CHAPTER 1

INTRODUCTION TO ACCOUNTING

- **Business Events –** Those events which occur in the normal operation of a business like, sale and purchase of goods are called business events
- **Types of Business Events –** There are two types of business events.

  - **Monetary Events –** Those business events that can be expressed in monetary terms are called monetary events. These affect the financial position of the business. For example, sale and purchase of goods.
  - **Non Monetary Events –** Those events that cannot be expressed in monetary terms like, recruitment of an employee are called non-monetary events.

    ***NOTE*:** In accountancy, only monetary events are recorded in the books of account, ignoring the non-monetary events.
- **Business Transactions –** Those financial transactions or events which are measured and recorded in monetary terms in the books of account are called business transactions. These transactions affect the financial position of an enterprise.
- **Accounting**– Accounting is an art of identifying, measuring, recording, classifying and summarising the transactions or events (in monetary terms) and analysing and communicating the financial results of business to the various interested parties.
- **Functions of Accounting**
  - Identifying the events to be recorded in the books of account
  - Measuring the events in the monetary terms
  - Recording the financial events in the books of accounts
  - Classifying the recorded transaction into their respective groups (accounts) in the ledger (a book having different accounts). The transactions relating to the similar nature are posted under the same head. For example, all cash sales related transactions are recorded in the Sales Account.

- Summarising the classified event in such a manner (Trial Balance, Profit and Loss Account and Balance Sheet) which can be understood by different accounting users without any ambiguity
- Analysing the summarised data by using different tools of analysis, according to the needs of different users of accounting information
- Communicating the accounting information to various users and the interested parties

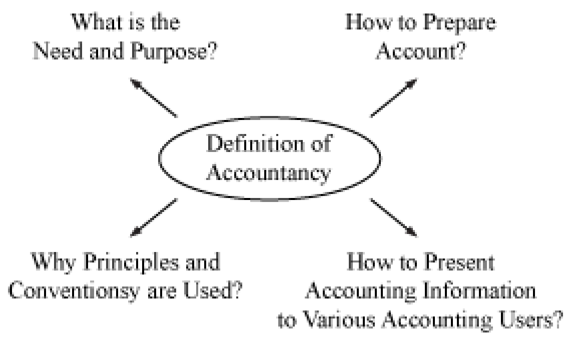
❖ Branches of Accounting

Depending on different accounting users' interests vested in a business, accounting is sub-divided into three branches:

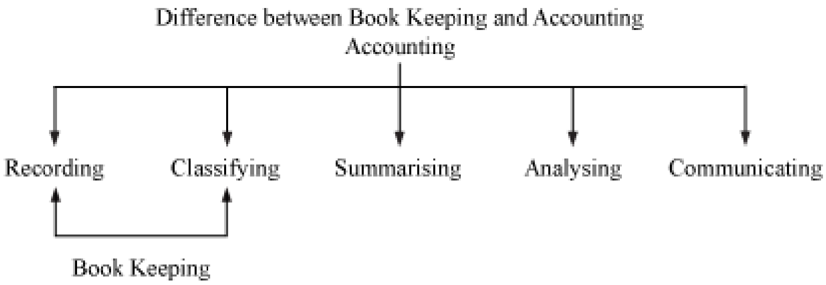
- **Financial Accounting** primarily deals with identifying, recording, summarising the transactions and analysing and communicating the financial results to various users of accounting information.
- **Cost Accounting** is **primarily** concerned with estimating the cost of production by ascertaining cost of inputs and accordingly facilitating the pricing policy of the final output of the business. It helps in cost controlling and checking the viability of expenses incurred and reducing cost inefficiencies.
- **Management Accounting** basically caters to the managerial need of accounting information, i.e. gathering accounting information for the need of the management for designing various policy measures. Cash Flow Statements, Cash Budgeting and Ratio Analysis are the prime tools of Management Accounting.

❖ Accountancy

Accountancy is the science or study of accounting. It explains the need and purpose of accounting and also explains various principles and conventions that are used in the accounting process and imparts know-how of preparing accounts and presenting and communicating accounting information in a summarised form to various users of accounting information.



❖ Difference Between Book Keeping and Accounting



- Book Keeping is an art of recording and classifying the transactions in a systematic manner, whereas accounting in addition to Book Keeping also includes summarising, analyisng and communicating financial results to various interested parties.

❖ Objectives of Accounting

- Recording of transaction in the chronological order
- Ascertaining profit and loss made during an accounting period
- Assessing the financial position of the business
- Communicating the accounting information and financial results to various users
- Locating, rectifying and preventing errors and frauds
- Assessing and analysing the progress of the business by conducting inter-firm and intra-firm comparisons

❖ Advantages of Accounting

- Provides permanent records of transactions Helps in recalling the transactions Assists management to perform various activities like, planning and controlling
- Accounting records can be used as an evidence in the court of law
- Acts as ready source
- of accounting information to various interested parties and users

❖ Limitations of Accounting

- Qualitative aspects like, quality, size, colour, etc. are not revealed by accounting records
- Window dressing (manipulation and misrepresentation) is possible in preparation and presentation of accounts
- Market value of assets are ignored
- Effects of inflation (price change) are ignored in the accounting records

- Some items like, anticipated losses and profits are based on estimation and past experiences

❖ Accounting Information

Accounting information refers to the accounting data which are presented in such a manner that they are understandable to various accounting users.

Accounting information is in the form of financial statements, financial reports etc.

❖ Qualitative Characteristics of Accounting Information

The accounting information besides being true and fair must also bear the following qualities:

- **Reliable** – All accounting information must be supported by verifiable evidences.
- **Relevance** – Accounting information must fulfill the legal requirements and should also disclose the items which are material.
- **Understandability** – Accounting information should be presented in such a manner that it is easily understood and interpreted without any ambiguity to all users of the accounting information.
- **Comparable** – Accounting information should be comparable, so that both inter-firm as well as intra-firm comparisons are possible to assess the progress of the business.

❖ Users of Accounting Information

The parties, organisations and the individuals whose interests are vested in the performance of the business are called users of accounting information. These users can be internal and external users. In order to assess the performance of the business, they rely on the financial statements and other accounting information which are prepared and communicated by the business.

Users of Accounting Information

Internal Users
- Owners
- Management
- Employees and Workers

External Users
- Lenders
- Creditors
- Government and Tax Authorities
- Researchers
- Consumers
- Public

Internal Users	Interest	Reasons
Owners	Return on capital and profit or loss made	To assess the profitability and viability of the capital invested by them in the business.

Management	Return on investment, expenditure, assets and liabilities	To draft various policies measures, facilitating planning and decision making process. Also helps the management for cost controlling and to remove inefficiencies.
Employees and Workers	Amount of profit earned	Timely payment of wages and salaries, bonus, increment in wages and salaries

External users	**Interest**	**Reasons**
Lenders	Profitability and solvency position	To assess the credit worthiness of the business and ensure timely repayment of loans from the business,
Creditors	Liquidity position	Timely repayment of amount lend to the business and ensuring the safety and security of their amount.
Future Investors	Return on investment	To ensure the safety of their funds and future returns of their investment.
Tax Authorities	Amount of profit earned	To levy tax proportionately to the profit earned.
Researcher	Accounting records and data	To conduct various researches.
Consumers	Price fixing policy and cost per unit of the product	To know whether the business is charging fair prices.
Public	Contribution to social welfare and upliftment projects	Proportion of the profit spent on development and welfare of the society

❖ Basic Terms in Accounting

- **Assets**– Assets are the right of ownership of the business on its physical properties (called tangible assets) or on non-physical properties (called intangible assets). Both the rights are measured and recorded in monetary terms in the books of account.
- **Classification of Assets**

On the Basis of Existence

- **Tangible Assets**
  They have physical existence like, Building, Machinery, etc.
- **Intangible Assets**
  They have no physical existence like, Goodwill, Patents, etc.

On the Basis of Longetivity

- **Fixed Assets**
  Their benefit can be availed for long period of time like, Building, Patents, etc.
- **Current Assets**
  They are maintain for short period of time like, Debtors, B/R, Cash in Hand, Cash at Bank

- **Liabilities**– Those amount which the business is liable to pay are called liabilities. For example, creditors, capital invested by the owner, bank overdraft, etc.
- **Classification of Liabilities**

Classification of Liabilities

Claims

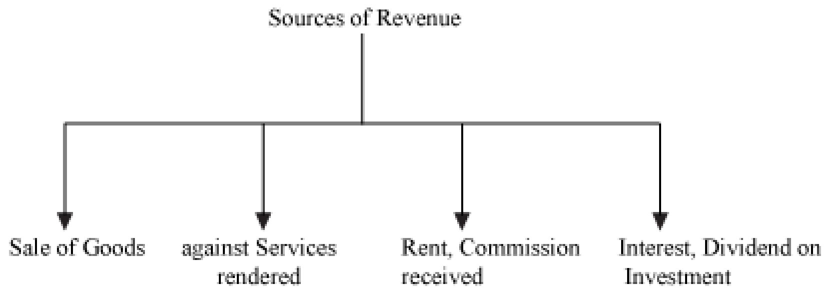
- **Internal Claims**
  It include claims of proprietors like, Capital, Profit, etc.
- **External Claims**
  It include claims of outsiders like, Creditors, Investors, Lenders, etc.

On the Basis of Term

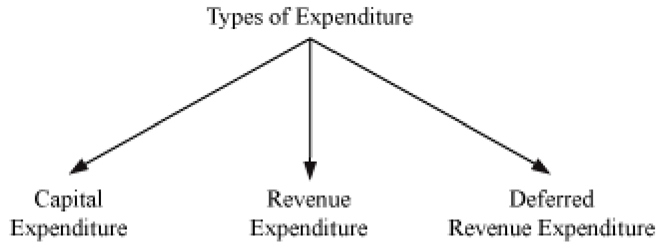
- **Short Term Liabilities**
  These are incurred with an intention to pay in near future like, Creditors, B/P, etc.
- **Long Term Liabilities**
  These are incurred with an intention to pay beyond one year like, Long term Loans, Debentures, etc.

- **Contingent Liabilities** – Contingent liabilities refer to the amount that may or may not become liability depending on the outcome of a future event. In other words, these are potential liabilities. These liabilities are not shown in the Balance Sheet, but are shown as footnote of the Balance Sheet.
- **Capital** – The amount invested (either in form of cash or assets) by the proprietor in the business is called capital. Capital is a liability for the business, as the business is liable to pay back the amount of capital to the proprietor.
- **Drawings**– The amount withdrawn in cash or in form of other asset like, goods withdrawn from business by the proprietor is called drawings. Drawings reduce the amount of capital of the business.
- **Sales**– The sale of goods either in cash or in credit are called sales.

- **Revenues**– The amount which is either received or receivable from various business operations like, sale of goods, interest, dividend, rent etc. are called revenue.

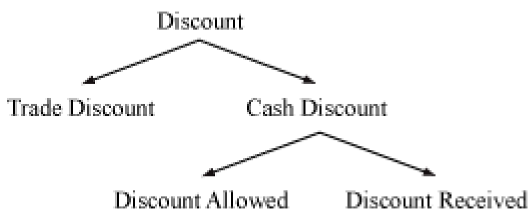


- **Expenses** – The amount that are incurred for generating revenue are called expenses. For example, purchase of goods, payment of wages, etc.
- **Expenditure** – Amount spent or liabilities incurred for the purchase of goods and services and for acquiring assets are called expenditure. For example, purchase of machinery on credit, or cash is expenditure for the business.



- **Capital Expenditure** – Expenditures that are incurred for the purchase of fixed assets like, machinery, building, land, etc. are called capital expenditure. This expenditure is of capital nature, as the benefits of these expenditures can be availed for a long period of time.
- **Revenue Expenditure** – Expenditure that are incurred during a normal operation of business, like rent paid, salaries, are called revenue expenditures. The benefits of this expenditure are availed only for one accounting period.
- **Profit** – Profit refers to the excess of revenue over its related expense. Algebraically, Profit = Revenue – Expense
- **Gain** – Gain refers to the profit from non-recurring business transaction. For example, profit on sale of machine of Rs 2,000 is considered as gain, as sale of machine is non-recurring in nature.

- **Loss** – Loss refers to the excess of expense over its related revenue. For example, loss on sale of machinery.
- **Discount** – It refers to:
    - Deduction in the sale price of goods and services
    - Deduction allowed on account of receiving quick payment from the debtors.



- **Trade discount** – Generally this discount is allowed on the list price of the goods from whole seller to retailer or when goods are sold in bulk
- Cash Discount – This discount is allowed for spontaneous payment. This discount is allowed only when the payment is made.
- **Discount Allowed** – This discount is allowed when payment from the debtors is received.
- **Discount Received** – This discount is received when payment is made to the creditors.
- **Voucher** – Voucher is an evidential document containing details of a transaction. Some examples of voucher are bill, receipt, cash memo, etc.
- **Goods** – Those items which are produced or purchased with an intention to sell in the main course of a business are called goods. For example, furniture produced is considered as goods for a furniture company.
- **Stock** – Goods which are held by a firm for the purpose of sale in the normal course of the business are called stock.
- **Debtors** – Persons who owe amount to the business on account of credit sales of goods and services are called debtors.
- **Creditors** – Person to whom business owe amount on account of credit purchases of goods and services are called creditors.