 and sold the entire stock for ₹ 1,40,000. During the month, it paid salary to its Shop Manager ₹ 10,000 and Rent ₹ 6,000.

	Particulars	₹	₹
	Sales		1,40,000
Less:	Cost of Goods purchased and sold	1,00,000	
	Expenses paid (Salary ₹ 10,000 + Rent ₹ 6,000)	16,000	(1,16,000)
	Surplus – Profit		**24,000**

- Purchase and Sale of goods, and Payment of Salary and Rent Expenses are **"Transactions"**.
- Earning Surplus / Profit is an **"Event"**.

2. **Types of Transactions – 2 Types:**

Types	Financial Transaction	Non–Financial Transaction
Meaning	When a business transaction involves a transfer of **money or moneys' worth**, then the transaction is called "Financial Transaction". **(Refer Point 3 below)**	When a business transaction does not involve money or money's worth.
Example	Purchase and Sale of goods, Payment of Expenses, Purchase of Assets, Goods lost by fire etc.	Quarrel between 2 Managers, Death of an Employee, etc.
Types	Cash and Credit Transaction (Refer Point 4)	No such classification.

3. **Financial Transactions – Meaning of Money or Money's worth:**

Money	Cash – Rupee Notes / Coins.
Money's Worth	Cheque/ **Obligation to pay**, but actual payment to be made later (credit transactions)/ Bill of Exchange / Promissory Note / Setting off one liability against another receivable / Exchange of Assets / Debit Note / Credit Note

Notes: Hence, a transaction can be regarded as Financial Transaction even if money is not involved. It is sufficient that it involves money's worth. Further note that Accounting is concerned with only financial transactions. Non–Financial transactions are not considered.

Barter – It refers to exchange of goods among persons. **Example:** A sells pen to B. B sells pencil to A.

4. **Cash & Credit Transaction:** Financial Transaction can be classified into two types –

Type	Meaning	Example
Cash Transaction	If the Financial transaction involves Cash / Cheque / Other modes of immediate settlement (Refer note below)	Cash received from Debtors / Cash Sales
Credit Transaction	If the Financial Transaction does not involve immediate settlement, but there is an **obligation to pay in future,** it is called as credit transaction. The actual settlement in cash will be made later.	Sales made to Mr.A on condition that A will pay after 60 days, Debit Note – **Credit Sales**

Students' Notes:

1. It is to be noted that if the Financial Transaction involves Money / Money's worth **(other than Obligation to pay)**, then it is **considered as Cash Transaction.**
2. **Cash Transaction does not mean that Cash must be involved.**
3. Hence, if the transaction involves settlement by a Bill of Exchange / Promissory Note / Setting off one liability against another Receivable / Exchange of Assets, it shall be considered as Cash Transaction only

1.3 Accounting Processes

The Accounting Process involves – Accounting

Recording | **Classifying** | **Summarising** | **Analysing** | **Interpreting** | **Communicating**

Generating Financial Information (Recording, Classifying, Summarising)

Using the Financial Information (Analysing, Interpreting, Communicating)

<u>Processes of Generating Financial Information (3 processes)</u>

1. Recording:

Meaning	All **business transactions** which are of **financial nature** (i.e. expressed in terms of money) are recorded in the books of accounts.
Purpose	A businessman cannot keep in his memory all the business activities carried out by him. Hence, there is a need for keeping track of such activities in a separate record.
Basis of Recording	All transactions must be evidenced by supporting documents like Sales Invoice, Purchase Bill, Receipts, Pay Slip, etc. ***(These are called Vouchers)***
Relevant A/cs Book	The Books in which primary entry is made is called "**Journal**", which is further sub–divided into several **Subsidiary Books** for Sales, Purchases, Cash & Bank, etc. according to the nature and size of the business.
Checkpoint	It is to be noted that Accounts is concerned with only **Financial Transactions**. Accounting will not record Non–Financial Transactions in its books.
Example	• **Salary paid to Manager** will be recorded in the books of accounts. • But, good health of the Manager, even if it is of great use to the business, has no financial character and no economic value, and therefore, will not be considered in Accounting.

2. Classifying:

Meaning	Classifying involves grouping transactions of a similar nature at one place, such that information will be compressed and presented in useable form.
Purpose	While the process of recording ensures that all financial transactions are recorded, one cannot make any observations unless all the transactions are grouped together under different categories.
Basis	Classification is based on the transactions recorded in the Journal / Subsidiary Books.
Relevant A/cs Book	The book containing the classified information of transactions is called "**Ledger**". Each page in the Ledger is called as "**Folio**". In each folio (Page No.), an individual Account Head and all transactions relating to that Account Head is recorded / posted.
Checkpoint	Ledger can be prepared only after the preparation of Journal / Subsidiary Books
Example	• At recording stage, all transactions are normally recorded chronologically (i.e. date–wise). • Assuming a businessman made 10 sale transactions (out of which 6 are on credit), paid telephone charges, rent etc., received payments from 3 debtors in a week, it is not possible to ascertain the exact position of each item unless they are grouped as "Sales A/c, Telephone Charges A/c, Rent A/c, Debtors A/c etc." • This will help in finding out Total Sales (Cash & Credit sales) / Expenditure / Amounts due from Debtors, etc.

3. Summarizing:

Meaning	This involves presentation and preparation of the classified information in a manner useful to the internal and external users of Financial Statements.
Accounts Books	It involves preparation of Trial Balance, and Financial Statements therefrom, viz. (i) Profit and Loss Account (to find out Profits/Losses of the business), (ii) Balance Sheet (to ascertain the Financial Position), and (iii) Cash Flow Statement (to determine the factors for increase or decrease in Cash & Bank Balances)
Basis	Summarizing is based on the classified transactions presented in Ledger.

Processes of Usage of Financial Information (generated through above 3 processes)

4. **Analysing:**

Meaning	Analysis involves **methodical classification** of the data given in the **Financial Statements.**
Nature of process	Analysis is concerned with the determining the relationship between the items in the Profit and Loss Account and Balance Sheet (i.e. Ratio Analysis). Thus, it **provides the basis for interpretation.** Further, analysis involves comparing current year figures with the previous year figures
Basis	Financial Statements generated above in summarizing
Example	**Net Profit Ratio** – The Sales and Net Profit is compared to find out the % of Net Profit earned on Sales. This helps to ascertain how much sales have to be achieved, to make specified net profits. **Example:** If NP Ratio is 20% on Sales and a Businessman wants to achieve Net Profits of ₹ 20 Lakhs in a year, then he must make a Sales of ₹ 100 Lakhs (20 Lakhs ÷ 20%) during that year.

5. **Interpreting:**

Meaning	Drawing observations from the items in the financial statements and also from relationships determined in analyzing process
Purpose	The recorded financial data is analysed and interpreted in the manner that will enable the data users to make a meaningful judgment about the financial condition and profitability of the business operation.
Nature of process	Financial Statements are interpreted to explain **what had** happened, **why** it had happened and **what is likely** to happen under specified conditions. Based on analysed information, interpretation shall be done.
Basis	Financial Statements generated in summarizing process and relationships determined in Analyzing process.
Example	Assuming the NP Ratio for 2018 is 20% on Sales, whereas it was 15% in 2017. Similarly the Expenses Ratio for 2018 is 80% on Sales, whereas it was 85% in 2017. This means the Profit has increased mainly due to decrease in Expenses. (so the Increase is not due to increase in Sales)

6. **Communicating:**

Meaning	It is concerned with the transmission of summarised, analysed and interpreted information to the end user to enable them to make rational decisions.
Modes	This is done through preparation and distribution of Accounting Reports, which includes Profit and Loss Account and Balance Sheet, additional information in the form of Accounting Ratios, Graphs, Diagrams, Funds Flow Statement, etc.

1.4 Objectives and Functions of Accounting

The objectives of Accounting are –

1. To have a **systematic record all business transactions** which are of financial nature.
2. To know the **result of business operations** for a particular period of time. If Revenue / Income exceeds the Expenses, then it is said that the business is running profitably, but if the Expenses exceed the Revenue, then the business is operating at a loss.
3. To know the **financial position** of the business. This will help answer questions like how much Assets and Liabilities that the business has on any date, whether the business is solvent, i.e. ability to meet its liabilities in the short run and also in the long run as and when they fall due.
4. To provide **information to Users for decision making**. Accounting, as the language of business, communicates the financial result of enterprises, to various Users. Accounting aims to meet the information needs of the decision maker and help them in rational decision making.

Objectives of Accounting

Systematic record of all business transactions	Ascertainment of results of business operation	Ascertainment of financial position	Providing information to Users
↓	↓	↓	↓
Book–Keeping, i.e. Journal, Ledger and Trial Balance	Trading and Profit & Loss Account	Balance Sheet	Financial Statements and Reports

1.5 Functions of Accounting

The **American Principles Board** of the **AICPA** enumerated the following functions of accounting:

1. **Measurement:** Accounting measures the performance of the business entity and depicts its current financial position.
2. **Forecasting:** Accounting helps in forecasting future performance and financial position of enterprise using past data.
3. **Decision–making:** Accounting provides relevant information to the Users of accounts to aid rational decision–making.
4. **Comparison & Evaluation:** Accounting assesses performance achieved in relation to targets and discloses information regarding accounting policies and Contingent Liabilities, which play an important role in predicting, comparing and evaluating the financial results.
5. **Control:** Accounting identifies weaknesses in the operational system and provides feedback regarding effectiveness of measures to rectify such weaknesses.
6. **Government Regulation:** Accounting provides necessary information to the Government, to exercise control on the entity as well as in collection of direct and indirect tax revenues.

1.6 Book–Keeping – Meaning and Features

Meaning	It is an activity of **recording and classifying** the financial data relating to business operations in a significant and orderly manner.
Objective	• Complete recording of transactions. • Ascertainment of financial effect on the business.
Features	• It is an art of scientifically **recording** the transactions. • The recording is done only in **monetary terms**. • Recording of transaction is restricted only to that of a **particular enterprise.** • The recordings are made in a given set of **books**.
Advantages	• From the Financial Statements, financial information is **readily available** to the Users. • **Qualitative financial decisions** can be taken, since the financial information is reliable. • Valuable **conclusions** can be drawn on comparing the books of different years of the same enterprise, or comparing books of the same period for different enterprise. • Financial accounts of an enterprise are treated as **evidence** in a Court of Law. • Maintaining records of various assets helps **control**, i.e. to ensure there is no unauthorized use or disposal of any asset or property of the business.

1.7 Book–Keeping vs Accounting

	Basis	Book–Keeping	Accounting
1	Scope	Book–keeping involves – (a) Identifying the transactions, (b) Measuring the identified transactions, (c) Recording the measured transactions, (d) Classifying the recorded transactions.	In addition to book–keeping, Accounting involves– (a) Summarizing the classified transactions, (b) Analyzing the summarized results, (c) Interpreting the analysed results, and (d) Communicating the information to interested parties.
2	Stage	Book–keeping is the primary stage. (i.e. record–keeping phase)	Accounting is the secondary (summarizing) stage. It starts where book–keeping ends.
3	Basic Objective	To maintain systematic records of financial transactions.	To ascertain net results of operations and financial position and to communicate information to the interested parties.
4	Person	Book–keeping is done by Junior Staff.	Accounting work is performed by Senior Staff.
5	Knowledge level	Book–Keeper is not required to have higher level of knowledge than an accountant.	Accountant is required to have higher level of knowledge than that of Book–Keeper.
6	Analytical skills	Book–Keeper may or may not possess analytical skills.	Accountant is required to possess analytical skills.
7	Nature of job	The job of a Book–Keeper is often routine and clerical in nature.	The job of an Accountant is analytical in nature.

	Basis	Book–Keeping	Accounting
8	Designing of System	It does not cover designing of accounts system.	It covers designing of accounting system.
9	Supervision	The Book–Keeper does not supervise and check the work of an Accountant.	An Accountant supervises and checks the work of a Book–Keeper.
10	Financial position	Financial position of the business cannot be ascertained through book–keeping.	Financial position of the business is ascertained based on the accounting reports.
11	Financial Statements	Financial Statements do not form a part of the book–keeping process.	Financial Statements are part of the accounting process. These Statements are prepared based on book–keeping records.
12	Managerial decision	Managerial decision cannot be taken with the help of book–keeping records alone.	Management can take decision on the basis of accounting records and statements.
13	Sub–fields	There are no sub–fields for Book–Keeping.	It has several sub–fields such as Financial Accounting, Management Accounting, etc.

Note: In terms of scope, Book–Keeping < Accounting < Accountancy.

1.8 Book–Keeping Vs Accounting

The various sub–fields of Accounting are – ***(Note: Foundation Syllabus covers only Financial Accounting)***

1. **Financial Accounting:** It covers the preparation and interpretation of Financial Statements (i.e. P&L Account and Balance Sheet) and communication thereof, to the User of accounts. It is historical in nature as it records transaction which has already occurred. It primarily helps in determination of the net result for an accounting period and the financial position as on a given date.
2. **Management Accounting:** It is used for internal reporting to the Management of a business unit. The different ways of grouping information and preparing reports as desired by the Managers for discharging their functions are referred to as Management Accounting.
3. **Cost Accounting:** It is the process of accounting for cost and determination of overall cost of the product or service. The study of the behavioural pattern of cost will enable to control cost.
4. **Social Responsibility Accounting:** It is concerned with accounting for social costs incurred by the enterprise and social benefits created.
5. **Human Resource Accounting:** It seeks to identify, quantify and report investments made in Human Resources of an organization that are not presently accounted under any conventional accounting practice.

1.9 Users of Financial Information

Users	Purpose
Management	For day–to–day decision–making and **performance evaluation.**
Proprietor / Shareholders	To analyse performance, **profitability** and financial position. **Note:** Prospective Investors are interested in the track record of the Company.
Lenders – Banks & Fin. Institutions	To determine the financial position and **strength** of the Company, Debt Service Coverage, etc.
Suppliers	To determine the **credit worthiness** of the Company.
Customers	To know **general business viability** before entering into long–term contracts and arrangements.
Employees	To know the **stability, continuity and growth** of the enterprise, and its ability to pay remuneration, retirement & other benefits, and to enhance career opportunities.
Government	• To ensure prompt collection of Direct and Indirect Tax revenues, • To evaluate performance and contribution to social objectives.
Research Scholars	For study, **research** and analysis purposes.
Public at Large	To see whether the Enterprise is making a reasonable / substantial **contribution to the local economy**, e.g. employment opportunities, patronage of local suppliers.

1.10 Relationship of Accounting with other Disciplines

The relationship of Accounting with other disciplines is highlighted as under –

Discipline	Relationship
1. **Auditing**	Auditing process reviews the Financial Statements, which are the outcome of the accounting process. Thus, The Auditor should have a thorough and sound knowledge of Accounting Standards and Generally Accepted Accounting Principles for reviewing the Financial Statements.
2. **Economics**	• Economics uses the database provided by Accounting System, for developing decision–models and for rational decision–making on the use of scarce resources. • Economic Theories have influenced the development of decision–making tools used in accounting. • *However, there are differences between the Economists' and Accountants' concepts of Income, Capital and Valuation of Assets.*
3. **Law**	• Transactions and events are governed by the laws of the land like the law of Contracts, Sale of Goods, Negotiable Instruments and Taxation Laws. • The entity itself is governed by specific statutes like Partnership Act, Companies Act, Co–operative Societies Act, which have a bearing on maintenance of account books. • The format of Financial Statements is also prescribed by certain Statutes like Companies Act, Banking Regulation Act, etc. • Also, accounting influences law in the sense that legislation about accounting system cannot be enacted unless there is a corresponding development in the accounting discipline, e.g. formulation of Accounting Standards and adoption by Companies Act.
4. **Mathematics**	• Knowledge of arithmetic and algebra is a pre–requisite for accounting computations and measurements, e.g. Depreciation, Use of interest and annuity tables, Lease Rentals, Hire Purchase Instalments, etc. • Ratios, Graphs, and Operations Research Models have been widely used in accounting
5. **Management**	Management relies on accounting and other data for effective decision–making. Accounting System can be designed to serve management purposes.
6. **Statistics**	In accounting, many ratios and financial calculations are based on statistical methods, which help in averaging them over a period of time. Thus, Statistics is helpful in development of accounting data and in their interpretation, using Pie–Charts, Graphs and Trend Curve Diagrams, etc.

1.11 Services of a Chartered Accountant

1. Accounting Services	2. Audit Services	3. Consultancy Services	4. Other Services
• Maintenance of Books of accounts • Preparation of Financial Statements • Interpretation of Financial Statements	• Statutory Audit • Internal Audit • Limited Review • Due Diligence Audit • Investigation	• Taxation Consultancy (Direct & Indirect Taxes) • Corporate Laws Consultancy • Management Consultancy	• Financial Advisory Services, e.g. Investment, Insurance, Business Expansion, Investigations, etc. • Specific Services, e.g. Secretarial, formation of Companies, Insolvency Resolution, Arbitration, Costing, etc.

Note: Chartered Accountants play a significant role today, in various capacities – (a) as Independent practicing Professionals, (b) as Employees / Leaders of Corporate Entities, (c) as Advisors to Government in framing fiscal policies, etc.