

Accounting and Its Terminology

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1. Introduction

Human being has its separate and special existence in the universe. Human being is an intellectual animal. Human being has different life style. Its life style is related with social, religious, economic needs. To fulfill these needs, he has to take support of other people. Every individual has one's own distinct existence, skill and limitations. Every individual exchanges his skill with other individuals in the society. Every individual gives benefits of their personal skills to others and takes benefits of other's skills due to his own limitations. In this fashion an individual meets his own needs.

Barter system was prevailing in economy due to the absence of money as a medium of exchange. In this system product was exchanged against product or product was exchanged against service. e.g. A farmer has grain and he is in need of cloth and who has cloth is in need of grain. In this case both the parties used to fulfill their needs by exchange of products. In this barter system product or service was used in exchange to purchase another product or service. Barter system had practical limitations. Due to limitations of barter system a need was emerged for such medium of exchange which would be acceptable to all.

In present time money is used as medium of exchange. In present time coins, currency notes and now even plastic currency is used in the form of money. For such system, where money is used as medium of exchange, it is known as monetary economy. Under this system by selling product, money is procured and from acquired money, product is purchased. Thus it can be said that product purchases money and money purchases product.

So, in present time, human being uses money to fulfill his own needs. Generally, this medium of money is acceptable to all parties. Due to acceptability quality of money transactions take place. When transactions are made through money, they are called economic transactions. In absence of money, transactions used to take place; those transactions were based on barter system. Transactions made with the help of money as a medium are known as monetary transactions.

Transactions, whether are made through barter system or monetary system are required to record and prepare accounts. It is mentioned in the history that accounts were maintained in ancient time also.

Social and economic needs of society are changing with time and requirements. Like legal, medical, engineering, science subjects, accounting subject has also emerged to assist social and economic activities

of the society. From ancient times accounting system prevails in one or another way. Indian historians have described economics of Chanakya and explained the existence and significance of accounting. Western historians have given credit for the same to the mathematician named Mr. Luca Pacioli of Italy. There are several opinions about origin of accounting but for its use and significance, common practices prevail across the world. Due to industrial revolution and expansion of business – trade activities, the use and the significance of accounting has increased day by day. Before acquiring information of accounting let us acquire primary knowledge of accounting.

Accounts, in normal term are record of receipt and payment as well as of income and expenditure. (In addition to this record, difference of receipt and payment account and income and expenditure account is ascertained. This difference can be in the form of benefit means profit or in the form of loss or deficit.) When payment is deducted from receipt or expenditure from income, difference is as called benefit or profit. When receipt is deducted from payment or income from expenditure, difference is called as loss or deficit. For e.g. A trader has purchased goods of ₹ 10,000. Transportation expense is paid of ₹ 2000. The entire goods are sold for ₹ 15,000. Here receipt or income is of ₹ 15,000 against which payment or expenses are ₹ 12,000 (₹ 10,000 + ₹ 2000). Thus difference of ₹ 3000 (₹ 15,000 – ₹ 12,000) is called as profit or gain.

A method or system which is maintained to keep accounts is called as accounting. Accounts are also known as bookkeeping. **Accounting term is used as synonym of bookkeeping. In this book, accounting term is used in place of bookkeeping.** Subjects like Physics, Chemistry, Mathematics; accounting subject also has its own existence and significance in the society. Accounting has its own special utility. Accounting has its own rules and principles. It is also an Art and science. Professional bodies are working at national and international level for smooth functioning of accounting system.

2. Accounting

Accounting is presented in the form of definition by different accounting professional bodies. On the basis of definitions the concept of accounting can be understood the following definition is given by American Institute of Certified Public Accountants (AICPA).

“Accounting is an 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.”

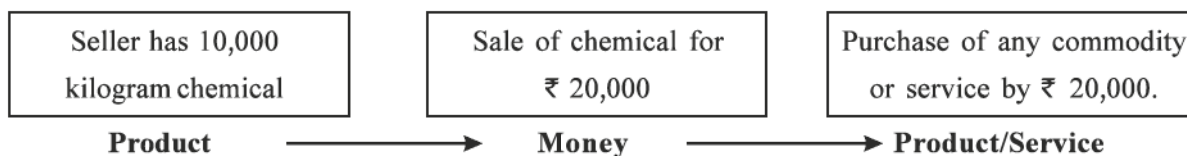
But keeping development of accounting in mind, the following definition is given by American Standards Council (ASC) : **“It is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities, that is intended to be useful in making economic decisions.”**

From the above mentioned definitions the following characteristics of accounting can be ascertained.

3. Characteristics of Accounting

(1) **Financial characteristic** : Transactions or events, which are recorded in accounting, must be measurable in monetary value. e.g. 10,000 kg of chemical is purchased. The value of this purchase has to be determined in terms of money. This chemical is purchased for ₹ 20,000 which means that 10,000 kg chemical = ₹ 20,000. In exchange of chemical ₹ 20,000 are payable. Rupee is money. Transaction made through money is known as economic transaction. This transaction has financial characteristics.

(2) **Money as a medium of exchange** : Transactions or events recorded in accounting come into existence through the usage of money. Money as an exchange will be received by seller for 10,000 kg of chemical sold and by this money he can purchase any other product or service. Let us understand the transaction of seller :



Thus, instead of having exchange of product / service against product, now the product is exchanged against money and subsequently money is converted into product / service. In this manner money becomes medium of exchange for any transaction or event.

(3) Classification and analysis of transactions : In accounting, different types of transactions are recorded. These transactions are made in cash form or non-cash form (also known as credit transactions), these transactions are performed for any income, expenses, asset or liability based activity. These transactions are classified and analyzed on basis of their nature which is derived from debit credit rules of accounting (which are discussed here after). Due to characteristic of classification and analysis, transactions of prescribed time can be seen together at one place. e.g. what was opening balance of assets? How many assets were purchased? How many assets were sold? What is the closing balance of assets ? Answers of all these questions are obtained because of classification and analysis.

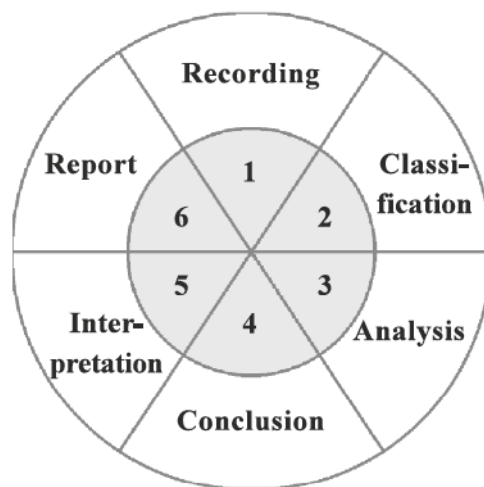
(4) Interpretation of transactions : In accounting, only accounts are not prepared. But after accounts are prepared as per the prescribed norms, they are also interpreted on the basis of disclosed details and figures (which is called as quantitative information). e.g. when blood pressure of a person is measured and if it comes to 120-80, it indicates that the person is healthy from the view point of blood pressure. 120-80 is the measure of blood pressure and the comment “healthy” is the interpretation. In accounting, interpretation can be done from the accounts prepared. e.g. Total Income is ₹ 20,000 and Total expense is ₹ 12,000, the difference of ₹ 8000 is the excess of income over expenses. This indicates that person has benefited from this transaction. The difference of income and expense is in the form of benefit, which is interpretation of these figures. In this manner transactions recorded in accounting, can be interpreted, and their results can be understood.

(5) Quantitative information : Information recorded in accounts is in the monetary form. So, this information is known as quantitative information.

(6) Economic decisions : Different stakeholders take their decisions based on accounts prepared by accounting. e.g. creditors make decision to lend money to the company. Potential share holder make decision to invest their funds. Company itself makes decision for its own development. All these decisions are based on money, thus are known as economic decisions. Thus, accounting assists to make economic decisions.

(7) Historical information : In accounting all past transactions and events are recorded. These past transactions or events become history. Past always discloses history. Accounts prepared on the basis of history represent historical information and results. Thus, accounting has relation with historical information.

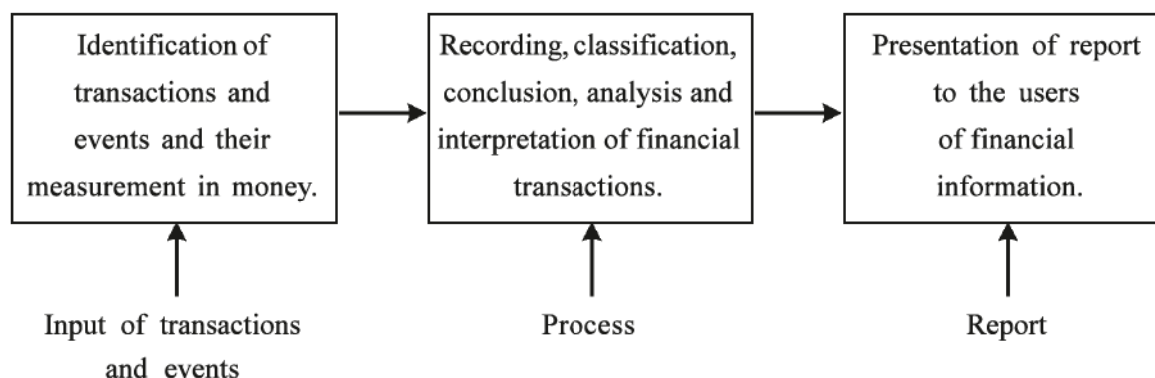
Characteristics, which are derived from definitions, explain the process of accounting. From where this process commences? From which stages does it pass ? What is derived from each stage? What is derived at the end of the process? Definitions and characteristics present information about all these issues. The stages of accounting process are given here in the form of figures :



Accounting Cycle

In brief, accounting records, classifies, analyses transactions and events; and gives conclusions. After having an interpretation on the basis of these conclusions, a report is prepared. Here, the meaning of report is accounts i.e. annual accounts. (This is discussed in subsequent chapter).

Accounting process can be presented as follows:



The characteristics of accounting explain the nature of accounting. The functions or objectives of accounting are provided as under :

4. Objectives of Accounting

(1) **Permanent records** : In accounting, transactions and events are recorded in written form. These records are kept either in the form of books or recorded in computer on permanent basis.

(2) **To know the effect of each transaction** : Each transaction has its effect on overall profitability or economic condition of the business. Thus accounting helps in obtaining this information. (This is discussed in subsequent chapter).

(3) **To know influential factors** : The information of factors affecting profit or loss as well as economic condition of the business can be obtained by preparing accounts. This objective plays vital role in the preparation of accounts.

(4) **To determine tax liability** : Generally, the tax payment liability is determined on the basis of prepared accounts. The burden of tax is determined on the basis of income of a tax payer. Therefore, the objective to prepare accounts is to determine tax liability.

(5) **To know quantum (size) of payables** : In business, in place of cash transactions, credit transactions are also made. e.g. purchase of raw material on credit. However, this payment is to be made in future. Till the nonpayment of this transaction, it is treated as liability. At the end of the year, what is the quantum of liability can be ascertained from accounts.

(6) **To know quantum of receivables** : Like credit purchase, goods are sold on credit to customers. This amount is receivable in the future. Until the non-receipt of this amount it is shown in the books as receivables. This information can be obtained from accounts.

(7) **To measure profitability of business** : The significant objective of accounts is to measure earned profit or incurred loss for respective period. The measurement of profitability is made available by accounting.

(8) **To know economic status of the business** : At the end of the year what is the size of liabilities, assets and receivables of the business can be seen from the accounts under accounting system. When assets and receivables are more than liabilities, it can be said that it is good economic condition. So economic condition, which is known as solvency, can be known from accounts.

(9) To detect and avoid errors and frauds : By investigating prepared accounts, financial mistakes or crimes can be traced out. Accounting helps to prevent such kinds of undesirable events. Accounting maintains indirect control to avoid errors and frauds.

Accounting is used for above-mentioned purposes. There are several benefits due to the existence and use of accounting. These are discussed as follows :

5. Advantages of Accounting

Accounting is a social science. This science is used in the entire world. Its utility discloses its advantages. These advantages are as under :

(1) Availability of accounting information : Accounting information is prepared by any owner of any business. If this information is readily available, it can be used by the owner as and when it is needed. e.g. an owner wants to obtain a loan from a bank, he can produce prepared accounting information of his economic status and can obtain the loan.

(2) To know profitability : During specific accounting period, how much profit is earned or how much loss is incurred by the business, this information is provided by accounting. This information is ascertained from profit and loss account.

(3) To know financial status : At the end of the period, what is the size of liability for the business can be ascertained. If the size of liability of business is more, it indicates weak economic condition and if the size of liability of business is less, it indicates good economic condition. This economic status can be ascertained through balance sheet.

(4) Tax planning : Tax on earned income has to be paid by every business unit, in different forms. The determination of tax size is based on quantum of transactions of business. Keeping in mind quantum of transactions, what amount of tax is to be paid for respective period is ascertained from accounts. From this information, planning for tax payable during the period can be made.

(5) Valuation of business : In practice sometimes an owner sells his own business to another person. Under these circumstances, what should be selling price of business ? Accounting is helpful to determine this selling price. What is the profitability of business? What is the economic condition? This sort of information is provided by accounting. Therefore, in this manner, accounting assists in business valuation.

(6) Decision making : Different forms of business like sole proprietorship, partnership firm, and company prepare their own accounts. Specifically accounts of company are used by several stakeholders like creditors, shareholders, investors for their investment decision. Accounting plays vital role in decision making.

(7) As an evidence : The formation of accounts is based on accounting rules and principles. Thus, accounts prepared in such manner are considered reliable. Due to this quality of reliability, at the time of any dispute accounts are used as evidences. e.g. in case of any dispute in the context of account between partners of a partnership firm, accounts become evidence to bring solution for the purpose of justice.

(8) Comparison with past operations : The rules and principles of accounts do not change. Due to this feature present performance of profitability or economic condition can be compared with past and information for the development of business can be obtained. If development has not taken place or is not as per the expectation, planning can be undertaken to achieve it in future. Apart from this, accounts can be compared with the accounts of competitors.

(9) **Moral control** : Accounts are in written form. These are used as evidence. Thus, the chances of fraud made by employees are reduced. Accounting assists to keep moral control over the employees.

(10) **Corrective measures** : In practice, it so happens that the business suffers due to some past decisions made by the owners or the management of business. The effects of these decisions are reflected in the accounts. To avoid the recurrence of such mistakes corrective measures and necessary care is generally taken.

As a component of social science, accounting has its own separate existence. As stated earlier accounting works under predetermined rules and principles. Because of change in society, or because of predetermined rules or principles, some limitations also arise. These limitations are discussed as under :

6. Limitations of Accounting

(1) **Non-financial transactions** : In accounting, those transactions are recorded, the value of which can be measured in terms of money. e.g. purchase-sale of material, purchase-sale of assets etc. The qualities like honesty, loyalty, commitment of employees working in the organization play significant role for the development of business. These aspects are not considered in accounting.

(2) **Stable value of money** : Accounting assumes that value of money is stable. e.g. an asset was purchased before five years for ₹ 50,000, if replacement is required to be done, then in this case more than ₹ 50,000 has to be paid to acquire same type of asset due to inflation. Accounting assumes that value of money remains stable. Practically this is not possible. A stable value of money assumption can be treated as a limitation of accounting.

(3) **Historical transactions - events** : In accounting historical transactions or events are recorded. No corrections are allowed in transactions for any mistakes but still historical transactions and events are useful to take future decisions.

(4) **Avoidance of market value** : The value of assets keeps on changing. Their market price keeps on changing. In accounting, market value is ignored and only actual cost based treatments are given.

(5) **Use of estimates** : In accounting, items like bad debt reserve is determined on estimation. If estimates are mistake oriented (wrong), it will be reflected in the accounts. But these kinds of estimates are done on the basis of past experience and logic. So, possibility of mistake remains minimum.

(6) **Dual standards** : There are two important components of accounts – Profit and Loss Account and Balance sheet. Profit and Loss Account (which is known as income statement) is prepared on current prices while items of Balance Sheet are disclosed at old price (historical price). This kind of disparity prevails.

In spite of having these limitations, accounting has very practical and important role for owners of business, government, other stakeholders like investors, creditors, lenders etc. These limitations of accounting do not work as hurdles in the development of accounting. Besides, these limitations can be removed because accounting has been developed as a language of business and science / art.

Accounting as a Language of Business :

Accounting is known as a language of business. Through accounting, information of business transactions is provided. Through language either by writing or speaking or analyzing or interpreting any content is described or explained by one person to other. This function is performed by accounting, by providing information of business activities or results to the related parties. Language is used with its own predetermined norms; accounting is also used with its own predetermined rules. Language has a feature of flexibility hence time based changes are incorporated in it. In accounting also time based changes are incorporated.

In brief, accounting provides information of accounts. Thus, it works as a language.

Is Accounting a Science or an Art ?

Science is always based on rules and principles. These rules and principles are universally accepted. Accounting is also a science. Its formation is based on rules and universally accepted principles prepared by human beings. To record economic transactions of the business they are classified on the basis of accounting rules. To record transactions an individual skill is not required. Only rules are to be followed. When accounts are prepared by different persons, the process of preparation of accounts and its results would remain the same. Thus, due to rules and principles accounting is known as science.

Apart from science, accounting is known as an art also. Accounting is mainly categorized into three categories (i) Financial Accounting (ii) Cost Accounting and (iii) Management Accounting. Keeping the limitations of these accounting in mind, a specific skill to prepare account is also required. The presentation of anything in a different manner without changing its nature and meaning is known as an art.

7. Qualitative Characteristics of Accounting Information

The use of the accounts prepared is not confined to accounts preparers and owners of the business. The information presented in the accounts is used by different parties. Parties such as creditors, government, lender institutions are included. It is expected from accounting that, whichever accounts are prepared or presented should have qualitative characteristics. The characteristics like reliability, relevance, understandability and comparison are qualitative characteristics. These characteristics cannot be measured. These qualities assist to sustain trust of users in accounting information. They use this information without any fear. They take their relevant decisions. The explanation of these characteristics is given as under :

(1) **Reliability** : The first qualitative feature of accounting is reliability. The users of information believe that prepared information represents real picture. The task of information preparer is to sustain the trust of users. The prepared information has to be completely errorless. There should not be inclusion of opinion of an accountant or any other party. If rules and principles are fully followed the prepared information would automatically disclose trustworthy presentation. Under the head of reliability, trustworthy presentation, neutrality and full disclosure are included as sub characteristics.

(2) Relevance : Relevant information is that information which meets the needs of users and is competent enough to meet the needs of users of information. Relevance is that kind of characteristic which assists users to take decisions based on this information. The information prepared or presented by the accountant, has to be of such kind on the basis of which investor can decide that (i) Whether his past decisions were appropriate or not? (ii) Whether his present decisions are appropriate or not? (iii) Whether his future decisions will be appropriate or not?

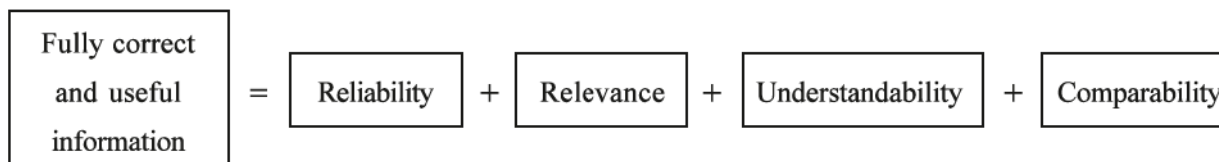
In brief, presented information should be useful in the context of past, present and future decisions.

(3) Understandability : In addition to relevance, the presented information should be of that kind which can be easily understood and interpreted by the information users. Understandability means provided information should have clear meaning. At the same time preliminary knowledge of business activities and accounting is expected from users of information. Accounting has its own terminology, rules and principles. If information user is not acquainted with this, he will not be able to understand presented information easily. In brief, information presented in accounts should have quality of understandability. The user also should have knowledge of expected content.

(4) Comparability : Another qualitative characteristic of accounting is comparability. Accounting information should be prepared and presented in such a manner where user can undertake comparison of profitability and economic solvency of two periods. Due to quality of comparability, users take their decision by undertaking the comparison of results of two different periods. In case of company accounts it includes accounting information of previous year and current year for income statement, Balance sheet and cash flow statement. Here, the comparison of accounting information of two different periods is made.

Besides, this, inter firm comparison also can be made.

In brief fully correct and useful information by including qualitative characteristics can be presented as follows:



8. Users of Accounting Information and their needs

The form of business is developed from sole proprietorship to partnership firm and partnership firm to company. Due to this development the boundaries of the use of information are also extended. The accounts are made by the sole proprietors or partnership firms to meet with their personal and legitimate requirements. In these forms of business, generally owners and management are same entity. Thus, the use of information is confined to them. In company form of business, owners and management are different entities. Thus, because of government restrictions the information of companies becomes public information. Therefore, there are several users of information. Who can be included in the group of users? Which kind of information do they require? are explained below :

(1) Management: In the company form, shareholders are treated as owners and the board of directors undertakes management. The effect of policy decision made by them is reflected in the accounts. Whether they have achieved determined goals or not? That information can be obtained from accounts. Their function is to achieve predetermined goals through planning and control. They identify the variances

by comparing planned estimates with actual results and they take corrective measures to avoid repetition of these kinds of variances. Accounts is the best tool to measure efficiency of management. Management can be classified as internal user. Thus, accounts are very important for management.

(2) Share holders: As per legal provisions, management has to send the certified copy of accounts to all the shareholders in prescribed time period. It is a right of shareholders to obtain a copy of accounts and at the same time it is a duty of the company. Shareholders analyze published financial and non-financial information, and undertake review of decision for their investment in the company. They can learn about the development and forecast the future of the company. They make decision either to dispose off or to retain the shares of the company on the basis of this information. Now companies have started to send accounts through email for environmental protection.

(3) Potential shareholders: This category of shareholders desire to buy shares of the company. After investing in the company, to decide whether they will have expected return or not, they use accounting information of the company.

(4) Creditors: In creditors, short-term creditors are those who provide facility of goods on credit to the business enterprise. Besides, in long-term creditors financial institutions and debenture holders are included. These parties have to collect their dues in future from the company. These parties use published accounts to know the present and future earning capacity and economic condition of the company.

(5) Employees: From accounts of the company, the employees of the company acquire the information about their salary improvement, bonus and job safety. Generally, profit of accounts is important for employees. They present their demands before management on the basis of profit. If the economic condition of the business enterprise is sound, they can estimate the security status of their service and development of the company. In this manner accounts has utility for them also.

(6) Tax authorities: Different types of taxes are collected by the government in the country keeping in mind business income, activities of business and other factors. To collect these taxes, in the budget of every year, government makes provisions. On the basis of these provisions taxes are paid by business enterprises / companies. Tax payment liability is determined from accounts. Accounts prepared and taxes paid whether are prepared or paid as per budgetary provisions or not is checked by the tax authorities. These taxes are collected by the state and the central government. For this purpose, accounts are used by the tax authorities.

(7) Customers: Customers of business can be considered one of the significant components of profit creation (earning). Existing market is not the market of seller but it is the market of buyer. For buyer means for customers, various acts are prevailing; and they are fully aware of their rights for purchased product. They are also aware of the price of product and service. Customers can get idea about price of product or service from accounts of the company. So accounts are useful to customers also.

(8) Foreign Entrepreneur: Due to facility of communication and transport the world has become very small. Besides, economic restrictions are liberalized due to liberalization. Consequently foreign enterprises wish to sell their products or services in other countries. Besides, they are interested to undertake amalgamation with company of other country. However, before execution of these kinds of decisions, they examine the aspects like solvency, liquidity, profitability etc of the company. After having this analysis, they make their decisions. So, accounts have importance from the view point of foreign entrepreneurs.

(9) Regulatory bodies: A company form of business is controlled either by the government or the regulatory bodies formed by the government. So, that the general public will not have any kind of financial loss due to any steps / activities of the company.

For this purpose, SEBI (Securities and Exchange Board of India), and IRDA (Insurance Regulatory Development Authority) are established. These bodies use accounts for preparation of rules and guidelines. Apart from this, whether accounts are prepared as per the norms or not, is also examined by these bodies. Therefore, accounts are essential for regulatory bodies also.

(10) Professional bodies: Accounts preparers are known as professionals. Accounting is a profession. For fair management of profession each country has professional bodies. From 1949 onwards, the Institute of Chartered Accountants of India is functioning for accounting profession in this country. In the context of accounts, this body prepares guidelines and accounting standards. So that uniformity and integration can be maintained in prepared accounts. In addition to this Institute of Chartered Secretary of India and the Institute of Cost Accountants of India also render necessary suggestions. So accounts assist professional bodies to prepare guidelines and accounting standards.

(11) Researchers and Analysts: There is one category of users of accounting information, researchers and analyst. This group is interested to know what the profitability of the company is and what the solvency of the company is ? Apart from this, they undertake research and analysis – why this kind of profitability – or economic status exists. Why in this quantum? This kind of research and analysis helps the company and investors. The contribution of this group of users is also significant. This group is not working only for its own interest but they work for the benefits of the others. So accounting information is necessary for these users. The institutions determining credit worthing function in India and abroad. CRISIL, CIBIL, ICRA etc. are included. These agencies also use the published accounts.

(12) Government: It is the responsibility of government to bring efficient and effective management in the country. The government forms policies for the development of the country. For the formation of policies, relevant information is required. The information presented by the companies is collected and is used for the formation of national policies. This accounting information plays vital role in policy oriented decisions of the government.

From the above discussion, the answers of who are users of accounting information? For which purpose accounting information is useful ? can be found out. The horizons of the use of accounting information are being expanded. This explains the significance of accounting information.

9. Terminology of Accounting

Education is acquired in different fields. Education is provided in different fields. An individual becomes an engineer, a doctor, an artist or a sportsman. Each individual takes education in the field of his choice. Each field of education has its own terminology; it means it has its own vocabulary. Each field uses its own specific words. These words provide explanation and meaning of respective content (terminology) of respective field. Respective word / words are used in the context of respective meaning. There is no possibility of subjectivity.

In accounting also, special words explain specific and clear meaning in the given context. The terminology of accounting is as follows:

(1) Business transaction : “Business transaction means exchange of product or service of business between two or more persons in the form of cash and / or on credit”. Business transaction

means an act of business. Business transaction is always economic transaction. Economic transaction means a transaction which can be measured in terms of money. Cash transaction, made in the form of money. Clearly depicts economic value. Dues of credit transaction are receivable in future but its economic value is determined in present. The prerequisite condition of business transaction is to have its economic value i.e. financial value. Business transaction comes in to existence through medium of cash or on credit condition.

E.g. Cash transaction of business : Goods of ₹ 5000 sold to Rajnikant for cash. This is an act of business. Cash is received against goods. Its economic value is ₹ 5000. This is a business transaction.

Where, — Rajnikant is a separate person

- Goods is a product
- ₹ 5000 is economic value which is received on the spot
- Money is exchanged against goods.

All conditions of business transaction are fulfilled.

Credit transaction of business : Goods of ₹ 5000 sold on credit to Rajnikant with condition to pay the amount within 10 days.

Goods sold on credit. Money of which is receivable within 10 days. This is a credit business transaction.

Where, — Rajnikant is a separate person

- Goods is a product.
- ₹ 5000 is economic value which will be received after 10 days.
- Money will be received in future against goods, this is a guarantee.

The above justification, explains the business transaction. A detailed classification and explanation about business transactions is specified subsequently.

(2) Event : Event is recognized as an incidence. Event means situation or result created from transaction. Transaction has its own explicit features, which are studied as above.

E.g. assume that goods sold to Rajnikant is purchased for ₹ 3000. Wages is paid ₹ 500. Transaction and event can be presented as follows.

Sales	₹ 5000	Sales is an act, thus it is transaction.
Less Purchase	₹ 3000	Purchase is an act, thus it is transaction.
+ Wages	₹ 500	Wages paid, it is an act, and thus it is transaction
Profit	₹ 1500	It is result, thus it is an event.

In brief transaction discloses an act done by the business while event represent situation or result created from transaction.

(3) Capital : An investment made by the owner to commence the business is known as capital. Investment in business is done in cash form or in the form of any asset. All those items are included in capital which is provided by owners and their value is measurable in terms of money.

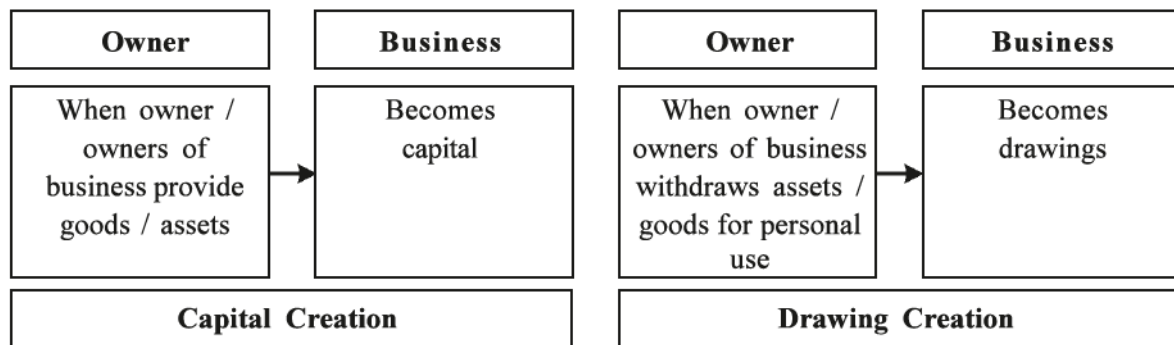
E.g. To commence business owner has brought ₹ 10,000 cash, furniture of ₹ 6000, Goods of ₹ 8000. Here the capital of owner will be ₹ 24,000. Items provided by the owner, each of them has

monetary value and will be used for business. Owner gives money to commence business as well as to expand the business. Capital is identified on basis of nature of business, which is as follows:

- For sole proprietorship capital word is used, which owner provides.
- For partnership, partners' capital word is used which partners provide.
- For company, share capital word is used, which is provided by shareholders. (Equity share capital word is more popular)

(4) Drawings : For creation of capital, owner of business provides his personal property to the business. Personal assets (properties) given by owners becomes assets of business.

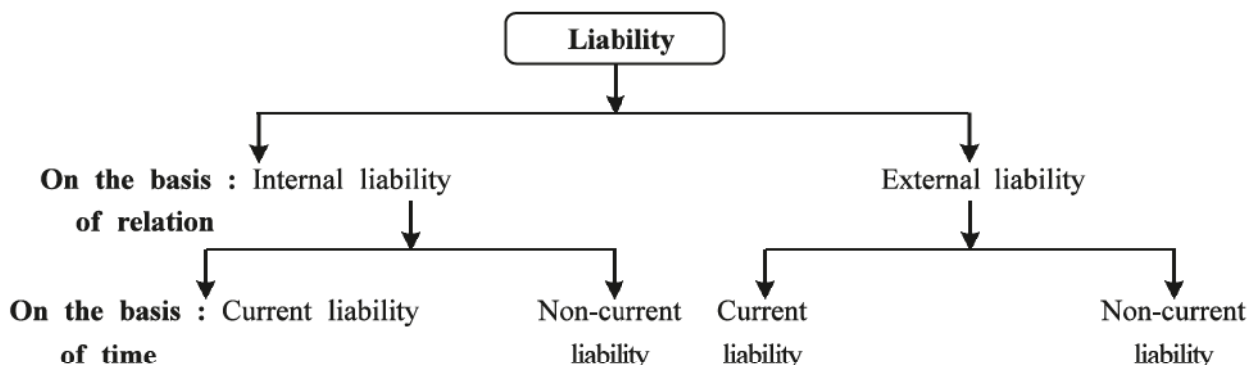
When owner of business withdraws assets from business means cash or goods for personal purpose this is known as drawings. Drawing indicates capital reduction. Instead deducting it directly from capital, it is shown separately as a drawing.



Generally, drawing word is used for sole proprietorship and partnership firm. **Owner gives capital to business. Business gives drawing to owner.**

(5) Liability : Amount payable by the business for credit purchase of goods / asset or amount payable for borrowed money is known as liability. This amount is payable in the future. It is treated as liability till it is not paid by the business.

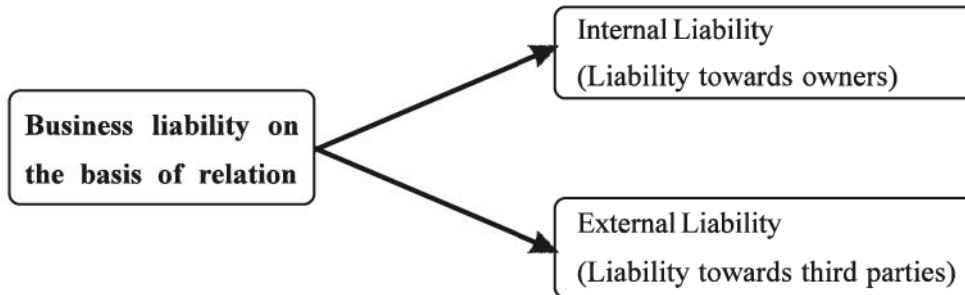
Liability can be classified as under :



(6) Internal liability and external liability : In accounting, business and owner are treated as separate entity. When owner of business is providing capital to the business, it becomes internal liability of the business. It is a liability of business towards owner. In brief, amount payable by the business to the owner is internal liability. Owner of business has provided capital of ₹ 1,00,000. This ₹ 1, 00,000 is a liability of business towards owner. This is an internal liability of business.

The amount payable by the business to the third party for credit purchase of goods / assets / services or payable amount for borrowed money is known external liability. E.g. ₹ 50,000 are borrowed from Bhavnaben with the condition to redeem after three years. Goods of ₹ 2000 purchased on credit

from Raman. ₹ 1000 are outstanding for the payment of rent. Furniture of ₹ 5000 is purchased on credit from Devang. All these dues are payable in future. These are all third parties.

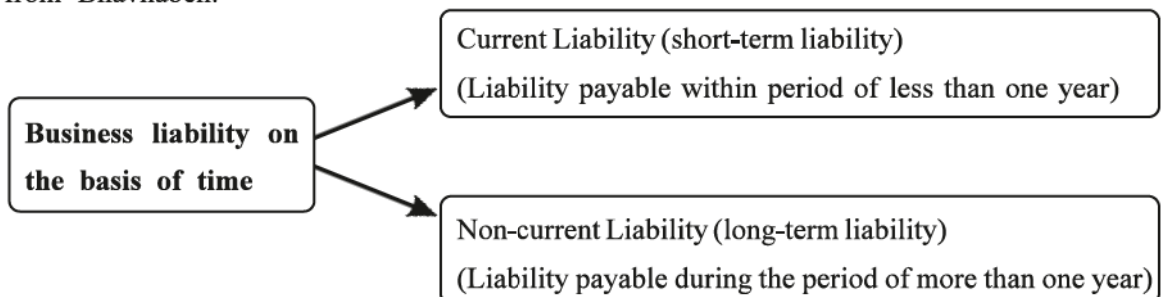


Internal and external liabilities are determined on the basis of relation of business with the owner and the third party.

(7) Current liability and non-current liability : As stated earlier, internal and external liability is determined on the basis of relation of the business with other person. While current and non-current liability is determined on the basis of time. Its explanation is as follows:

A liability, which is to be paid within one year by the business, is known as current liability. Current liability is treated as short-term liability also. Generally, in short-term liability; goods purchased on credit, expenses outstanding etc are included. E.g. as above stated goods purchased on credit from Raman, outstanding payment for rent, credit purchase of furniture etc.

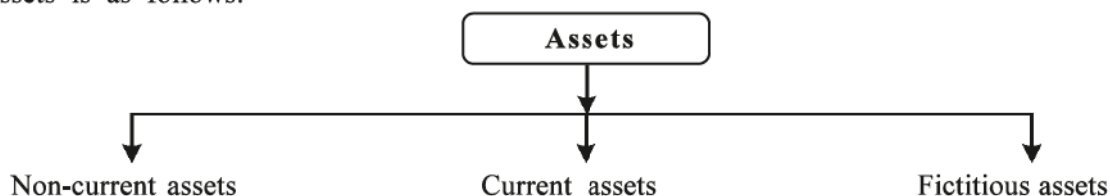
A liability, which is to be paid during the period of more than one year by the business, is known as Non-current liability. Non-current liability is also known as long-term liability of the business. In non-current liability bank loan, debenture etc are included. e.g. as above mentioned amount borrowed from Bhavnaben.



As described, above liability can be classified according to their different nature. Each liability plays, its specific role in business.

(8) Assets : There are two important aspects in business – liability and assets. We have obtained the information about liability. Now, let us have information about assets. Under double entry system at one side liability takes place and simultaneously on the other side asset emerges at the time of commencement of business.

Asset means any such tangible or intangible product or item which is of ownership of business and has economic value. In other words asset means economic resources which are held by owner and from which there is expectation of economic benefit to the business in the future. Classification of assets is as follows:



(9) Non-current assets: Non-current assets are identified on the basis of time. Like non-current liability, non-current assets are also for the period of more than one year. They are known as long-term assets or fixed assets. Land and building, plant, machineries, furniture, trademark, copy right, patent, goodwill, franchises etc are included in noncurrent assets. These assets have life of more than one year. Non-current assets can be categorized into further two categories: (i) Tangible assets (ii) Intangible assets. Their explanation is as under :

(10) Tangible assets: Tangible assets are those assets which are having physical existence. Tangible assets can be seen and can be touched. Tangible assets are subcategory of non-current assets. In tangible assets land, building, plant, machineries, furniture etc. are included.

(11) Intangible assets: Intangible word itself clarifies the meaning of these assets. Intangible assets do not hold physical existence. These cannot be seen and touched. Intangible assets are also subcategory of noncurrent assets. Trade mark, copyrights, patent, goodwill etc. are included in intangible assets.

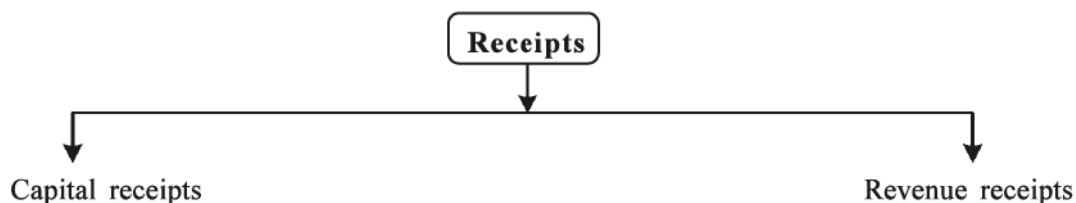
(12) Current assets: These assets are of that kind whose time duration is of less than one year. These assets can be converted into cash. For day to day transactions of business, these assets are used. In current assets cash balance, bank balance, debtors, bills receivable, raw material stock, finished stock etc. are included. A product for which trading is done by business is known as goods of business. For e.g. Grains is a goods for the business man of grains.

(13) Liquid assets: Liquid assets are recognized as sub category of current assets. All current assets excluding stock are recognized as liquid assets. These assets (excluding stock) can be converted into cash quickly, it means in short period. e.g. debtors, bill receivable etc. can be quickly converted into cash.

(14) Real assets: Real assets means assets that have value in reality. These assets have market price. This means it has realizable value. These assets can be converted into cash. In these assets, tangible, intangible and current assets are included. From sale of such assets, if money can be realized, then they are known as real assets. Through sale of real assets cash can be procured.

(15) Fictitious assets: Fictitious assets do not have physical form (existence). Realizable value of fictitious assets is zero. These assets cannot be converted into cash. This is non-recurring expense. The benefit of this expense is available for the period of more than one year. This amount is to be written off in certain years, thus shown as an asset. Every year predetermined amount is written off and shown as an expense. Issue cost of share and debenture, preliminary expense, share or debenture discount etc. are illustrations of fictitious assets. Fictitious assets are also known as spread revenue expenses or differed revenue expenses.

(16) Receipts: When money is received due to consequence of business transactions, it is known as receipt. These receipts are classified on the basis of their nature – receipts regularly received during the year and not regularly received during the year. Business receives regular receipts from day-to-day activities. E.g. receipt of the sale in business, receipt of commission, receipt of dividend. These receipts are received on regular basis. Certain receipts do not have regular nature. These receipts are categorized into two categories : (i) Regular Receipts which are known as Revenue Receipts (ii) Capital Receipts which are not regular in nature.

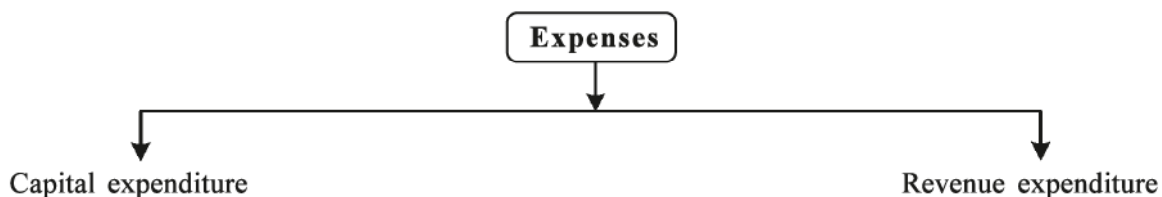


The explanation about types of receipts is given below :

(17) Capital receipts: This receipt is not received regularly. This receipt is procured from the sale of assets, this receipt is obtained by issuing debentures. Assets is not sold frequently; debentures are not issued frequently. These kind of receipts are not received frequently. Such kind of receipts are known as capital receipts.

(18) Revenue receipts: The flow of these receipts would remain constant. From these receipts, profit earned during the year or loss incurred can be ascertained. In this category of receipts income of sales, income of commission, income of discount, income of rent etc. are included. This kind of receipt arise frequently. Revenue receipt is also known as revenue income.

(19) Payments: Money paid due to consequence of business transactions is known as payments. These payments are classified on the basis of their nature – payment regularly paid during the year and not regularly paid during the year. e.g. Business is run in rented premises and rent is paid regularly every month. This is regular payment. Throughout the year it is paid. Assume, that machine is purchased for business, this expenditure is not regular expense. Like receipts, payments (expenses) are also classified into two categories.



The explanation about types of payment is given below :

(20) Capital expenditure : This payment is not regular in nature. Generally, when fixed assets are purchased capital expenditure arise. E.g. purchase of machine. Assets are not purchased frequently. Thus it is capital expenditure. The redemption of debenture is also a capital payment.

(21) Revenue expenditure : The flow of these payments would remain constant. From these payments, profit/loss is determined. In this category payment of salary, wages, telephone expense, advertisement expense etc. are included.

(22) Deferred revenue expenses : These expenses are known as fictitious assets. About this, discussion is undertaken in point no 15.

(23) Expense: The amount spent and benefit of which is available to the respective accounting year is expense. Accounting year is of 12 months. This is called as revenue expense. e.g. salary expense, wages expense, brokerage expense, commission expense, discount expense etc.

(24) Revenue: Goods and services are sold and provided to the customers respectively. If credit sales are made and amount is receivable it is also a revenue. Besides other incomes – interest, rent, commission, dividend received for the respective period and even outstanding are included in revenue.

(25) **Profit** : After deduction of regular payments (which is known as revenue payment) from regular receipt (which is known as revenue receipt) of the year, the remaining surplus is known as profit. The excess of day to day incomes over expenses of the business is called profit. This is revenue profit. In accounts, this kind of profit is computed from profit and loss account. This kind of profit is called revenue profit, because this profit is the difference of revenue incomes and revenue expenses. This is regular profit. But, many times there is a creation of irregular profit, known as capital profit.

(26) **Loss** : The computation of loss is contrary to profit computation. The difference obtained by the deduction of regular incomes from the regular expenses is called loss. This is called revenue loss. Deficit word is popular for loss in practice.

In another type of loss, there can be happening of loss without doing any kind of activity. This is also recorded in books of accounts. e.g.; Goods destroyed by fire. If cost of these goods is ₹ 5000, then loss will be of ₹ 5000. Goods stolen, destroyed in transit due to accident, goods destroyed due to rain etc, are illustrations of these sorts of loss. If any asset meets with an accident, this event is also treated as loss. Any asset is sold less than book value; amount which is not received is also called loss. This is known as capital loss.

(27) **Gain** : Profit and gain are popular as synonyms.

(28) **Purchase**: Many items or services are purchased in the business. All these purchases are not treated as purchase of business. They are expenses of business. A businessman does the business of goods, purchase of that goods is treated as purchase in accounting. e.g., when stationery is purchased by grain merchant, it is stationery expense but if he purchases grain, it is treated as purchase. This purchase can be in cash or in credit form.

(29) **Sales**: Businessman receives different types of incomes from business. All these incomes are not treated as sale. A businessman does the business of goods, sales of that goods is treated as sales in accounting. Income generated by grain merchant through sell of grain is called sales.

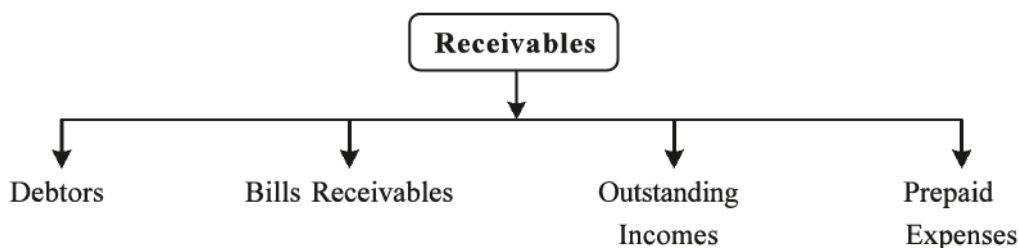
(30) **Stock**: Goods purchased by businessman for business purpose (trading purpose), goods remained unsold from that goods is called as stock. e.g. A businessman has purchased goods of ₹ 70,000 out of which that goods worth ₹ 45,000 sold for ₹ 75,000, then stock will be of ₹ 25,000 (₹ 70,000 – ₹ 45,000). At the end of the accounting year, the closing stock would be ₹ 25,000 and it would be opening stock of ₹ 25,000 for the next year. Closing stock is current asset. In brief stock means surplus of goods from purchase.

(31) **Debtors**: When a businessman sales goods on credit to his own customers, those customers are called as debtors. Customer becomes debtor of that amount for which goods is sold on credit. **Debtors are treated as current assets.**

(32) **Bills receivable**: Bills receivable is a written document where there are two parties, one is the bill writer and other is the bill acceptor. Where bill writer acquires right to receive certain amount as per predetermined date in the future; it becomes receivable. Bill is a bill receivable for the bill writer.

In this written document, bill acceptor accepts the written responsibility to pay specified amount on maturity date. Generally bill receivable emerges from debtors. Accommodation bills are also popular in practice. In this regard, detailed discussion is made in a separate chapter.

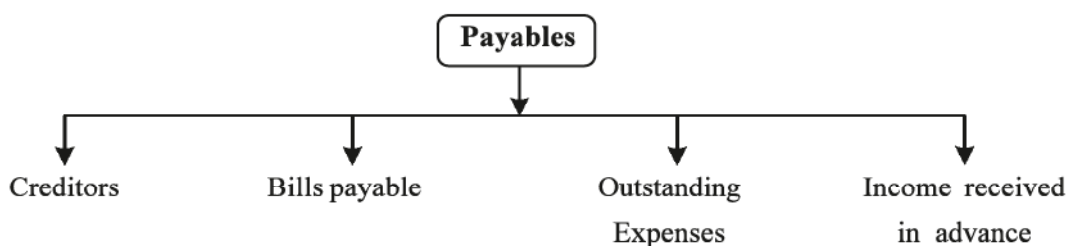
(33) Receivable: Any amount to be received by businessman in the future from any person or persons is known as receivables. Debtors and bills receivable are included in receivables. In other receivables; commission outstanding, rent outstanding, interest outstanding, prepaid expense etc are included. Loan, advances etc are also included in it.



(34) Creditors: As Businessman does credit sales, in the same way he undertakes credit purchase. A person from whom goods are purchased on credit, that particular person becomes creditor of business. A trader becomes creditor of the business, for that amount for which goods are purchased on credit. Creditors are treated as current liability.

(35) Bills payable: Bills payable is a written document. Where, there are two parties – bill writer and bill acceptor. Where bill acceptor accepts responsibility to pay certain amount as per predetermined date in the future, it becomes payable. In this written bill acceptor accepts written responsibility to pay specified amount on specified date. In case of bills payable, bill acceptor pays the amount written in bill to the bill writer on maturity date. Generally, bill payable emerges from creditors.

(36) Payables: Any amount to be paid by the business person in the future to any person or persons is known payables. Creditors and bill payable are included in payables. In other payables outstanding salary, outstanding wages, any expense outstanding, pre-received incomes are included. Pre-received incomes are one kind of liability. All these payables are current liabilities. There can be long-term liabilities which are discussed hereafter.



(37) Cost: To produce any product or to provide any service whatever expenses are required, the sum of these expenses is cost. Generally, in cost; raw material cost, labor cost and other costs are included.

(38) Voucher: Voucher is a written document of business transaction. A type of transaction is determined on the basis of voucher. A type of transaction like cash transaction, credit transaction, purchase transaction, sales transaction, transaction with bank, expense transaction, income transaction,

asset transaction, liability transaction etc. are determined from voucher. After deciding the types of transaction, transactions are recorded in the books according to the rules of accounts.

(39) Discount: Emergence of discount is from purchase-sales. Many times, from total amount of purchase or sales as per conditions, certain amount is deducted and net amount is paid. The amount, which is deducted from the total amount is known as discount. Out of the total amount of purchase-sale, the amount which is procured or deducted is known as discount. There are two main types of discounts : (a) Trade discount and (b) Cash discount.

(a) Trade discount: At the time of sales, a businessperson deducts certain percentage / amount from sales price, it is known as trade discount. Trade discount is not recorded in the books. Assume that the goods worth ₹ 10,000 sold at 2% trade discount. In this case, from selling price ₹ 10,000 after deducting 2 % ($₹ 10,000 \times 2 \% = ₹ 200$) sales of ₹ 9800 will be recorded in the books.

(b) Cash discount: To attract the customers with the purpose to receive quick collection of credit sales, the amount which is deducted from receivable amount is known as cash discount. Cash discount is recorded in the books. After deduction of trade discount, cash discount is determined. As above stated in (a), if ₹ 200 as discount is allowed on ₹ 9800, customer would pay ₹ 9600 to supplier. Thus, ₹ 200 will be treated as cash discount. This discount is allowed at the time of collection of cash, thus, it is called cash discount.

(40) Discount received – Discount allowed: Discount received or discount allowed are cash discounts. This discount is recorded in the books. Discount received is treated as income and discount allowed is treated as expense.

(a) Discount received: When a businessman purchases goods and pays less amount, amount which is not paid is called as discount received. This is income of business. e.g. goods of ₹ 10,000 purchased from Ramilaben and 2 % discount will be allowed if amount is paid in 15 days. If ₹ 10,000 are paid to Ramilaben within 15 days, in this case, instead of ₹ 10,000, ₹ 9800 (after deduction of 2 % on ₹ 10,000) will be paid. Now, ₹ 200 will be treated as discount received. This will be recorded in the books.

(b) Discount allowed: When businessman sales goods, and receives less amount, amount which is not received is called as discount allowed. This is expense of business e.g. goods of ₹ 15,000 sold to Kalpanaben. If amount is received in 10 days. 2 % discount will be allowed. If collection is received from Kalpanaben within 10 days in place of ₹ 15,000, ₹ 14,700 ($₹ 15,000 \times 2 \% = ₹ 300$) will be received. Now ₹ 300 will be treated as discount allowed. It will be recorded in books. This is an expense of business.

(41) Depreciation: Depreciation is expense of business. Every year the value of assets is reduced by certain rate. Amount which is reduced, is called as depreciation. Before making tax payment to the government depreciation is deducted. Depreciation is non-cash expense of the business.

(42) Bad debts: When goods sold on credit by the business, person to whom goods sold is debtor of the business; from him the amount of sales is to be collected. Many times debtor of business may not be in a position to pay full amount, due to his weak financial condition. If the amount is not collected even after the necessary efforts; the amount which is not received is known as bad debts. Bad debt is not an expense of business but it is a loss.

(43) Solvent: In accounting a person who pays his financial obligations regularly and whose assets are more than liabilities, that person is known as solvent person.

(44) Insolvent: In accounting a person who doesn't pay his financial obligations regularly it means he is not in a position to pay these obligations and whose assets are less than liabilities. That person is known as insolvent person. Unless the person is declared insolvent, by the court, he cannot be treated as insolvent.

(45) Debit and credit: There are two important words of accounting. Every transaction has two effects in double entry system – **debit and credit**. True and fair understanding of debit and credit is true and fair understanding of accounting.

In accounting, two sides are used. The **left hand side in accounting is called as debit side**. The **right hand side is in accounting called credit side**. Any account to be debited means accounting treatment at debit side of account i.e. the treatment at left hand side. Any account to be credited means accounting treatment at credit side of accounts is the treatment at right hand side.

Discussion about rules of debit and credit is undertaken subsequently.

(46) Account: Business transactions pertaining to certain items and persons would take place frequently. These transactions may be of debit side having debit effect – may be of credit side having credit effect. Transaction pertaining to respective item or person is recorded at one place and from where the summary of transactions of that item or person can be obtained, it is called account. e.g. Pushpaben is a customer of business. Goods are sold on credit to her. Assume that credit sales are made 20 times in a year and she also settles her account 20 times. Now there will be $20 \times 2 = 40$ transactions with Pushpaben during the year. All these transactions are recorded at one place in the books of accounts. Where, all these transactions are recorded is called Pushpaben's account. Pushpaben is a person. Thus, it is a personal account. Like personal account, goods account, asset account, income account, expenses account etc. are also prepared. As per rules of accounting even if there is one transaction, respective account is to be prepared.

These terminologies make the subject of study easy. The terminologies clarify meanings of the concerned topics so that there is no space for any controversy.

Terminology has significant place and importance in every branch of education.

Let us know about the types of accounting systems after having studied the meaning, the characteristics and many other things of Accounting.

10. Methods of Preparing of Accounts

As stated earlier accounting is a social science. It is essential for this subject to incorporate social changes and new researches. There are two types of accounting in practice. They also keep on changing. (i) Deshi nama system (ii) Double entry system are included in these two types. The organization of the preparation of accounts under both the types is different but the rules and principles are identical. Both the types are permissible. In present time, double entry system is more popular than the deshinama; because the accounts are prepared through computer rather than manually written. Computer based accounts are prepared under double entry system.

Types and Bases of Accounting Systems/Methods

Types of Accounting Systems : Deshi nama system

Double entry system

Bases of Accounting Methods :

Mercantile base

Cash base

Mixed base

(i) Deshi nama system : It is an ancient method of writing accounts. Generally it was used by sole proprietor and partnership firms. Gradually, the use of this system is getting reduced. Under this system, how accounts are prepared? Which accounting books are maintained? Information in this context is discussed in the subsequent chapter.

(ii) Double entry system : According to historians, the mathematician of Italy Luca Pacioli is considered as the father of the double entry system.

The understanding of the double entry system is based on the rules of debit and credit. Basically there are three rules of debit and credit, which are discussed in detail subsequently. These rules are the pillars of the double entry system. A correct and full understanding of these rules is the correct and full understanding of double entry system. Under the double entry system what will be the debit effect and credit effect of each transaction is included in these rules.

To prepare accounts under double entry system, three different bases are used.

(1) Mercantile base (2) Cash base (3) Mixed base

(1) Accrual or Mercantile base : Under this method when accounts are prepared.

- All transactions of that respective year are considered.
- In transactions of that accounting year, transactions pertaining to receipts, payments, liability and assets are included.
- Incomes and expenses of respective accounting year are considered. Where outstanding income, expenses paid in advance, expenses outstanding, incomes received in advance etc. are included.
- The incomes and expenses of that particular financial year only are considered. It includes the receivable incomes of the current year and the payable expenses of the current year. Cash incomes and expenses related transactions of previous year or next year are not considered to determine profit / loss. The transactions of the previous year are recorded in the previous year and the transactions of the next year will be recorded in the next year.

e.g. Assume that accounts are prepared for the period 1-4-2014 to 31-03-2015 and salary of ₹ 5000 is paid every month. Further assume that salary of March is outstanding. It will be recorded as under :

Salary paid for 11 months (5000 × 11) =	₹ 55,000	
+ Salary outstanding of 1 month (March)	₹ 5000	
	₹ 60,000	will be considered as expense of year 2014-15

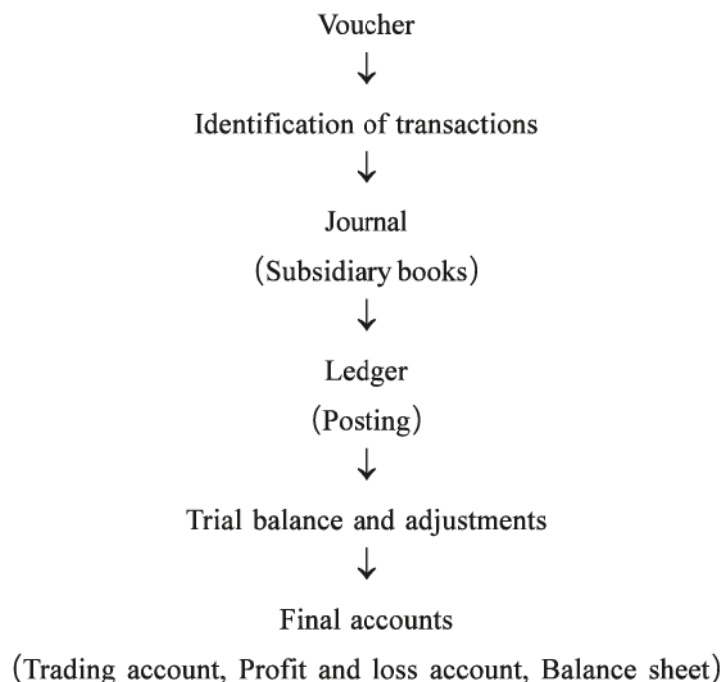
In practice, excluding certain sectors, in all the other sectors, the accounts are maintained under mercantile (accrual) system. This is a very popular method. All the chapters in this book are presented on the basis of this method.

(2) **Cash or receipt base** : Under this method, the accounts of whichever accounting year are being prepaid :

- Only all cash transactions of that respective accounting year are recorded.
 - Cash transactions of that respective accounting year include transactions pertaining to receipts, payments, liability and assets
 - The cash transactions of the previous year and the current year are also considered.
- The use of this method is very limited.

(3) **Hybrid Method - Mixed Method** : This method is identified as modified method of mercantile system. It is known as mixture of the mercantile system and the cash system. This method is not popular. In India, generally, the companies maintain their accounts under the mercantile system and as per accounting standard 1, the companies give certificate that the accounts are prepared as per the mercantile (accrual) base.

11. Steps to Prepare Accounts



Account is a science developed by the human being. Since accounting is a science, it has its rules. In accounting, the operation regarding the preparation of accounts is made. Operations are made on the basis of rules, where accounts are prepared as per the different, developed steps. These steps are followed in the chronological order.

(1) **First step : Voucher** : Voucher is the first step of a business transaction which is a valid written document of the transaction made.

(2) **Second step : Identification of Transaction** : Whether transaction of business is economic or non-economic, whether the transaction is cash or credit is determined at this stage.

(3) **Third step : Recording of Transaction** : Under this stage, economic transactions of business are recorded in journals or subsidiary books.

(4) **Fourth step : Posting in Ledger** : Transactions recorded in journals or subsidiary books are classified through posting in a ledger it is managed that the transactions of that account can be availed at one place.

(5) **Fifth step : Trial Balance** : In trial balance, all balances of accounts disclosed in fourth stage are disclosed. It is the prior stage of the preparation of final accounts.

(6) **Final step : Annual Accounts** : These are prepared on the basis of Trial Balance and adjustments where trading account, Profit and Loss account and Balance Sheet are included.

Apart from this, other aspects which are associated with accounts like bank balance, rectification of errors, depreciation, reserves and provisions etc. are to be studied simultaneously.

Exercise

1. Select appropriate option for each question :

- (1) Under barter system, which of the following is not correct?
 - (a) Exchange of money for product
 - (b) Exchange of product for product
 - (c) Exchange of product for service
 - (d) Exchange of product / service for product / service
- (2) What is the limitation of accounting?
 - (a) Shows profitability
 - (b) Shows economic status
 - (c) Tax planning
 - (d) stable value of money
- (3) Accounting is known as
 - (a) Historical accounting
 - (b) Future accounting
 - (c) Present accounting
 - (d) Unnecessary accounting

2. Answer in one sentence :

- (1) Who provides capital to the business?
- (2) What is bad debt for business?
- (3) What is stable value of money?
- (4) What is double entry system of accounting?
- (5) State whether discount received is an income or expense?

3. Answer in two or three sentences :

- (1) Explain economic transaction
- (2) Describe types of liabilities
- (3) Discuss types of assets
- (4) Explain accounting as an art and science

- (5) Accounting is a language of business. Explain.
- (6) Describe definition of accounting.

4. Answer in detail :

- (1) Explain Deshi Nama system and double entry system.
- (2) Explain process of accounting
- (3) Discuss characteristics of accounting
- (4) Describe advantages of accounting
- (5) What are the limitations of accounting ?
- (6) Who are the users of accounting information ?
- (7) Explain the qualitative characteristics of accounting
- (8) Explain the following terms :
 - (i) Capital and drawings
 - (ii) Capital receipts and revenue receipts
 - (iii) Payable and receivable
 - (iv) Debit and credit
 - (v) Account
 - (vi) voucher
- (9) Explain the methods of maintaining accounts on mercantile system and cash system (Basis).

