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224en01

INTRODUCTION TO ACCOUNTING

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You must have seen a shopkeeper selling goods to earn profit. He/she sells goods for cash and on credit, purchases the goods from suppliers, pays for electricity bills, telephone bills, wages to workers etc. These are all business transactions involving money. A large number of such transactions take place daily. A businessman cannot remember all these transactions, he therefore, keeps a record of all these transactions in writing, so that he can make use of this recorded information later on. The trader would like to know at the end of a period (which is generally one year), what he has earned during this period from his business. He would also like to know the amount he has to pay to his suppliers and the amount his customers have to pay to him. He can get various other information of this kind only if he maintains proper record of business transactions, which have taken place during the year. This is called Book Keeping. This information needs, to be recorded, classified and summarized in a systematic manner. It is called 'Accounting'. In this lesson you will learn the meaning, objectives and uses of Book-keeping and Accounting.



OBJECTIVES

After studying this lesson, you will be able to:

- explain the meaning of business transactions;
- explain the meaning of book-keeping;
- identify the need of book-keeping;
- describe the objectives of book-keeping;
- define the term 'accounting';
- explain the branches of accounting;
- discuss the objectives of accounting;
- describe the advantages and limitations of accounting;
- distinguish between book-keeping and accounting and
- identify the users of accounting information and understand the various uses of accounting information.

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1.1 BUSINESS TRANSACTIONS

In your own house, you see many transactions taking place, for example, purchase of vegetables, paying for school fee, telephone, rent, etc. Just as many transactions take place in a house, many more transactions take place in a business.

Let us observe the activities of a nearby stationery shop. A customer comes, he buys register and pays money for it. Then, another customer comes, he buys a text-book and pays for it. After sometime, a third customer comes to the shop, he purchases different stationery items like writing pads, pencils, pens, etc., he buys these items on credit. Then, a supplier comes, he supplies various stationery items to the shopkeeper and submits a bill. The shopkeeper keeps the bill and promises to pay after one month. These are some of the important business transactions. There can be many more such activities. You have noticed that these business transactions involve exchange of goods for money or promise for payment in future. These transactions have some important features which are as follows:

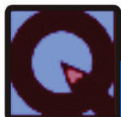
- i. Business transactions are business activities.
- ii. These involve exchange of goods or services like transportation, storage, packaging, etc for money or money's worth.
- iii. These are monetary in nature.
- iv. In cash business transactions, goods or services are exchanged for money.
- v. In credit business transactions, goods or services are exchanged but money is received or paid at a future date.
- vi. All business transactions are recorded in the books of accounts.

You might have noticed that all the above business transactions are with the OUTSIDERS. Sometimes, business transactions pertain to the OWNER. For example, Abhishek starts a small shop with cash ₹1,00,000/-. In exchange, the owner (Abhishek) gets an ownership right against business. Take another example, Abhishek withdraws goods costing ₹5,000/- from the shop for his own use. It is a business transaction. Here, the owner gets goods worth ₹5,000/- while, the business gets a right to receive money from the owner. Thus you may say that business transactions pertain to the outsiders or to the owner. Now, business transaction may be defined as:- “An exchange of goods, services, or any other activity for money or money's equivalent. It involves exchange of money also.” In simple words, it includes all events and activities of business which are financial in nature.

You know that a businessman enters into several transactions in a day. Some of these may be meant for his personal purposes. For example, Abhishek goes to a movie with his friends. This is his personal transaction and not the business transaction. Since a business transaction has an effect on business, therefore, it is recorded in the

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books of the business. Owner's personal transactions where the money of the business is not affected, are not recorded anywhere in the books of the business. This separation of business transactions and personal transactions is very helpful in recording business transactions.



INTEXT QUESTIONS 1.1

- I. Find which of the statements are true and which are false:**
- Shifting of goods from one place to another within a shop is business transaction.
 - Profit is the reward to the owner for his business activities.
 - Purchase of vegetables for use at home is not business transaction.
 - Purchase of goods on credit for personal use from his friend is personal transaction.
- II. Classify the following into business and non-business transactions:**
- Rahim starts business with Cash – ₹1,00,000/-
 - He deposits money into the Bank – ₹50,000/-
 - He buys goods for Cash – ₹10,000/-
 - He takes out money from the shop and gives it to his wife for buying a saree – ₹1,000/-
 - He attends a family function and gets present worth – ₹3,000/-
 - He pays salary to his domestic servant – ₹500/- out of his pocket.

1.2 BOOK-KEEPING

Some people take book-keeping and accounting as synonymous terms, but they are different from each other. Book-keeping is mainly concerned with recording of financial data relating to the business operations in a significant and orderly manner. Book-keeping involves the systematic recording of the financial transactions and the maintenance of the correct & up-to-date financial records of the organization. Accounting is primarily concerned with designing the systems for recording, classifying and summarizing the data and interpreting them for internal and external end users. Accountants often direct and review the work of the book-keepers.

Need of Book-keeping

It is significant for a business to have transparent record keeping systems which would make the transaction clear. The need of book-keeping can be understood with the help of the following points:

- i) Helps in Assessing the Financial Position:** Recording the business

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transactions would be helpful to businessman for monitoring the financial success or failure of his business. You probably don't know where you are going if you do not realize where you have been. Hence, understanding the existing scenario of financial status of business is of much importance to the business to achieve the objectives and avoid the unexpected losses.

- ii) **Helps in making business decisions :** Keeping a record would help to make future business decision. Business decisions have to be taken by considering the financial consequences that happened earlier and the same can be done only if we maintain the accounting books properly. Without the precise data and financial information, it is extremely difficult to predict the impact of any given action.
- iii) **For Record for Income tax Purposes :** Maintaining books of accounts would help businessmen to file the income tax returns accurately. Every business entity has to file income tax returns and pay income tax. With proper records, it is very easy to prepare the tax returns and filing can also be done on time without any delay.
- iv) **Preparing Budgets :** Keeping the older transactions would help you to plan the budget for forthcoming year. Preparing budget would keep you on the safer side and help you to avoid the unwanted expenditure.
- v) **Tax Assessment :** Keeping good records would help you to prepare payroll, tax returns and sales tax without any delay. If you are doing a partnership business, you can avoid unwanted issues in profit distribution by recording your business transactions accurately.

Moreover, effective book-keeping would help you to identify the activities, which are not profitable, and the unwanted operating expenses. Businessman can avoid such expenditures and prepare an effective budget to optimize business financially. Hence, book-keeping plays an essential role in every business.

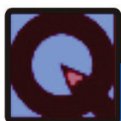
Objectives of Book-keeping

After understanding the need of book-keeping let us now discuss the objectives of book-keeping which are as follows:

- i) **To show permanent record of business :** Book keeping is to record business transactions in proper books of accounts which can be kept safe for years together.
- ii) **To know profit or loss of business :** Various statements are prepared from the information contained in books of accounts called final accounts. One of such statements is called Income Statement or Profit and Loss Account which helps in ascertaining business profit.
- iii) **To know the financial position of business :** Book keeping helps in preparing balance sheet and ascertaining the net capital employed.



- iv) **To provide information of total sales and purchases of business :** Businessman is interested in knowing the total sales and total purchases of business which help him in taking decisions regarding sales strategies.
- v) **To provide information about creditors and debtors of business :** Businessman would like to know how much and to whom he owes and how much and who owe to him. Book-keeping records will help in it.
- vi) **To know the quantity and value of stock :** Quantity and value of stock is required to manage stock levels. This can be ascertained by maintaining proper books of accounts.



INTEXT QUESTIONS 1.2

Which of the following statements are True and which are False?

- i. Book-keeping is concerned with recording of business transactions in a systematic and significant manner.
- ii. Book-keeping and accounting are synonymous terms.
- iii. Book-keeping is a broader term than accounting.
- iv. Book-keeping helps in preparing budget of the business.

1.3 ACCOUNTING

Accounting has rightly been termed as the language of the business. The basic function of a language is to serve as a means of communication. Accounting communicates the result of business operations to various parties who have some stake in the business. With the help of accounting records the business is able to ascertain the profit or loss and the financial position of the business at the end of a given period and communicate such information to all interested parties. The function of accounting is to provide quantitative information, primarily of financial nature, about economic entities, that is needed to be useful in making economic decisions.

The meaning of accounting was given by the American Institute of Certified Public Accountants (AICPA) in 1961 when it defined accounting as :

“Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events, which are, in part at least, of financial character and interpreting the results thereof”:

American Accounting Association (AAA) has defined Accounting as:

“Accounting is the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information”.



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Branches of Accounting : There are three branches of accounting :

- i) **Financial Accounting :** Financial Accounting is concerned with recording financial transactions, summarising and interpreting them and communicating the results to users. It shows the profit or loss of a particular period & the position of the business on a particular date.
- ii) **Cost Accounting :** It helps in finding out the cost of production of a product manufactured or services rendered and helps the management in decision making.
- iii) **Management Accounting :** Management Accounting is concerned with generating accounting information relating to funds, costs, profits etc. as it enables the management in decision making.

You will study only Financial Accounting in this course.

Objectives of Accounting

The following are the main objectives of accounting:

- i) **To keep systematic records :** Accounting is done to keep a systematic record of financial transactions, like purchase of goods, sale of goods, cash receipts and cash payments.
- ii) **To ascertain the operational profit or loss :** Accounting helps in determining the net profit earned or loss suffered on account of running the business. This is done by keeping a proper record of revenues and expenses of a particular period.
- iii) **To ascertain the financial position of the business :** The businessman is not only interested in knowing the operating result, but also interested in knowing the financial position of his business i.e., where it stands. In other words, he wants to know what the business owes to others and what others owe to business.
- iv) **To facilitate rational decision making :** Apart from the owners, there are various other parties who are interested in knowing about the position of business, such as tax authorities, the management, the bank, the creditors, etc. The required information is furnished to all these parties through accounting system.

Advantages of Accounting

- i) **Replaces memory :** Since all the financial events are recorded in the books. The books of accounts will serve as historical records. Any information required at any time can be easily collected from these records.
- ii) **Meets the information requirements :** Various interested parties such as owners, lenders, creditors, etc., get the necessary information at frequent intervals which help them in their decision making.



- iii) **Assists the management in many other ways :** The accounting information provided to the management helps them in taking rational decisions in planning and controlling all business activities.
- iv) **Facilitates a comparative study :** With the help of accounting information one can compare the present performance of the enterprise with its past performance and also with that of similar organisations. This enables the management to draw useful conclusion about the business and make efforts to improve the performance.
- v) **Acts as reliable evidence :** Systematic record of business transactions is generally treated by courts as good evidence in case of disputes.
- vi) **Tax matters:** The Government levies various taxes such as custom duty, excise duty, sales tax, and income tax. Properly maintained accounting records will help in the settlement of all tax matters with the tax authorities.
- vii) **Ascertaining value of business:** In the event of sale of a business firm, the accounting records will help in ascertaining the correct value of business.

Limitations of Accounting

- i) **Financial accounting permits alternative treatment :** Accounting is based on concepts and it follows “Generally Accepted Principles” but there exist more than one principle for the treatment of any one item. This permits alternative treatments within the framework of Generally Accepted Principles. For example, the closing stock of a business may be valued by any one of the following methods: FIFO (First-in-First-out), LIFO (Last-in-First-out), Average Price, Standard Price etc., but the results are not comparable.
- ii) **Financial accounting is influenced by personal judgments :** Accounting is influenced by personal judgments as one accountant may consider the life of a particular asset say 5 years whereas another accountant may consider the life of that asset say 6 years and the method of charging the depreciation on asset by both the accountants may also be different.
- iii) **Financial accounting ignores non-monetary information :** Financial accounting does not consider the transactions of non-monetary nature. For example, extent of competition faced by the business, technical innovations possessed by the business, loyalty and efficiency of the employees etc. are the important matters in which management of the business is highly interested but accounting is not tailored to take note of such matters.
- iv) **Financial accounting does not provide timely information :** Financial accounting is designed to supply information in the form of statements (Balance Sheet and Profit and Loss Account) for a period normally one

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year. The business requires timely information at frequent intervals to enable the management to plan and take correct action wherever the performance is not as per plans.

1.4 DIFFERENCES BETWEEN BOOK KEEPING AND ACCOUNTING

Book keeping and Accounting have the following points of differences :

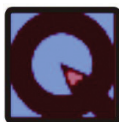
Basis of distinction	Book-Keeping	Accounting
i) Objective	The objective of Book-keeping is to maintain records of business transactions.	Accounting aims at maintaining business records, calculation of business income, and depiction of financial Position and communication of business results
ii) Function	The function of Book- is to record business transactions.	The function of Accounting is recording, classifying, summarizing interpreting the business transactions and communicating the results.
iii) Scope	Book-keeping has a limited scope.	It has wider scope.
iv) Level of knowledge required.	For, it elementary knowledge of accounting rules is enough.	In accounting, advance and in depth understanding is required.
v) Basis of recording	For recording business transactions, vouchers and other supporting documents are prepared.	Book-keeping serves the basis for accounting information.
vi) Stage	It is primary stage.	It is the final stage.
vii) Level of Person Engaged.	Lower level mainly account clerks.	Higher level mainly qualified accountants.

1.5 USERS OF ACCOUNTING INFORMATION

Accounting is of primary importance to the proprietors and the managers. There are many more parties who use the accounting information. These parties are as follows:

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- i) **Investors and Potential Investors :** A person who wants to invest in business will like to know about its profitability and financial position. Basically, investors are interested in the amount of dividends they are likely to get from the business. Hence, they would like to know the profitability of the enterprise which they can get from the income statements of the enterprise for a number of years.
- ii) **Creditors :** Creditors are the persons who have extended credit to the business. They would like to know whether the enterprise will be in a position to meet its commitments well in time towards them both regarding payment of interest and principal. Their main interest lies in liquidity and profitability of business enterprise.
- iii) **Proprietors :** The proprietor is the owner of business who starts the business with an objective to make profit. He is interested in knowing the position of his business as if he is earning profits or incurring loss. The profitability and financial soundness are, therefore, matters of prime importance to the proprietors who have invested their money in the business.
- iv) **Employees :** The employees are interested in the financial statements on account of various profit sharing and bonus schemes. Their interest may further increase in case they purchase shares of the companies in which they are employed. They are interested in more wages or salary, bonus, overtime payments, medical facilities and their demands for these matters are based on profitability as provided by income statement.
- v) **Customers :** They are interested in knowing whether a company will continue to honour product warranties and continue to provide its products in future, and how much profit is made by a company by providing goods and services to them.
- vi) **Government :** The Government is interested in the financial statements of business enterprise on account of taxation, labour and corporate law. The reason is that the Government activities and welfare schemes are financed through collection of different types of taxes. So they would like to know, whether the business is paying appropriate taxes well in time or not.
- vii) **Researchers :** They need accounting information for the purpose of studying the financial aspects of business enterprises and their effect on the economy as a whole, so that the new policies & planning can be made.



INTEXT QUESTIONS 1.3

- I. **Fill in the blanks:**
 - i. Accounting is the language of the _____.
 - ii. Accounting records only transactions which are of a _____ character.
 - iii. Accounting starts where _____ ends.

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- iv. _____ is influenced by personal judgments.
v. _____ is concerned only with the recording of business transactions.

II. Multiple Choice Questions

- i. Which of the following is an advantage of accounting?
a) Personal judgements influence it.
b) Helps in keeping systematic records.
c) Acts as a reliable evidence.
d) Shows permanent record of business.
- ii. Which of the following is not an advantage of Accounting?
a) Replaces memory.
b) Facilitates a comparative study.
c) It permits alternative treatments.
d) Helps in knowing the value of business.
- iii. Which of the following is a limitation of Accounting?
a) Ascertaining value of business.
b) It is influenced by personal judgments.
c) It helps in ascertaining right amount of taxes.
d) Facilitates a comparative study.
- iv. Which is a correct statement related to book-keeping?
a) Book keeping is summarizing and analyzing of business transactions, financial in nature.
b) Book keeping is posting transactions in the ledger.
c) Book keeping is recording business transactions in an orderly manner.
d) None of the above.
- v. To ascertain the operational profit or loss is:
a) An objective of Accounting.
b) An advantage of Accounting.
c) A limitation of Accounting.
d) Need of Accounting.
- vi. Book-Keeping is recording:
a) All events affecting a business.
b) All business transactions.
c) Only business transactions with outsiders.
d) Only internal business transaction.
- vii. Which of the following is not a business transaction?
a) Purchase of goods for business.
b) Sale of goods.
c) Payment of sales tax.
d) Payment of house tax belonging to owner.

- viii. Which of the following is not an advantage of accounting?
- Facilitates performance comparisons.
 - Acts as reliable evidence.
 - Influenced by personal judgement
 - Replaces memory.



WHAT YOU HAVE LEARNT

- Business undertakes a series of transactions. It is not possible to remember all the transactions which have taken place over a period of time, and calculate the net effect of all such transactions. i.e., profit or loss. Hence, the need for accounting arises.
- Information about the business enterprise is required for both internal and external use. To get the required information, a systematic record is necessary.
- Accounting is the process of identifying, measuring, recording, classifying, summarising, analysing, interpreting and communicating the results of financial transactions and events.
- The objectives of accounting are: to keep systematic records; to ascertain the profit or loss and also the financial position; and to provide accounting information to interested parties for rational decision-making.
- Book-keeping is a part of accounting. It is the record keeping function of accounting and is limited upto the classifying stage.
- Bookkeeping is largely a mechanical process and does not involve any analysis of the financial transactions whereas, accounting includes the preparation of statements concerning assets, liabilities and the operating results of a business.
- Many groups of people like owners, management, lenders, creditors, investors, tax authorities, employees, etc., are interested in the accounting information of the enterprise.
- There are many advantages of properly maintained accounting system such as it acts as reliable evidence, helps in determining tax liability. It may also lead to many limitations such as influenced by personal judgements, ignores important non-monetary informations etc.



TERMINAL EXERCISE

- What is meant by book-keeping? State the need of book –keeping.
- Define accounting. What are its objectives?
- How is accounting information useful to Government and Investors?
- Distinguish between accounting and book- keeping.



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5. Explain the advantages and limitations of accounting.
6. What is a business transaction? Give five examples of business transactions.
7. Explain the different branches of Accounting.
8. Explain how accounting is useful to employees.



ANSWER TO INTEXT QUESTIONS

- 1.1 I.** i) False ii) True iii) True iv) True
- II.** i) Business ii) Business, iii) Business, iv) Non-business,
v) Non-business, vi) Non-business
- 1.2** i) True ii) False iii) False iv) False
- 1.3 I.** i) Business ii) Financial iii) Book-keeping
iv) Financial accounting v) Book-keeping
- II.** i) c, ii) c, iii) b, iv) c, v) a, vi) b, vii) d, viii) c.

ACTIVITY FOR YOU

- Visit two small business organisations and meet their Accountants and Senior Accounts officers and identify their accounts maintaining activities.