

Unit 1

INTRODUCTION TO ACCOUNTING



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Points to recall

The following points are to be recalled before learning introduction to Accounting:

- Barter system
- Money as a medium of exchange
- Activities involving transfer of money or money's worth



Learning Objectives

To enable the students to

- Understand the meaning and functions of accounting
- Analyse the importance of accounting
- Understand the basic accounting terminologies
- Analyse the role of an accountant

Key terms to know

- Accounting
- Accountant
- Cash basis
- Accrual basis



1.1 Introduction to Accounting

Business entities and other organisations carry on activities which involve exchange of money or money's worth or economic resources. Where the volume of these activities are large in number it is necessary that these are recorded for the purpose of taking important decisions as to whether the activities are viable, gainful and are to be continued or not. Information about the business and other organisations is required not only to the proprietors and managers of business and other organisations but also to various other interested users such as the government, investors, customers, employees and researchers.

Raising and utilising of finance for various purposes must be recorded systematically, scientifically and uniformly. It is very important because finance is the most important resource next to the human element for any economic activity. Hence, there is a need for principles, methods and procedures to be followed to record all these information and to derive from these information, the feasibility and benefit of the activities carried out. Accountancy provides the basic theory, principles and methods to be followed to account for all financial activities taking place in an organisation. Accounting the financial activities in a systematic way helps in ascertaining the efficiency of performance of these activities and provides data about the state of affairs of the organisation for further analysis and planning.

Accounting is the language of business. The most important function of a language is to facilitate communication. The information about business entities regarding their operating performance and financial status can be obtained from the financial information recorded in the accounting records. This information is communicated to the interested users of business information such as proprietors, management, investors, customers and the government.

1.2 Evolution of Accounting

In India, 23 centuries ago, Chandragupta Maurya's Minister Kautilya wrote a book named 'Arthashastra', wherein some references can be traced regarding the way of maintaining accounting records.

In the earliest days of civilisation, accounting was done by stewards who managed the properties of wealthy people. They rendered accounts periodically to the owners of property. The stewardship accounting is said to be the root of accounting. Records of debit and credit were found in the 12th century itself.

In 1494, Luca Pacioli an Italian developed double-entry book-keeping system. Due to the industrial revolution in the 18th and 19th centuries, large scale operations were carried on and joint stock companies emerged as an important form of organisation which required separation of ownership from management. Hence, to safeguard the interest of owners and investors, the business establishments required detailed information about business which paved the way for development of comprehensive financial accounting information system.

In the 20th century, the need for analysis of financial information for managerial decision making caused emergence of Management Accounting as a separate branch of accounting.

Though accounting was individual centric in the initial stage of evolution of accounting, it has gradually developed into Social Responsibility Accounting in the 21st century, due to the vast growth in business activities as a result of development in various fields. Thus, accounting has become inevitable in the modern world for business.



1.3 Meaning and Definition of Accounting



Student activity

Think: Before the evolution of money, commodities were exchanged for commodities. In such situations, how would people have maintained their accounts?

Accounting is the systematic process of identifying, measuring, recording, classifying, summarising, interpreting and communicating financial information. Accounting gives information on:

- (i) the resources available
- (ii) how the available resources have been employed and
- (iii) the results achieved by their use.

The profit earned or loss incurred during the accounting period, value and nature of assets, liabilities and capital can be ascertained from the information recorded in accounts.

According to the **American Institute of Certified Public Accountants** “Accounting is the art of recording, classifying and summarising 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”.

American Accounting Association has defined accounting as “the process of identifying, measuring, and communicating economic information to permit informed judgements and decisions by users of the information”.

From the above definitions, the following attributes of accounting emerge:

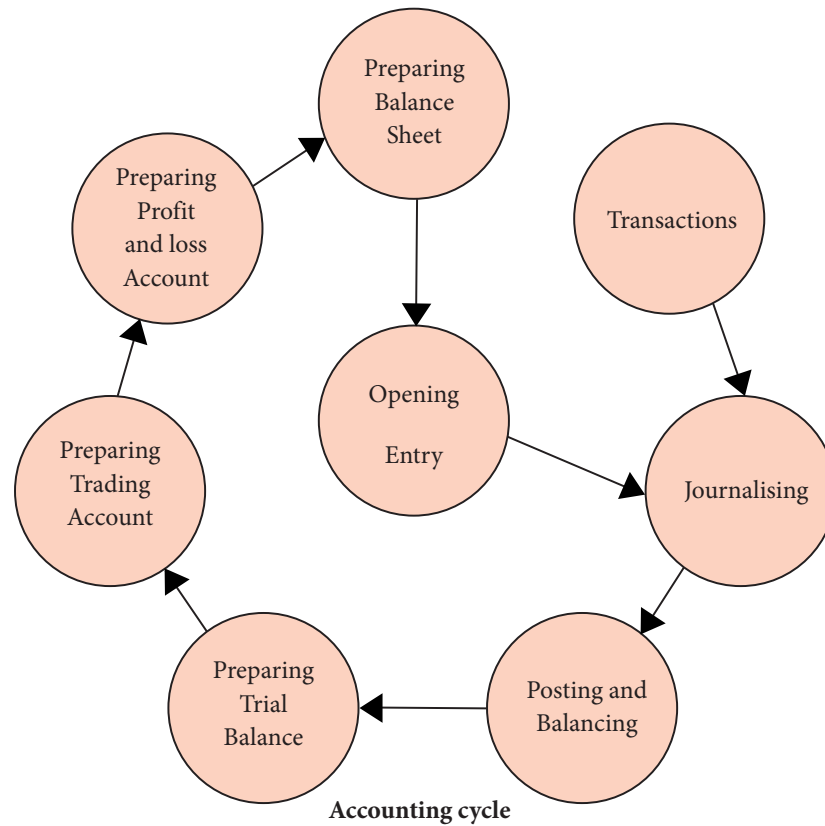
- (i) Accounting is an art. It requires the expertise and skill of accountants to design accounting system and policies, to decide the accounting process in order to suit the requirements of an organisation.
- (ii) The transactions or events of a business must be recorded in monetary terms.
- (iii) Accounting process involves recording, classifying and summarising of transactions and analysis and interpretation of the results.
- (iv) The results of such analysis must be communicated to the persons who are interested in such information.

1.4 Accounting cycle

Accounting cycle is the sequence of steps involved in the accounting process. Accounting cycle starts with the identification and recording of financial transactions of an organisation and ends with the preparation of final accounts for the accounting year. The cycle continues for the next accounting year with the opening balances of assets and liabilities which are the closing balances of the preceding year. The steps involved are:

(i) Identifying the transactions and journalising

The first step in the accounting process is identifying the financial transactions of a business. All the monetary transactions are recorded in the books of original entry called journals. Recording the transactions in the journal is called journalising. Entries are made in the journals on the basis of source documents in the chronological order, i.e., the order of occurrence of the transactions.



(ii) Posting and balancing

Transferring the entries from the journal to the ledger is called posting. In the ledger, entries are made in each account after classifying them under common heads. Finding the difference between the total of the debit column and credit column of all the ledger accounts is called balancing.

(iii) Preparation of trial balance

The list of ledger balances namely trial balance is prepared as the next step. On the basis of ledger balances the financial statements are prepared.

(iv) Preparation of trading account

Next step is preparation of trading account for a particular accounting period. All the direct revenues and direct expenses are transferred to trading account. The balance in the trading account is the gross profit or gross loss.

(v) Preparation of profit and loss account

Profit and loss account is prepared next for a particular accounting period. All the indirect revenues and indirect expenses along with gross profit or gross loss are transferred to profit and loss account. The balance in the profit and loss account is the net profit or net loss.

(vi) Preparation of balance sheet

A statement showing the balances of assets and liabilities namely balance sheet is prepared as the final step in the accounting process. It is prepared on a particular date, normally, on the last day of the accounting period.

The closing balances of an accounting year are taken as the opening balances for the next accounting year. The transactions identified and recorded for the next year are followed by posting and other steps.

The results are communicated to the users of accounting information for the purpose of analysis and decision making.



1.5 Objectives of Accounting

Following are the objectives of accounting:

- (i) To keep a systematic record of financial transactions and events
- (ii) To ascertain the profit or loss of the business enterprise
- (iii) To ascertain the financial position or status of the enterprise
- (iv) To provide information to various stakeholders for their requirements
- (v) To protect the properties of an enterprise and
- (vi) To ascertain the solvency and liquidity position of an enterprise

1.6 Functions of Accounting

The main functions of accounting are as follows:

(i) Measurement

The main function of accounting is to keep systematic record of transactions, post them to the ledger and ultimately prepare the final accounts. Accounting works as a tool for measuring the performance of the business enterprises. It also shows the financial position of the business enterprises.

(ii) Forecasting

With the help of the various tools of accounting, future performance and financial position of the business enterprises can be forecasted.

(iii) Comparison

Accounting helps to compare the actual performance with the planned performance. It is also possible to compare with the accounting policies. Through comparison of the actual financial results of the business enterprises with projected figures and standards, effective measures can be taken to enhance the efficiency of various operations.

(iv) Decision making

Accounting provides relevant information to the management for planning, evaluation of performance and control. This will help them to take various decisions concerning cost, price, sales, level of activity, etc.



Decision refers to choosing a desirable course of action from alternative courses of action.

(v) Control

As accounting works as a tool of control, the strengths and weaknesses are identified to provide feedback on various measures adopted. It serves as a tool for evaluating compliance of business policies and programmes.



Control refers to comparison of actual performances with planned performances, measure deviation and take corrective action.

(vi) Assistance to government

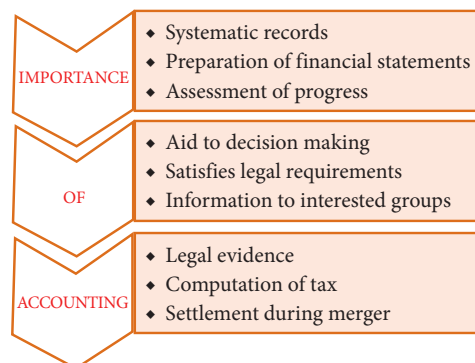
Government needs full information on the financial aspects of the business for various purposes such as taxation, grant of subsidy, etc. Accounting provides relevant information about the business to exercise government control on business enterprises.

1.7 Importance of Accounting

Accounting is a basic necessity for all enterprises. Importance of accounting is enumerated as below:

(i) Systematic records

All the transactions of an enterprise which are financial in nature are recorded in a systematic way in the books of accounts. The records are classified under common heads and summaries are prepared.



(ii) Preparation of financial statements

Results of business operations and the financial position of the concern can be ascertained from accounting periodically through the preparation of financial statements namely, income statement or trading and profit and loss account and balance sheet. This helps in distribution of profits to the owners and to provide funds for future growth of the business.

(iii) Assessment of progress

Analysis and interpretation of financial data can be done to assess the progress made in different areas and to identify the areas of weaknesses. Management is provided with a complete picture of the liquidity, profitability and solvency of the business.

(iv) Aid to decision making

Management of a firm has to make routine and strategic decisions while discharging its functions. Accounting provides the relevant data to make appropriate decisions. Future policies and programmes can be planned by the management based on the accounting data provided.

(v) Satisfies legal requirements

Various legal requirements like maintenance of Provident Fund (PF) for employees, Employees State Insurance (ESI) contributions, Tax Deducted at Source (TDS), filing of tax returns are properly fulfilled with the help of accounting. Preparation of accounts and financial statements as per the legal requirements is also facilitated.

(vi) Information to interested groups

Accounting supplies appropriate information to different interested groups like owners, management, creditors, employees, financial institutions, tax authorities and the government.

(vii) Legal evidence

Accounting records are generally accepted as evidence in courts of law and other legal authorities in the settlement of disputes.

(viii) Computation of tax

Accounting records are the basic source for computation and settlement of income tax and other taxes.

(ix) Settlement during merger

When two or more business units decide to merge, accounting records provide information for deciding the terms of merger and any compensation payable as a consequence of merger.



Two or more business units forming a single entity is known as merger.

1.8 Basic Accounting terminologies

Accounting is a versatile system which serves a large number of purposes in the modern business world. Hence, the following terminologies need to be understood.

Transaction	An activity which involves transfer of money or money's worth (goods, services, ideas) from one person to another.
Cash transaction	It is a transaction which involves immediate cash receipt or immediate cash payment.
Credit transaction	It is a transaction in which cash is not received or paid immediately, but will be received or paid later.
Account	It is the basic unit for measurement in accounting. It is used for identifying a person, or an item in accounting. An account is opened individually for a person, asset, expense, income, etc. In ledger, an account is a summary of transactions under a head.
Capital	It is the amount invested by the owner or proprietor in an organisation.
Drawings	It is the amount of cash or value of goods, assets, etc., withdrawn from the business by the owner for the personal use of the owner.
Voucher	Any written or printed document in support of a business transaction is called a voucher. Examples: cash receipt, invoice, cash memo, bank pay-in-slip, etc.
Invoice	It is a statement prepared by a seller of goods to be sent to the buyer. It shows details of quantity, price, value, etc. of the goods and any discount given, finally showing the net amount payable by the buyer.
Goods	It includes articles, things or commodities in which a business is dealing with. Example: Furniture will be goods for those who deal in furniture.
Purchases	Buying of goods with the intention of resale is called purchases.
Purchases returns or returns outward	When goods bought are returned to the suppliers, it is known as purchases returns or returns outward.
Sales	When goods meant for resale are sold, it is called sales.
Sales returns or returns inward	When goods sold are returned by the customers, it is called as sales returns or returns inward.
Stock	Unsold goods lying in a business on a particular date are known as stock.
Income	It is the amount receivable or realised from sale of goods and earnings from interest, dividend, commission, etc.
Expense	It is the amount incurred in order to produce and sell the goods and services.
Solvency	Solvency is the capability of a person or an enterprise to pay the debts.
Insolvency	Insolvency is the incapability of a person or an enterprise to pay the debts.
Asset	Any physical thing or right owned that has a monetary value is called asset.
Liability	It refers to the financial obligation of the business.
Debtor	A person who receives a benefit without giving money or money's worth immediately, but liable to pay in future or in due course of time.
Creditor	A person who gives a benefit without receiving money or money's worth immediately but to claim in future.

Depreciation	It refers to the gradual reduction in the value of fixed assets due to usage and passage of time.
Bad debt	It is a loss to the business arising out of failure of a debtor to pay the dues. It is irrecoverable debt.

1.9 Branches of Accounting

Depending on the informational needs of various users of accounting information, several branches or subfields of accounting have been developed.

The various branches of accounting are:

(i) Financial Accounting

It involves recording of financial transactions and events. It is historical in nature and records are maintained for transactions and events which have already occurred. It provides financial information to the users for taking decisions. It is concerned with identification, recording, classifying and summarising of financial transactions and events and ends up with the preparation of financial statements, namely, trading and profit and loss account or income statement and balance sheet and communication of the same to the interested users. Trading and profit and loss account shows the profit or loss made during an accounting period and the balance sheet shows the financial position of the business as on a particular date.



(ii) Cost Accounting

It involves the collection, recording, classification and appropriate allocation of expenditure for the determination of the costs of products or services and for the presentation of data for the purposes of cost control and managerial decision making.

(iii) Management Accounting

It is concerned with the presentation of accounting information in such a way as to assist management in decision making and in the day-to-day operations of an enterprise. The information collected from financial accounting, cost accounting, etc. are grouped, modified and presented as per the requirements of management for discharging their functions and for decision making.

(iv) Social Responsibility Accounting

It is concerned with presentation of accounting information by business entities and other organisations from the view point of the society by showing the social costs incurred such as environmental pollution by the enterprise and social benefits such as infrastructure development and employment opportunities created by them. It arises because of corporate social responsibility.

(v) Human Resources Accounting

It is concerned with identification, quantification and reporting of investments made in human resources of an enterprise.



Student activity

Think: Do you think financial accounting, cost accounting and management accounting can be maintained by the same person?

1.10 Bases of Accounting

There are three bases of accounting in common usage, namely

- (i) Cash basis
- (ii) Accrual or mercantile basis
- (iii) Mixed or hybrid basis.

(i) Cash basis

Under cash basis of accounting, actual cash receipts and actual cash payments are recorded. In this basis, revenue is recognised when cash is received and expenses are recognised when cash is paid. Credit transactions are not recorded till cash is actually received or paid. Under this basis,

- (a) Any income received
- (b) Any expenditure paid
- (c) Any asset purchased for which cash is paid
- (d) Any liability paid during the accounting period whether related to the past, present or future is taken into account.

(ii) Accrual or mercantile basis

Under accrual basis of accounting, the revenue whether received or not, but has been earned or accrued during the accounting period and expenses incurred whether paid or not are recorded. In other words, revenue is recognised when it is earned or accrued and expenses are recognised when these are incurred. Under this basis,

- (a) Any income earned whether received or not
- (b) Any expenditure incurred whether paid or not
- (c) Any asset purchased whether cash is paid or not
- (d) Any liability incurred whether paid or not during the accounting period is recorded.

Under section 128(1) of the Indian Companies Act, 2013, all the companies are required to maintain the books of accounts according to the accrual basis of accounting.

(iii) Hybrid or mixed basis

This basis is a combination of cash basis and accrual basis of accounting. Under mixed basis of accounting, both cash basis and accrual basis are followed. Revenues and assets are generally recorded on cash basis whereas expenses and liabilities are generally taken on accrual basis.

1.11 Users of Accounting information



Student activity

Think: 'Accounting is useful only to the owner of the business' – Do you agree?

There are several persons who need the accounting information for various purposes. They can be classified into two:

- (A) Internal users and
- (B) External users

A) Internal Users

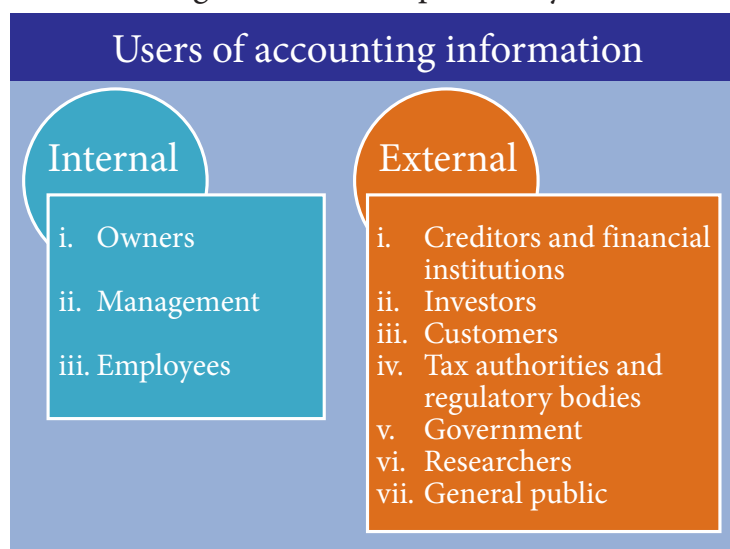
The internal users are owners, management and employees who are within the organisation.

(i) Owners

The owners of a business provide capital to be used in the business. They are interested to know whether the business has earned profit or not during a particular period and also its financial position on a particular date. They want accounting reports in order to have an appraisal of performance and also for an assessment of future prospects to ensure that they will get their expected returns from the business and get back their capital safely.

(ii) Management

Accounting data are the basis for most of the decisions made by the management. The trends in sales and purchases, relationship of expenses to the sales, efficiency of employees, comparative profitability of different departments, capital structure and solvency position are some of the vital data required by management for planning and controlling the business operations. Financial statements and other reports prepared under financial accounting provide this information to the management.



Capital structure refers to the mix of a firm's permanent long-term financing represented by debt, preference share capital and equity shareholders' funds.

(iii) Employees

The employees are interested in the profit earning capacity of the business which will affect their remuneration, working conditions and retirement benefits and stability and growth of the enterprise.

B) External users

External users are the persons who are outside the organisation but make use of accounting information for their purposes. They are:

(i) Creditors and financial institutions

Suppliers of goods and services, commercial banks, public deposit holders and debentureholders are included in this category. They are interested in knowing the liquidity position and repaying capacity of the business to ensure the safety of getting the amount due to them or interest and the principal amount.

(ii) Investors

Persons who are interested in investing their funds in an organisation should know about the financial condition of a business unit while making their investment decisions. They are more concerned about future earnings and risk bearing capacity of the organisation which will affect the return to the investors.

(iii) Customers

Customers who buy and use the products and services of business enterprises are interested in knowing the details of the products and the prices charged to them. They are interested in knowing the stability and profitability of an enterprise to ensure continued supply of the products or services by the enterprise.

(iv) Tax authorities and other regulatory bodies

Accounting information helps the tax authorities in computing income tax and taxes on goods and services and other taxes to be collected from business units. Other regulatory bodies also require information about revenues, expenses and other financial aspects of business to ensure that the enterprises comply with statutory requirements.

(v) Government

The scarce resources of the country are used by business enterprises. Information about performance of business units in different industries helps the government in policy formulation for development of trade and industry, allocation of scarce resources, grant of subsidy, etc. Government also administers prices of certain commodities. In such cases, government agencies have to ensure that the guidelines for pricing are followed.

(vi) Researchers

Researchers to carry out their research can use accounting information and make use of the published financial statements for analysis and evaluation.

(vii) General public

From accounting information, the general public at large can get a view of the earning capacity and stability of the enterprise as well as the social responsibility measures undertaken by the enterprise particularly in its area of operation and also the employment opportunities provided to the local people.

1.12 Role of an accountant

An accountant designs the accounting procedures for an enterprise. He plays several roles in an organisation as follows:

(i) Record keeper

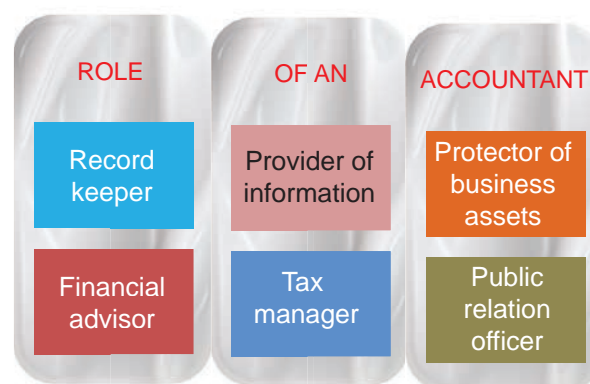
The accountant maintains a systematic record of financial transactions. He also prepares the financial statements and other financial reports.

(ii) Provider of information to the management

The accountant assists the management by providing financial information required for decision making and for exercising control.

(iii) Protector of business assets

The accountant maintains records of assets owned by the business which enables the management to protect and exercise control over these assets. He advises the management about insurance of various assets and the maintenance of the same.





(iv) Financial advisor

The accountant analyses financial information and advises the business managers regarding investment opportunities, strategies for cost savings, capital budgeting, provision for future growth and development, expansion of enterprise, etc.

(v) Tax manager

The accountant ensures that tax returns are prepared and filed correctly on time and payment of tax is made on time. The accountant can advise the managers regarding tax management, reducing tax burden, availing tax exemptions, etc.

(vi) Public relation officer

The accountant provides accounting information to various interested users for analysis as per their requirements.

Points to remember

- Accounting is termed as the language of the business.
- There are various branches of accounting such as financial accounting, cost accounting, management accounting, social responsibility accounting and human resource accounting.
- There are three bases of accounting namely cash basis, accrual or mercantile basis and mixed or hybrid basis.
- There are several persons who need the accounting information - internal users and external users.
- Accountants have several roles and responsibilities.

Self-examination questions

I Multiple choice questions

Choose the correct answer

1. The root of financial accounting system is
 - (a) Social accounting
 - (b) Stewardship accounting
 - (c) Management accounting
 - (d) Responsibility accounting
2. Which one of the following is not a main objective of accounting?
 - (a) Systematic recording of transactions
 - (b) Ascertainment of the profitability of the business
 - (c) Ascertainment of the financial position of the business
 - (d) Solving tax disputes with tax authorities
3. Which one of the following is not a branch of accounting?
 - (a) Financial accounting
 - (b) Management accounting
 - (c) Human resources accounting
 - (d) None of the above.
4. Financial position of a business is ascertained on the basis of
 - (a) Journal
 - (b) Trial balance
 - (c) Balance Sheet
 - (d) Ledger



5. Who is considered to be the internal user of the financial information?
 (a) Creditor (b) Employee (c) Customer (d) Government

Answers

1 (b)	2 (d)	3 (d)	4 (c)	5 (b)
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II Very short answer questions

1. Define accounting.
2. List any two functions of accounting.
3. What are the steps involved in the process of accounting?
4. Who are the parties interested in accounting information?
5. Name any two bases of recording accounting information.

III Short answer questions

1. Explain the meaning of accounting.
2. Discuss briefly the branches of accounting.
3. Discuss in detail the importance of accounting.
4. Why are the following parties interested in accounting information?
 (a) Investors (b) Government
5. Discuss the role of an accountant in the modern business world.

CASE STUDY

A Self-Help Group (SHG) is an informal, self-managed voluntary group of 5-20 individuals, who come together to address their common problems and are generally engaged in credit and savings activities operating on principles of mutuality and solidarity. Most SHG members are minimally educated. Regardless, every SHG should be aware of the status of its outstanding loans to members, the status of its loans from external institutions and the member payments due. Book-keeping is a difficult task for SHGs.

Now, discuss on the following points:

How do SHGs maintain their accounting?

Do you think that financial accounting system is suitable for all businesses?

To explore further

Can each business unit follow its own way for maintaining accounting records?

Will it serve the requirements of different users of accounting information?

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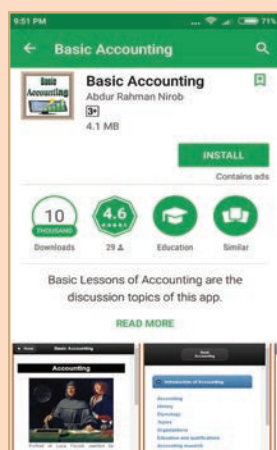
INTRODUCTION TO ACCOUNTANCY

Lets get introduced to
Basic Accounting

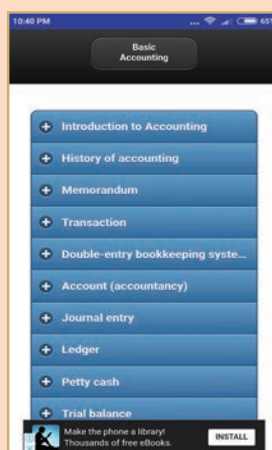


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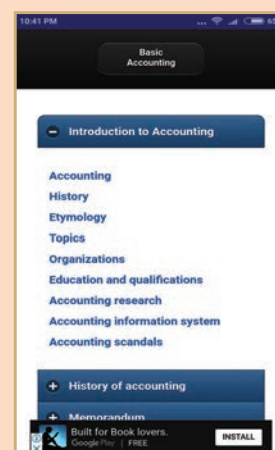
- This is an Android app activity. Open the Browser and type the URL given (or) Scan the QR Code. (Or) search for “Basic Accounting” in google play store. Install and open the app. This is Hands on Lesson.
- Select any one of the topic you want to learn. Open “Introduction to Accounting.
- In the Next page you have sub menus. Select one by one and go through the lesson.



Step1



Step2



Step3

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