Accountancy

Accountancy is a systematic knowledge of accounting. It explains how to deal with various aspects of accounting. It educates us how to maintain the books of accounts and how to summarise the accounting information and communicate it to the users. In the words of **Kohler**, *accountancy refers to the entire body of the theory and practice of accounting.*

Accounting and Accountancy

Accountancy is an area of knowledge whereas accounting is the action or process used in this area. Accounting depends on the rules and principles framed by accountancy but accountancy does not depend on accounting. Thus, it may be said that accountancy is knowledge of accounting and accounting is the application of accountancy.

OBJECTIVES OF ACCOUNTING

The objectives of accounting are:

1. Record of Financial Transactions and Events: The objective of accounting is to record financial transactions and events of the organisation in the books of accounts following the principles of accounting in a systematic manner.

2. Determine Profit or Loss: Another objective of accounting is to determine the financial performance, *i.e.*, profit earned or loss incurred, for the accounting period. Income Statement or Trading and Profit and Loss Account or Statement of Profit and Loss (by companies) prepared at the end of the accounting year shows the profit earned or loss incurred during the accounting year.

3. Determine Financial Position: Another objective of accounting is to determine financial position. It is known from the Balance Sheet. Financial position of the business is as relevant for the users of financial statements as is the Income Statement.

4. Assisting the Management: Another objective of accounting is to assist the management by providing financial information to it. The management often requires financial information for decision-making, exercising control, budgeting and forecasting.

5. Communicating Accounting Information to Users: Another objective of accounting is to provide accounting information to users who analyse them as per their individual requirements.

6. Protecting Business Assets: Another objective of accounting is to have records of assets owned by the business. Accounting maintains record of assets owned by the business which enables the management to protect them and exercise control.

FUNCTIONS OF ACCOUNTING

The functions of accounting are:

1. Maintaining Systematic Accounting Records: The primary function of accounting is to maintain systematic accounting records of financial transactions and events. It means that the accounting records should be maintained following the accounting principles and concepts. In other words, the function of Book Keeping is the primary function of accounting. It is so because reliable financial statements can be drawn if Book Keeping is proper. The process of Book Keeping involves recording financial transactions and events in the books of accounts and classifying the recorded transactions. The transactions having been classified, Trial Balance can be drawn to prepare financial statements, *i.e.*, Income Statement and Position Statement.

2. Preparation of Financial Statements: Financial statements means final accounts prepared at the end of the accounting period. It includes Income Statement (Profit and Loss Account or Statement of Profit and Loss, in the case of companies) and Position Statement (Balance Sheet). It is an important function of accounting because the financial statements show the financial performance, *i.e.*, profit earned or loss incurred during the accounting year and the financial position, *i.e.*, Balance Sheet as at the end of the accounting year. Both the statements are important for all the users because users make decisions on the basis of these statements.

3. Meeting Legal Requirements: Accounting records are accepted as evidence by the court of law if they are maintained systematically following the accounting principles and concepts. Besides, the law such as the Companies Act, Income Tax Act, VAT Act, etc., require submissions of returns in the form and period as is prescribed in the law. The returns can be prepared if the accounting records are maintained systematically and timely. Besides, the returns so submitted may have to be proved correct before the authorities. A systematic accounting record maintained following the accounting principles and concepts is accepted by the authorities to be correct. Thus, it is a function of accounting to meet the legal requirements.

4. Communicating the Financial Data: It is yet another function of accounting to communicate the financial data to the users, which may be internal users or external users, such as management, banks, employees, government authorities, etc.

5. Assistance to Management: Management often requires information beyond the information conveyed by the financial data. Accounting records should be maintained in such a manner that the information sought by the management is available, which in turn helps in decision-making. For example, financial statements do not show since when the amount is due from debtors. It is the function of accounting to make such information available to the management. Similarly, accounting record should be maintained in such a manner that the assets owned are known. It will assist the management in protecting the assets and also exercising control.

ADVANTAGES OF ACCOUNTING

1. Financial Information about Business: Financial performance during the accounting period, *i.e.*, profit or loss and also the financial position at the end of the accounting period is known through accounting.

2. Assistance to Management: The management makes business plans, takes decisions and exercises control over the affairs on the basis of accounting information.

3. Replaces Memory: A systematic and timely recording of transactions obviates the necessity to remember transactions. The accounting record provides the necessary information.

4. Facilitates Comparative Study: A systematic record enables a businessman to compare one year's results with those of other years and locate significant factors leading to change, if any.

5. Facilitates Settlement of Tax Liabilities: A systematic accounting record immensely helps in settlement of income tax, sales tax, VAT and excise duty liabilities, since it is a good evidence of the correctness of transactions.

6. Facilitates Loans: Loan is granted by the banks and financial institutions on the basis of growth potential which is supported by the performance. Accounting makes available the information with respect to performance.

7. Evidence in Court: Systematic record of transactions is often accepted by the Courts as good evidence.

8. Facilitates Sale of Business: If someone desires to sell his business, the accounts maintained by him will enable the ascertainment of the proper purchase price.

9. Helps in Decision-making: Accounting helps in taking a large number of decisions like the amount to be withdrawn by proprietor, the price at which goods should be sold, etc.

LIMITATIONS OF ACCOUNTING

1. Accounting is not Fully Exact: Although most of the transactions are recorded on the basis of evidence such as sale or purchase or receipt of cash, yet some estimates are also made for ascertaining profit or loss. Examples of this are providing depreciation on the basis of estimated useful life of an asset, possible bad debts, the probable market price of the stock of goods, etc.

2. Accounting does not Indicate the Realisable Value: The Balance Sheet does not show the amount of cash which the firm may realise by the sale of all the assets. This is because many assets are not meant to be sold; they are meant for use and are shown at cost *less* depreciation that may have been written off.

3. Accounting Ignores the Qualitative Elements: Since accounting is confined to monetary matters only, qualitative elements like quality of staff, industrial relations and public relations are ignored.

4. Accounting Ignores the Effect of Price Level Changes: Accounting statements are prepared at historical cost. Money, as a measurement unit, changes in value. It does not remain stable. Unless price level changes are considered while preparing financial statements, accounting information will not show true financial results.

5. Accounting may Lead to Window Dressing: The term window dressing means manipulation of accounts so as to conceal vital facts and present the financial statements in such a way as to show better position than what it actually is. In this situation, income statement (*i.e.*, Profit and Loss Account) fails to provide a true and fair view of the result of operations and the Balance Sheet fails to provide a true and fair view of the financial position of the enterprise.

ACCOUNTING INFORMATION

"Accounting is a service activity. Its function is to provide qualitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions."

—Accounting Principles Board

USERS OF ACCOUNTING INFORMATION

Users of Accounting Information may be categorised into Internal Users and External Users.

Internal Users

(i) ***Owners:*** Owners contribute capital in the business and thus are exposed to maximum risk. Naturally, they are interested in knowing the profit earned or loss suffered by the business besides the safety of their capital. The financial statements give the information about profit or loss and financial position of the business.

(ii) ***Management:*** The management makes extensive use of accounting information to arrive at informed decisions such as determination of selling price, cost controls and reduction, investment into new projects, etc.

(iii) ***Employees and Workers:*** Employees and workers are entitled to bonus at the year-end, which is linked to the profit earned by an enterprise. Therefore, the employees and workers are interested in financial statements. Besides, the financial statements also reflect whether the enterprise has deposited its dues into the provident fund and employees state insurance, etc., or not.

External Users

(i) ***Banks and Financial Institutions:*** Banks and financial institutions are an essential part of any business as they provide loans to businesses. Naturally, they watch the performance of the business to know whether it is making progress as projected to ensure the safety and recovery of the loan advanced. They assess it by analysing the accounting information.

(ii) ***Investors and Potential Investors:*** Investment involves risk and also the investors do not have direct control over the business affairs. Therefore, they rely on the accounting information available to them and seek answers to questions such as—what is the earning capacity of the enterprise and how safe is their investment?

(iii) ***Creditors:*** Creditors are those parties who supply goods or services on credit. It is a common business practice that a large number of suppliers remain invested in credit sales. Before granting credit, creditors satisfy themselves about the credit-worthiness of the business. The financial statements help them immensely in making such an assessment.

(iv) ***Government and its Authorities:*** The government makes use of financial statements to compile national income accounts and other information. The information available to it enables it to take policy decisions.

Government levies varied taxes such as excise duty, VAT, service tax and income tax. These government authorities assess correct tax dues after an analysis of the financial statements.

(v) ***Researchers:*** Researchers use accounting information in their research work.

(vi) ***Consumers:*** Consumers require accounting information for establishing good accounting control so that cost of production may be reduced with the resultant reduction in the prices of products they buy. Sometimes, prices of some products are fixed by the government, so it needs accounting information to fix fair prices so that consumers and producers are not exploited.

(vii) ***Public:*** They want to see the business running since it makes substantial contribution to the economy in many ways, *e.g.*, employment of people, patronage to suppliers, etc. Thus, financial accounting provides useful financial information to various user groups for decision-making.

QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION

Qualitative characteristics are attributes that make the accounting information useful to users. The qualitative characterstics are:

*1. **Reliability:*** Accounting information must be reliable. Reliability of information means it is verifiable, free from material error and bias.

*2. **Relevance:*** Accounting information must be relevant to the user. Information is relevant if it meets the needs of the users in decision-making.

*3. **Understandability:*** Understandability means that the information provided through the financial statements must be presented in a manner that the users are able to understand it.

*4. **Comparability:*** Comparability means that the users should be able to compare the accounting information of an enterprise of the period either with that of other periods, known as **intra-firm comparison** or with the accounting information of other enterprises, known as **inter-firm comparison.**

SYSTEMS OF ACCOUNTING

The systems of recording transactions in the books of accounts are two namely:
1. Double Entry System and 2. Single Entry System.

1. Double Entry System

Double Entry System of accounting is a system of accounting under which both, debit and credit, aspects of accounting are recorded. A transaction has two aspects—Debit and Credit—and at the time of recording a transaction, it is recorded once on the debit side and again on the credit side. For example, at the time of cash purchases, goods are received and in return cash is paid. In the transaction, two aspects are involved, *i.e.*, receiving goods and paying cash and under the Double Entry System, both these aspects are recorded. One part, *i.e.*, the receipt of goods, is debited and the second part, *i.e.*, payment of cash, is credited. In other words, if only two accounts are affected (as in the purchase of building for cash), one account, Building, is debited and the other account, Cash, is credited for the same amount. If more than two accounts are affected by a transaction, the sum of the debit entries must be equal to the sum of the credit entries. Thus, on any day, total amount debited is equal to the total amount credited.

Thus, we can define Double Entry System as: "*The system which recognises and records both aspects of a transaction. The Double Entry System has proved to be a scientific and complete system of accounting.*"

Features of the Double Entry System

1. It maintains a complete record of each transaction.
2. It recognises two-fold aspect of every transaction, *viz.*, the aspect of receiving (value in) and the aspect of giving (value out).
3. In this system, one aspect is debited and the other aspect is credited following the rules of debit and credit.
4. Since one aspect of a transaction is debited and the other is credited, the total of all debits is always equal to total of all credits. It helps in establishing arithmetical accuracy by preparing the Trial Balance.

Stages of Double Entry System

A complete system of double entry book keeping has following three stages:

1. Recording the transactions in the Journal.
2. Classifying transactions in the Journal by posting them to the appropriate ledger accounts and then preparing the Trial Balance.
3. Closing the books and preparing the final accounts.

All these stages shall be discussed one by one in succeeding chapters.

Advantages of the Double Entry System

The advantages of Double Entry System are:

(i) ***Scientific System:*** Double Entry System is a scientific system of recording business transactions as compared to other systems of Book Keeping. It helps attain the objectives of accounting.

(ii) ***Complete Record of Transactions:*** Under the system, both sides of a transaction are recorded. It is a complete record as it results in showing correct income or loss, assets and liabilities.

(iii) ***A Check on the Accuracy of Accounts:*** By the use of this system, accuracy of the accounting work can be established through the Trial Balance.

(iv) ***Determining Profit or Loss:*** Profit earned or loss incurred during a period can be determined by preparing Profit and Loss Account.

(v) ***Knowledge of Financial Position:*** Financial position of the firm or the institution can be ascertained at the end of each period by preparing the Balance Sheet.

(vi) ***Full Details for Purposes of Control:*** The system permits accounts to be maintained in as much detail as necessary and, therefore, provides significant information for purposes of control, etc.

(vii) ***Comparative Study is Possible:*** Results of one year may be compared with those of previous years and reasons for the change may be ascertained.

(viii) ***Helps Management in Decision-making:*** Management may be able to obtain good information for its work, especially in making decisions.

(*ix*) ***Frauds and Misappropriations:*** Frauds and misappropriations are minimised since complete information about all assets and liabilities is available.

It is because of these advantages that the Double Entry System has been used extensively in all countries.

2. Single Entry System

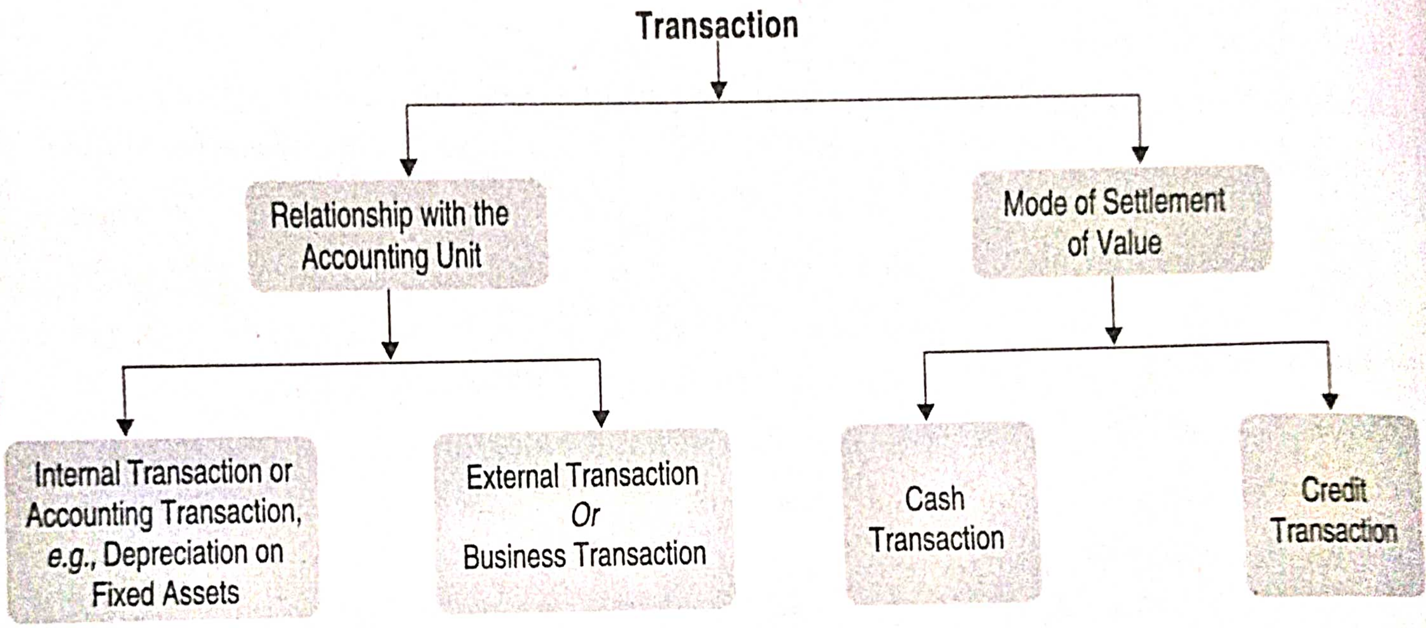
Single Entry System of recording transactions in the books of accounts may be defined as an incomplete Double Entry System. In this system, all transactions are not recorded on double entry basis. As regards some transactions, both aspects of the transactions are recorded, as regards others, either one aspect is recorded or not recorded at all. Instead of maintaining all the accounts, only Personal Accounts and Cash Book are maintained under this system. The accounts maintained under this system are incomplete and unsystematic and, therefore, not reliable. The Single Entry System is also known as **Accounts from Incomplete Records**.

Since all transactions are not recorded under double entry principle, it is not possible to prepare a Trial Balance. As a result, the Profit and Loss Account and the Balance Sheet cannot be prepared.

1. Business Transaction: The term 'Business Transaction' means a financial transaction or event entered into by the two parties and is recorded in the books of accounts. It is a financial event expressed in terms of money which brings a change in the financial position of an enterprise. It is an agreement between two parties involving the transfer or exchange of goods or services. Examples of business transactions are sales of goods, purchases of goods, receipt from debtors, payment to creditors, purchase or sale of fixed assets, payment of interest, dividend, etc.

Characteristics of a Business Transaction

1. It is concerned with money or money's worth of goods or services.
2. It arises out of the transfer or exchange of goods or services.
3. It brings about a change in the financial position (*i.e.*, in assets and liabilities).
4. It has an effect on the accounting equation.
5. It has dual aspect or two sides—'receiving' (Debit) and 'giving' (Credit) of the benefit.



A transaction may be a cash transaction or a credit transaction. When the amount is transacted immediately on entering into a transaction it is a *cash transaction* and when it is promised to pay later, it is a *credit transaction*. Transactions may be external (between a business entity and a second party, for example, goods sold on credit to Z) or internal (does not involve second party, *e.g.*, depreciation charged on machinery).

2. Account: Account is a summarised record of transactions relating to a particular head at one place. It records not only the amount of transactions but also their effect and direction.

2. It may be in...

3. It should have some value attached to it.

4. It should be capable of being measured in money terms.

Assets can be classified into (*i*) Non-current Assets, (*ii*) Current Assets, and (*iii*) Fictitious Assets:

(*i*) ***Non-current Assets:*** Non-current Assets are those assets which are held by a business from a long-term point of view. They are not held with a purpose to resell but are held either as investment or to facilitate business operations. Examples of non-current assets are Fixed assets, Non-current Investments, Long-term Loans and Advances and Other Non-current Assets.

Fixed assets are further classified into:

(*a*) ***Tangible Assets:*** Tangible Assets are those assets which have physical existence, *i.e.*, they can be seen and touched. Examples of tangible assets are land, building, machinery, computer, furniture, goods, etc.

(*b*) ***Intangible Assets:*** Intangible Assets are those assets which do not have physical existence, *i.e.*, they cannot be seen and touched. Examples of intangible assets are patents, goodwill, trademark, Computer Software, etc.

(*ii*) ***Current Assets:*** Current Assets are those assets which are held by the business with the purpose of converting them into cash within a short period, *i.e.*, one year. For example, goods are purchased with a purpose to resell and earn profit, debtors exist to convert them into cash, *i.e.*, receive the amount from them, bills receivable exist again for receiving cash against it, etc.

Prepaid expenses are also classified as Current Assets although they cannot be converted into cash. They are so classified because a part of the benefit from such expenses is available in the next accounting year.

(*iii*) ***Fictitious Assets:*** Fictitious Assets are those assets which are neither tangible assets nor intangible assets. They are losses not written off in the year in which they are incurred but in more than one accounting period.

In the case of firms, an example of fictitious asset is Deferred Revenue Expenditure. Discount on Issue of Shares and Loss on Issue of Debentures are examples of fictitious asset in the case of companies.

7. Receipts: Receipt is the amount received or receivable for selling assets, goods or services.

Revenue Receipts: It is the amount received or receivable in the normal course of business. For example, amount received or receivable against sale of goods or rendering of services.

Capital Receipts: It is the amount received or receivable against transactions which are not revenue in nature. For example, amount received or receivable for sale of machinery, building, furniture, investment, loan, etc.

8. Expenditure: Expenditure is the amount spent or liability incurred for acquiring assets, goods or services. Expenditure may be categorised into:

(i) *Capital Expenditure:* It is an expenditure incurred to acquire assets or improving the existing assets which will increase the earning capacity of the business, *i.e.*, will give benefit of enduring nature to the business. It may be incurred to acquire tangible asset or intangible asset. Examples of capital expenditure are purchase of machinery to manufacture goods, purchase of furniture or computers to carry on business.

Capital Expenditure is shown on the assets side of the Balance Sheet.

(ii) *Revenue Expenditure:* Revenue Expenditure is the expenditure incurred, the benefit of which is consumed or exhausted within the accounting period. It has direct relationship with revenue or with the accounting period, *e.g.*, cost of goods sold, salaries, rent, electricity expenses, etc.

Revenue Expenditure is shown on the debit side of the Profit and Loss Account, in the case of firms and in the Expenses part of the Statement of Profit and Loss, in the case of companies.

(iii) *Deferred Revenue Expenditure:* Deferred Revenue Expenditure is a revenue expenditure in nature but is written off (charged) in more than one accounting period. For example, large advertising expenditure that will give benefit for more than one accounting period is a Deferred Revenue Expenditure.

Meaning of Transaction

A transaction is a particular type of external event, which can be expressed in terms of money and brings change in the financial position of a business unit. A transaction involves transfer of something of value between two or more entities. A transaction may be an exchange in which each party receives as well as sacrifices value. In other words, in every transaction, there is a movement of value from one source to another. For example, when goods are purchased for cash, there is a movement of goods from the seller to the buyer and a movement of cash from the buyer to the seller.

A transaction can also be a non-reciprocal transfer in which a business unit incurs a liability (penalty imposed by a local authority) or transfer an asset to another entity (payment of income tax) or receives an asset (subsidy received from Government) or cancellation of a liability (provision for workmen's compensation) without directly receiving (or giving) value in exchange.

Transactions may be external (between a business entity and a second party, for example, goods sold on credit to X) or internal (not involving second party, for instance, depreciation charged on the machinery).

Meaning of Event

Event is an occurrence, happening, change or incident, which may or may not bring any change in the financial position of a business unit. It may be an internal event that occurs within a business unit, such as using new materials in production, death of the general manager or threat by a labour union to call a strike. It may be an external event that involves interaction between a business unit and its environment, for example, a change in the price of a product that the business unit buys or sells, or an improvement in technology by a competitor.

Illustration 1

State with reasons whether the following events are transactions or not to Mr. X (Proprietor) :

(i) Mr. X started business with capital (brought in cash) ₹ 40,000.
(ii) Paid salaries to staff ₹ 5,000.
(iii) Purchased machinery for ₹ 20,000 in cash.
(iv) Placed an order with Sen & Co. for goods for ₹ 5,000.
(v) Opened a bank account by depositing ₹ 4,000.
(vi) Received pass book from bank.
(vii) Appointed Mr. B. Sen as manager on a salary of ₹ 4,000 per month.
(viii) Received interest from bank ₹ 500.
(ix) Received a price list from B.
(x) Received free samples ₹ 1,000.
(xi) Gave lift to a supplier in the business car.
(xii) Sent peon to post office to bring the V.P.P. of ₹ 600.

Solution

Here, each event is to be considered from the view point of Mr. X's business. Those events which can be measured in terms of money and will change the financial position of the business of Mr. X, should be regarded as transaction.

(i) It is a transaction, because it changes the financial position of Mr. X's business. Cash will increase by ₹ 40,000 and Capital will increase by ₹ 40,000.
(ii) It is a transaction, because it changes the financial position of Mr. X's business. Cash will decrease by ₹ 5,000 and Salaries (expenses) will increase by ₹ 5,000.
(iii) It is a transaction, because it changes the financial position of Mr. X's business. Machinery comes in and cash goes out.
(iv) It is not a transaction, because it does not change the financial position of the business.
(v) It is a transaction, because it changes the financial position of the business. Bank balance will increase by ₹ 4,000 and cash will decrease by ₹ 4,000.
(vi) It is not a transaction, because it does not change the financial position of the business of Mr. X.
(vii) It is also not a transaction, because it does not change the financial position of the business of Mr. X.
(viii) It is a transaction, because it changes the financial position of Mr. X's business. Bank interest will increase by ₹ 500 and cash will increase by the same amount.
(ix) It is not a transaction, because it does not change the financial position of the business of Mr. X.
(x) It is not a transaction.
(xi) It is not a transaction because it does not change the financial position of the business of Mr. X.
(xii) It is not a transaction because it does not change the financial position of the business of Mr. X.

Classification of Transaction

Cash transaction: A transaction which involves immediate cash/cheque receipt or payment is called a Cash Transaction. For example, goods sold to X for cash ₹ 5,000. In a cash transaction, the name of the party to whom goods are sold or from whom goods are purchased, is not recorded. This is because, it serves no purpose.

Credit transaction: An external transaction not involving immediate cash receipt or payment is called a Credit Transaction. For example, Purchase of goods on credit from Y. In a credit transaction, delivery of goods and receipt/payment of money takes place on two different dates.

In a credit transaction, the name of the party is recorded to ascertain how much is owed to or from him.

External transaction: A transaction which involves the business entity and a second party is called an External Transaction. For example, goods sold to Ram for ₹ 2,000 on credit.

Internal transaction: A transcation which does not involve a second party is called Internal Transaction. For example, depreciation charged on machinery.

Rules for Determining Cash or Credit Transaction

Students sometimes experience a little difficulty deciding whether a transaction is for cash or on credit. The following rules will help :

(1) Cash purchases, cash sales and all transactions where the word 'paid'is mentioned are to be treated as cash transactions. For example, salary paid, goods sold for cash and so on.

(2) When a personal name or the name of a firm is mentioned in the transaction, it will be treated as credit transaction. For example, goods sold to X for ₹ 500.

(3) When both cash and personal name are mentioned in the transaction, it will be treated as a cash transaction. For example, goods sold to Y for cash ₹ 1,000.

Illustration 2

State whether the following are cash transactions or credit transactions :

1. Sachin commenced business with ₹ 1,00,000.
2. Paid rent in advance ₹ 5,000.
3. Purchased a typewriter for ₹ 7,000 from Sen & Co.
4. Bought furniture from M/s. Modern Furniture for cash ₹ 3,000.
5. Purchased goods from Sohan Brothers for cash ₹ 30,000.
6. Sold goods to Shyam for ₹ 25,000.
7. Bought goods from Ramesh ₹ 20,000.
8. Paid rent ₹ 1,000.
9. Paid salary to staff ₹ 4,000.
10. Received cash from Shyam ₹ 20,000.
11. Paid Romesh ₹ 19,000.

Solution

1. It is a cash transaction.
2. It is a cash transaction.
3. It is a credit transaction.
4. It is a cash transaction.
5. It is a cash transaction.
6. It is a credit transaction.
7. It is a credit transaction.
8. It is a cash transaction.
9. It is a cash transaction.
10. It is a cash transaction.
11. It is a cash transaction.

Illustration 3

State whether the following are external transactions or internal transactions:

1. Purchased a computer from HCL on credit for ₹ 60,000.
2. Goods destroyed by fire ₹ 1,000 (not insured).
3. Purchased an electronic typewriter for cash ₹ 20,000.
4. Charged depreciation on furniture ₹ 400 and ₹ 200 on typewriter.

Solution

1. It is an external transaction.
2. It is an internal transaction.
3. It is an external transaction.
4. It is an internal transaction.