**Definition of Accounting:**

American Institute of Certified Public Accountants (AICPA) which defines accounting as “the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events, which are, in part at least, of a financial character and interpreting the results thereof”.

**Objective of Accounting:**

* 1. **To keeping systematic record:** It is very difficult to remember all the business transactions that take place. Accounting serves this purpose of record keeping by promptly recording all the business transactions in the books of account.
  2. **To ascertain the results of the operation:** Accounting helps in ascertaining result i.e., profit earned or loss suffered in business during a particular period. For this purpose, a business entity prepares either a Trading and Profit and Loss account or an Income and Expenditure account which shows the profit or loss of the business by matching the items of revenue and expenditure of the same period.
  3. **To ascertain the financial position of the business:** In addition to profit, a businessman must know his financial position i.e., availability of cash, position of assets and liabilities etc. This helps the businessman to know his financial strength. Financial statements are barometers of health of a business entity.
  4. **To portray the liquidity position:** Financial reporting should provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, cash dividends and other distributions of resources by the enterprise to owners and about other factors that may affect an enterprise’s liquidity and solvency.
  5. **To protect business properties:** Accounting provides up to date information about the various assets that the firm possesses and the liabilities the firm owes, so that nobody can claim a payment which is not due to him.
  6. **To facilitate rational decision – making:** Accounting records and financial statements provide financial information which help the business in making rational decisions about the steps to be taken in respect of various aspects of business.
  7. **To satisfy the requirements of law:** Entities such as companies, societies, public trusts are compulsorily required to maintain accounts as per the law governing their operations such as the Companies Act, Societies Act, and Public Trust Act etc. Maintenance of accounts is also compulsory under the Sales Tax Act and Income Tax Act.

**Importance of Accounting:**

* 1. **Owners:** The owners provide funds or capital for the organization. They possess curiosity in knowing whether the business is being conducted on sound lines or not and whether the capital is being employed properly or not. Owners, being businessmen, always keep an eye on the returns from the investment. Comparing the accounts of various years helps in getting good pieces of information.
  2. **Management:** The management of the business is greatly interested in knowing the position of the firm. The accounts are the basis; the management can study the merits and demerits of the business activity. Thus, the management is interested in financial accounting to find whether the business carried on is profitable or not. The financial accounting is the “eyes and ears of management and facilitates in drawing future course of action, further expansion etc.”
  3. **Creditors:** Creditors are the persons who supply goods on credit, or bankers or lenders of money. It is usual that these groups are interested to know the financial soundness before granting credit. The progress and prosperity of the firm, two which credits are extended, are largely watched by creditors from the point of view of security and further credit. Profit and Loss Account and Balance Sheet are nerve centres to know the soundness of the firm.
  4. **Employees:** Payment of bonus depends upon the size of profit earned by the firm. The more important point is that the workers expect regular income for the bread. The demand for wage rise, bonus, better working conditions etc. depend upon the profitability of the firm and in turn depends upon financial position. For these reasons, this group is interested in accounting.
  5. **Investors:** The prospective investors, who want to invest their money in a firm, of course wish to see the progress and prosperity of the firm, before investing their amount, by going through the financial statements of the firm. This is to safeguard the investment. For this, this group is eager to go through the accounting which enables them to know the safety of investment.
  6. **Government:** Government keeps a close watch on the firms which yield good amount of profits. The state and central Governments are interested in the financial statements to know the earnings for the purpose of taxation. To compile national accounting is essential.
  7. **Consumers:** These groups are interested in getting the goods at reduced price. Therefore, they wish to know the establishment of a proper accounting control, which in turn will reduce to cost of production, in turn fewer prices to be paid by the consumers. Researchers are also interested in accounting for interpretation.
  8. **Research Scholars:** Accounting information, being a mirror of the financial performance of a business organization, is of immense value to the research scholar who wants to make a study into the financial operations of a particular firm. To make a study into the financial operations of a particular firm, the research scholar needs detailed accounting information relating to purchases, sales, expenses, cost of materials used, current assets, current liabilities, fixed assets, long-term liabilities and share-holders funds which is available in the accounting record maintained by the firm.

**GAAP (Generally Accepted Accounting Principles)**

A term that applies to the board concepts or guidelines and detailed practices in accounting, including all the conventions, rules, and procedures that make up accepted practice at a given time. Accounting principles are the rules of action or the methods and procedures of accounting commonly adopted while recording business transactions. Accounting principles are general decision rules, derived from objectives and concepts of accounting which govern the development of accounting techniques.

**Accounting Concepts:**

The term ‘concept’ is used to denote accounting postulates, i.e., basic assumptions or conditions upon the edifice of which the accounting super-structure is based. The following are the common accounting concepts adopted by many business concerns.

|  |  |  |  |
| --- | --- | --- | --- |
| **S. No** | **Concept** | **S. No** | **Concept** |
| 1 | Business Entity Concept | 6 | Historical Cost Concept |
| 2 | Money Measurement Concept | 7 | Matching Concept |
| 3 | Going Concern Concept | 8 | Realisation Concept |
| 4 | Dual Aspect Concept | 9 | Accrual Concept |
| 5 | Periodicity Concept | 10 | Objective Evidence Concept |

* 1. **Business Entity Concept:** A business unit is an organization of persons established to accomplish an economic goal. Business entity concept implies that the business unit is separate and distinct from the persons who provide the required capital to it. This concept can be expressed through an accounting equation, viz., Assets = Liabilities + Capital. The equation clearly shows that the business itself owns the assets and in turn owes to various claimants. It is worth mentioning here that the business entity concept as applied in accounting for sole trading units is different from the legal concept. The expenses, income, assets and liabilities not related to the sole proprietorship business are excluded from accounting. However, a sole proprietor is personally liable and required to utilize non-business assets or private assets also to settle the business creditors as per law. Thus, in the case of sole proprietorship, business and non-business assets and liabilities are treated alike in the eyes of law. In the case of a partnership, firm, for paying the business liabilities the business assets are used first and it any surplus remains thereafter, it can be used for paying off the private liabilities of each partner. Similarly, the private assets are first used to pay off the private liabilities of partners and if any surplus remains, it is treated as part of the firm’s property and is used for paying the firm’s liabilities. In the case of a company, its existence does not depend on the life span of any shareholder.
  2. **Money Measurement Concept:** In accounting all events and transactions are record in terms of money. Money is considered as a common denominator, by means of which various facts, events and transactions about a business can be expressed in terms of numbers. In other words, facts, events and transactions which cannot be expressed in monetary terms are not recorded in accounting. Hence, the accounting does not give a complete picture of all the transactions of a business unit. This concept does not also take care of the effects of inflation because it assumes a stable value for measuring.
  3. **Going Concern Concept:** Under this concept, the transactions are recorded assuming that the business will exist for a longer period of time, i.e., a business unit is considered to be a going concern and not a liquidated one. Keeping this in view, the suppliers and other companies enter into business transactions with the business unit. This assumption supports the concept of valuing the assets at historical cost or replacement cost. This concept also supports the treatment of prepaid expenses as assets, although they may be practically un-saleable.
  4. **Dual Aspect Concept:** According to this basic concept of accounting, every transaction has a two-fold aspect, Viz., 1.) Giving certain benefits and 2.) Receiving certain benefits. The basic principle of double entry system is that every debit has a corresponding and equal amount of credit. This is the underlying assumption of this concept. The accounting equation viz., Assets = Capital + Liabilities or Capital = Assets – Liabilities, will further clarify this concept, i.e., at any point of time the total assets of the business unit are equal to its total liabilities. Liabilities here relate both to the outsiders and the owners. Liabilities to the owners are considered as capital.
  5. **Periodicity Concept:** Under this concept, the life of the business is segmented into different periods and accordingly the result of each period is ascertained. Though the business is assumed to be continuing in future (as per going concern concept), the measurement of income and studying the financial position of the business for a shorter and definite period will help in taking corrective steps at the appropriate time. Each segmented period is called “accounting period” and the same is normally a year. The businessman has to analyse and evaluate the results ascertained periodically. At the end of an accounting period, an Income Statement is prepared to ascertain the profit or loss made during that accounting period and Balance Sheet is prepared which depicts the financial position of the business as on the last day of that period. During the course of preparation of these statements capital revenue items are to be necessarily distinguished.
  6. **Historical Cost Concept:** According to this concept, the transactions are recorded in the books of account with the respective amounts involved. For example, if an asset is purchased, it is entered in the accounting record at the price paid to acquire the same and that cost is considered to be the base for all future accounting. It means that the asset is recorded at cost at the time of purchase but it may be methodically reduced in its value by way of charging depreciation. However, in the light of inflationary conditions, the application of this concept is considered highly irrelevant for judging the financial position of the business.
  7. **Matching Concept:** The essence of the matching concept lies in the view that all costs which are associated to a particular period should be compared with the revenues associated to the same period to obtain the net income of the business. Under this concept, the accounting period concept is relevant and it is this concept which necessitated the provisions of different adjustments for recording outstanding expenses, prepaid expenses, outstanding incomes, incomes received in advance, etc., during the course of preparing the financial statements at the end of the accounting period.
  8. **Realisation Concept:** This concept assumes or recognizes revenue when a sale is made. Sale is considered to be complete when the ownership and property are transferred from the seller to the buyer and the consideration is paid in full. However, there are two exceptions to this concept, viz., 1.) Hire purchase system where the ownership is transferred to the buyer when the last instalment is paid and 2.) Contract accounts, in which the contractor is liable to pay only when the whole contract is completed, the profit is calculated on the basis of work certified each year.
  9. **Accrual Concept:** According to this concept the revenue is recognized on its realization and not on its actual receipt. Similarly the costs are recognized when they are incurred and not when payment is made. This assumption makes it necessary to give certain adjustments in the preparation of income statement regarding revenues and costs. But under cash accounting system, the revenues and costs are recognized only when they are actually received or paid. Hence, the combination of both cash and accrual system is preferable to get rid of the limitations of each system.
  10. **Objective Evidence Concept:** This concept ensures that all accounting must be based on objective evidence, i.e., every transaction recorded in the books of account must have a verifiable document in support of its, existence. Only then, the transactions can be verified by the auditors and declared as true or otherwise. The verifiable evidence for the transactions should be free from the personal bias, *i.e.,* it should be objective in nature and not subjective. However, in reality the subjectivity cannot be avoided in the aspects like provision for bad and doubtful debts, provision for depreciation, valuation of inventory, etc., and the accountants are required to disclose the regulations followed.

**Accounting Conventions:**

The following conventions are to be followed to have a clear and meaningful information and data in accounting:

* 1. **Consistency:** It refers to the state of accounting rules, concepts, principles, practices and conventions being observed and applied constantly, i.e., from one year to another there should not be any change. If consistency is there, the results and performance of one period can be compared easily and meaningfully with the other. It also prevents personal bias as the persons involved have to follow the consistent rules, principles, concepts and conventions. This convention, however, does not completely ignore changes. It admits changes wherever indispensable and adds to the improved and modern techniques of accounting.
  2. **Disclosure:** The convention of disclosure stresses the importance of providing accurate, full and reliable information and data in the financial statements which is of material interest to the users and readers of such statements. This convention is given due legal emphasis by the Companies Act, 1956 by prescribing formats for the preparation of financial statements. However, the term disclosure does not mean all information that one desires to get should be included in accounting statements. It is enough if sufficient information, which is of material interest to the users, is included.
  3. **Conservatism:** In the prevailing present day uncertainties, the convention of conservatism has its own importance. This convention follows the policy of caution or playing safe. It takes into account all possible losses but not the possible profits or gains. A view opposed to this convention is that there is the possibility of creation of secret reserves when conservatism is excessively applied, which is directly opposed to the convention of full disclosure. Thus, the convention of conservatism should be applied very cautiously.
  4. **Materiality:** According to materiality convention, only those transactions, important facts and items are shown which are useful and material for the business. The firm need not record events, which are insignificant and immaterial. Such convention is practiced so as to skip the insignificant details which will burden accounting.

**Methods (or) Systems of Book Keeping:**

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

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

**Types of Accounts**

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

1. **Transactions Relating to Persons (Personal A/C)**
2. **Natural persons:** An account recording transactions with an individual human being is termed as a natural persons’ personal account. e.g., Kamal’s account, Mala’s account, Sharma’s accounts. Both males and females are included in it
3. **Artificial or legal persons:** An account recording financial transactions with an artificial person created by law or otherwise is termed as an artificial person, personal account, e.g. Firms’ accounts, limited companies’ accounts, educational institutions’ accounts, Co-operative society account.
4. **Groups/Representative Personal Accounts:** An account indirectly representing a person or persons is known as representative personal account. When accounts are of a similar nature and their number is large, it is better to group them under one head and open representative personal accounts. e.g., prepaid insurance, outstanding salaries, rent, wages etc.
5. **Transactions relating to Properties and Assets (Real A/C)**
6. **Tangible Real Accounts:** These accounts represent assets and properties which can be seen, touched, felt, measured, purchased and sold. eg. Machinery account Cash account, Furniture account, stock account etc.
7. **Intangible Real Accounts:** These accounts represent assets and properties which cannot be seen, touched or felt but they can be measured in terms of money. e.g., Goodwill accounts, Patents account, Trademarks account, Copyrights account, etc
8. **Transactions relating to Incomes and Expenses (Nominal A/C)**

Accounts relating to income, revenue, gain expenses and losses are termed as nominal accounts. These accounts are also known as fictitious accounts as they do not represent any tangible asset. A separate account is maintained for each head or expense or loss and gain or income. Wages account, Rent account Commission account, Interest received account are some examples of nominal account

**Rules of Accounts**

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| --- | --- | --- |
| **S. No** | **Type of Account** | **Rule** |
| 1 | Personal Account | Debit the Receiver |
| Credit the Giver |
| 2 | Real Account | Debit What Comes In |
| Credit What Goes Out |
| 3 | Nominal Account | Debit All Expenses and Losses |
| Credit All Incomes and Gains |

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

There are many types of journals and the following are the important ones:

1. **Sales Day Book** - to record all credit sales.
2. **Purchases Day Book** - to record all credit purchases.
3. **Cash Book** - to record all cash transactions of receipts as well as payments.
4. **Sales Returns Day Book** - to record the return of goods sold to customers on credit.
5. **Purchases Returns Day Book** - to record the return of goods purchased from suppliers on credit.
6. **Bills Receivable Book** - to record the details of all the bills received.
7. **Bills Payable Book** - to record the details of all the bills accepted.
8. **Journal Proper** - to record all residual transactions which do not find place in any of the aforementioned books of original entry.

**Distinction between Journal and Ledger**

1. Journal is a book of prime entry, whereas ledger is a book of final entry.
2. Transactions are recorded daily in the journal, whereas posting in the ledger is made periodically.
3. In the journal, information about a particular account is not found at one place, whereas in the ledger information about a particular account is found at one place only.
4. Recording of transactions in the journal is called journalising and recording of transactions in the ledger is called posting.
5. A journal entry shows both the aspects debit as well as credit but each entry in the ledger shows only one aspect.
6. Narration is written after each entry in the journal but no narration is given in the ledger.
7. Vouchers, receipts, debit notes, credit notes etc., from the basic documents form journal entry, whereas journal constitutes basic record for ledger entries.

**Ledger:** Ledger is the collection of all accounts used by a business. Here the grouping of accounts is performed. Journal is posted to ledger. Ledger account is defined as a summary statement of all the transactions relating to a person, asset, expense, or income or gain or loss which have taken place during a specified period and shows their net effect ultimately.

**Trial Balance:** It is a statement prepared with the balances or total of debits and credits of all the accounts in the ledger to test the arithmetical accuracy of the ledger accounts.

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

**Transaction:** It means the exchange of money or money’s worth from one account to another account Events like purchase and sale of goods, receipt and payment of cash for services or on personal accounts, loss or profit in dealings etc., are the transactions”

**Cash transaction:** It is one where cash receipt or payment is involved in the exchange.

**Credit transaction**: It will not have ‘cash’ either received or paid, for something given or received respectively, but gives rise to debtor and creditor relationship.

**Non-cash transaction:** It is one where the question of receipt or payment of cash does not at all arise, e.g. Depreciation, return of goods etc.,

**Debtor:** A person who owes money to the firm mostly on account of credit sales of goods is called a debtor. For example, when goods are sold to a person on credit that person pays the price in future, he is called a debtor because he owes the amount to the firm.

**Creditor:** A person to whom money owes by the firm is called creditor. For example, Madan is a creditor of the firm when goods are purchased on credit from him

**Capital:** It means the amount (in terms of money or assets having money value) which the proprietor has invested in the firm or can claim from the firm. It is also known as owner’s equity or net worth. Owner’s equity means owner’s claim against the assets. It will always be equal to assets less liabilities, say: Capital = Assets - Liabilities.

**Liability:** It means the amount which the firm owes to outsiders that is, excepting the proprietors. In the words of Finny and Miller, “Liabilities are debts; they are amounts owed to creditors; thus the claims of those who ate not owners are called liabilities”. In simple terms, debts repayable to outsiders by the business are known as liabilities.

**Asset:** Any physical thing or right owned that has money value is an asset. In other words, an asset is that expenditure which results in acquiring of some property or benefits of a lasting nature.

**Goods:** It is a general term used for the articles in which the business deals; that is, only those articles which are bought for resale for profit are known as Goods.

**Revenue:** It means the amount which, as a result of operations, is added to the capital. It is defined as the inflow of assets which result in an increase in the owner’s equity. It includes all incomes like sales receipts, interest, commission, brokerage etc., However, receipts of capital nature like additional capital, sale of assets etc., are not a part of revenue.

**Expense:** The terms ‘expense’ refers to the amount incurred in the process of earning revenue. If the benefit of an expenditure is limited to one year, it is treated as an expense (also know is as revenue expenditure) such as payment of salaries and rent.

**Expenditure:** It takes place when an asset or service is acquired. The purchase of goods is expenditure, where as cost of goods sold is an expense. Similarly, if an asset is acquired during the year, it is expenditure, if it is consumed during the same year; it is also an expense of the year.

**Sales:** When the goods purchased are sold out, it is known as sales. Here, the possession and the ownership right over the goods are transferred to the buyer. It is known as. Business Turnover or sales proceed. It can be of two types, viz.,, cash sales and credit sales. If the sale is for immediate cash payment, it is cash sales. If payment for sales is postponed, it is credit sales.

**Purchases:** Buying of goods by the trader for selling them to his customers is known as purchases. As the trade is buying and selling of commodities purchase is the main function of a trade. Here, the trader gets possession of the goods which are not for own use but for resale. Purchases can be of two types. viz, cash purchases and credit purchases. If cash is paid immediately for the purchase, it is cash purchases, If the payment is postponed, it is credit purchases.

**Stock:** The goods purchased are for selling, if the goods are not sold out fully, a part of the total goods purchased is kept with the trader unlit it is sold out, it is said to be a stock. If there is stock at the end of the accounting year, it is said to be a closing stock. This closing stock at the yearend will be the opening stock for the subsequent year.

**Drawings:** It is the amount of money or the value of goods which the proprietor takes for his domestic or personal use. It is usually subtracted from capital.

**Losses:** Loss really means something against which the firm receives no benefit. It represents money given up without any return. It may be noted that expense leads to revenue but losses do not. (e.g.) loss due to fire, theft and damages payable to others,

**Account:** It is a statement of the various dealings which occur between a customer and the firm. It can also be expressed as a clear and concise record of the transaction relating to a person or a firm or a property (or assets) or a liability or an expense or an income.

**Invoice:** While making a sale, the seller prepares a statement giving the particulars such as the quantity, price per unit, the total amount payable, any deductions made and shows the net amount payable by the buyer. Such a statement is called an invoice.

**Proprietor:** The person who makes the investment and bears all the risks connected with the business is known as proprietor.

**Discount:** When customers are allowed any type of deduction in the prices of goods by the businessman that is called discount. When some discount is allowed in prices of goods on the basis of sales of the items, that is termed as trade discount, but when debtors are allowed some discount in prices of the goods for quick payment, that is termed as cash discount.

**Solvent:** A person who has assets with realizable values which exceeds his liabilities is insolvent.

**Insolvent:** A person whose liabilities are more than the realizable values of his assets is called an insolvent.

**Accrued Income:** Accrued income means income which has been earned by the business during the accounting year but which has not yet been due and, therefore, has not been received.

**Capital reserve:** The reserve which transferred from the capital gains is called capital reserve.

**General reserve:** the reserve which is transferred from normal profits of the firm is called general reserve

**Provision:** provision usually means any amount written off or retained by way of providing depreciation, renewals or diminutions in the value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy.

**Reserve:** The provision in excess of the amount considered necessary for the purpose it was originally made is also considered as reserve

**Trade Credit:** It represents credit granted by suppliers of goods, in the normal course of business.

**Over draft:** Under this facility a fixed limit is granted within which the borrower allowed to overdraw from his account.

**Cash credit:** It is an arrangement under which a customer is allowed an advance up to certain limit against credit granted by bank.

**Drawings:** It denotes the money withdrawn by the proprietor from the business for his personal use.

**Outstanding Income:** Outstanding Income means income which has become due during the accounting year but which has not so far been received by the firm.

**Outstanding Expenses:** Outstanding Expenses refer to those expenses which have become due during the accounting period for which the Final Accounts have been prepared but have not yet been paid.

**Closing stock:** The term closing stock means goods lying unsold with the businessman at the end of the accounting year.

**Depreciation:** It denotes gradually and permanent decrease in the value of asset due to wear and tear, technology changes, laps of time and accident.

**Accrual:** Recognition of revenues and costs as they are earned or incurred. it includes recognition of transaction relating to assets and liabilities as they occur irrespective of the actual receipts or payments.

**Accrued expenses:** An expense which has been incurred in an accounting period but for which no enforceable claim has become due in what period against the enterprises.

**Accrued revenue:** Revenue which has been earned is an earned is an accounting period but in respect of which no enforceable claim has become due to in that period by the enterprise.

**Accrued liability:** A developing but not yet enforceable claim by another person which accumulates with the passage of time or the receipt of service or otherwise. It may rise from the purchase of services which at the date of accounting have been only partly performed and are not yet billable.

**Capital:** Generally refers to the amount invested in an enterprise by its owner. Ex: paid up share capital in corporate enterprise.

**Opening Stock:** The term ‘opening stock’ means goods lying unsold with the businessman in the beginning of the accounting year. This is shown on the debit side of the trading account.

**Closing Stock:** The term ‘Closing Stock’ includes goods lying unsold with the businessman at the end of the accounting year. The amount of closing stock is shown on the credit side of the trading account and as an asset in the balance sheet.