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Module 1

Chapter 1

Introduction to Accounting

CHAPTER AT A GLANCE (Chapter 1)

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MEANING AND DEFINITION OF ACCOUNTING

Accounting is an *art* of

- recording,
- classifying and
- summarizing
- in a significant manner and
- in terms of money,
- transactions and events
- which are of a financial character and
- interpreting the result thereof.

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CHARACTERISTICS OF ACCOUNTING

- Transactions and events that are of *financial character* are recorded.
- Transactions are recorded in *terms of Money*.

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FUNCTIONS OF ACCOUNTING

i) Recording:

- Recording is a process in which transactions are recorded in the books of original entries, i.e. in **Journal Books**.
- **Journal Book** is sub-divided into subsidiary books according to the number of transactions of particular category.

FUNCTIONS OF ACCOUNTING

These subsidiary books are:

- Cash Book
- Purchases Book
- Purchases Return Book
- Sales Book
- Sales Return Book
- Bills Receivable Book
- Bills Payable Book

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FUNCTIONS OF ACCOUNTING

Cash Book to record cash and bank transactions. Cash book may be-:

- **Single Column Cash Book**
- **Two Column Cash Book**
- **Three Column Cash Book**

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FUNCTIONS OF ACCOUNTING

ii) Classifying:

- Classification means transactions or entries of one nature are grouped under one head of account.
- The transactions recorded in 'Journal' or the 'Subsidiary Books' are classified or posted to the 'Ledger Account'.
- **Ledger** is the book that contains individual account heads under which all financial transactions of a similar nature are collected.

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FUNCTIONS OF ACCOUNTING

iii) Summarizing:

Summarizing is presenting the classified data in a form that is understandable and useful to users of accounting information.

It means preparation of Trial Balance, leading to preparation of financial statements i.e.

- Trading and Profit and Loss Account, and
- Balance Sheet.

❖ **Profit and Loss Account and Balance Sheet are collectively known as 'Final Accounts or Financial Statements'.**

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FUNCTIONS OF ACCOUNTING

iv) Analysis and Interpretation:

Analysis and interpretation means

- analyzing and then interpreting the financial data
- to make a meaningful judgment of the profitability and financial position of the business.
- It helps in planning for the future in a better way.

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FUNCTIONS OF ACCOUNTING

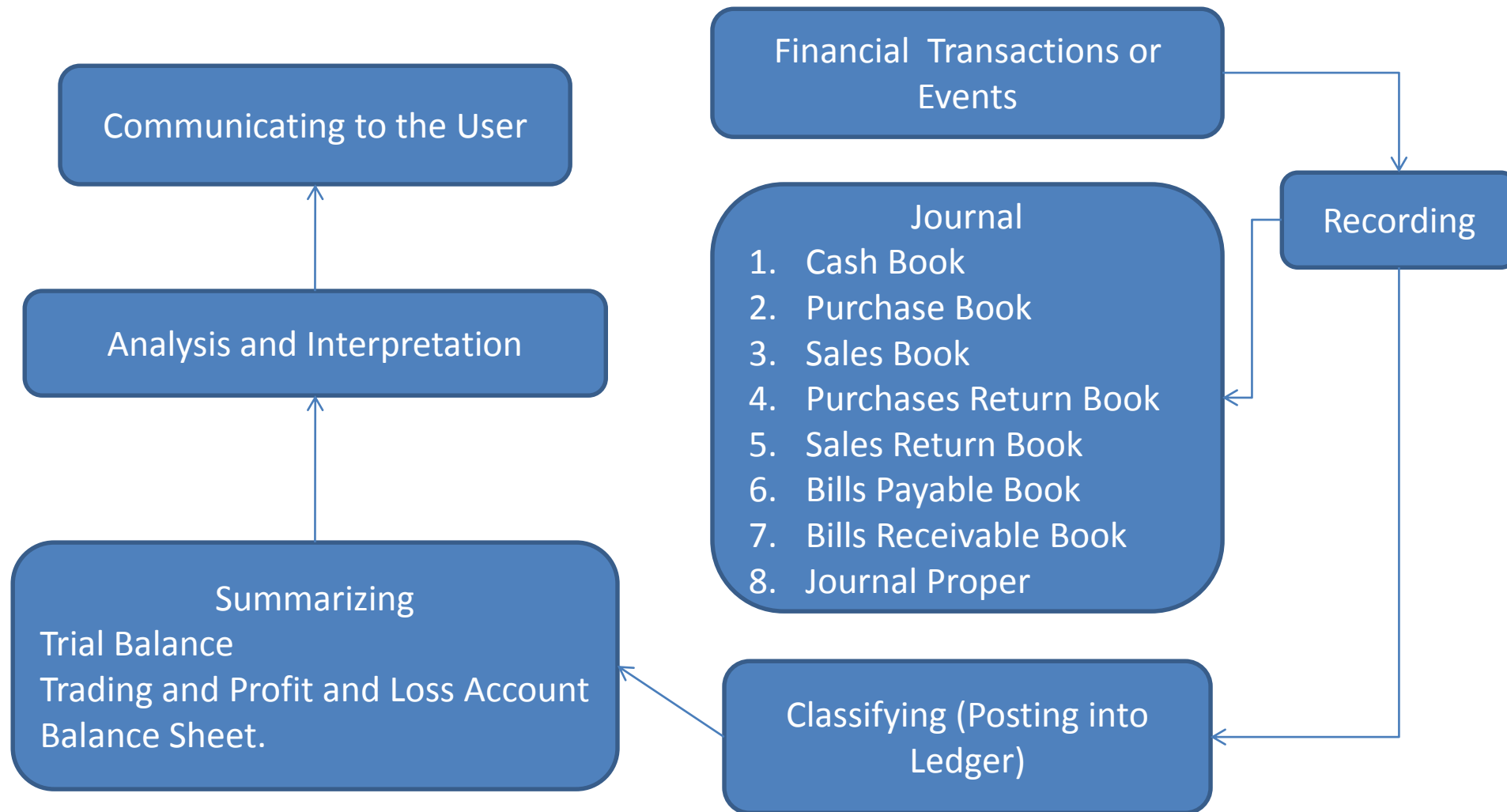
v) Communicating

- Finally, the accounting function is to communicate the financial data to the users.

Financial Accounting

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ACCOUNTING PROCESS



BOOK KEEPING

▪ Book Keeping is a part of accounting and is concerned with recording financial transactions and events in the books of accounts following accounting concepts and principles.

Thus, Book Keeping is concerned with:

- Identifying financial transactions and events;
- Measuring them in terms of money;
- Recording the financial transactions and events so identified in the books of accounts; and
- Classifying recorded transactions and events, i.e., posting them into Ledger accounts.

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OBJECTIVES OF ACCOUNTING

- Ascertaining Profit or Loss.
- Ascertaining Financial Position.
- Facilitating Management.
- Providing Accounting Information to Users.

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ADVANTAGES OF ACCOUNTING

- Financial Information about Business.
- Assistance to Management.
- Replaces Memory.
- Facilitates Comparative Study.
- Facilitates Settlement of Tax Liabilities.
- Facilitates Loans.
- Evidence in Court.
- Assistance in the Event of Insolvency.
- Helpful in settlement of accounts.

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LIMITATIONS OF ACCOUNTING

1. It is Not Fully Exact.

Accounting is based on evidences but yet estimates are also made for ascertaining profit or loss. Examples are

- estimating the useful life of an asset,
- bad debts,
- market price of closing stock, etc.

LIMITATIONS OF ACCOUNTING

2. It Ignores the Qualitative Elements.

Since accounting is confined to monetary matters only, qualitative elements like

- quality of management
- labour force
- industrial relations
- public relations
- are ignored.

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LIMITATIONS OF ACCOUNTING

3. It Ignores the Effect of Price Level Changes.

- Accounting statements are prepared at historical cost. Money, as a measurement unit, changes in value.
- Since Price Level Changes are not considered
- the financial statements do not show correct financial status.

LIMITATIONS OF ACCOUNTING

4. Accounting May Lead to Window Dressing.

The term window dressing means

- manipulation of accounts
- to conceal vital facts
- present better or worse financial position than actual
- In this situation, income statement fails to provide a true and fair view of the result of operations and
- the Balance Sheet fails to provide a true and fair view of the financial position of the enterprise.

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USERS OF ACCOUNTING INFORMATION

Internal Users

- Owners
- Management.
- Employees and Workers.

External Users

- Banks and Financial Institutions.
- Investors and Potential Investors.
- Creditors
- Government and its Authorities.

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SYSTEMS OF ACCOUNTING

The systems of recording transactions in the books of accounts are classified into two types:

- (a) Double Entry System of Accounting
- (b) Single Entry System of Accounting

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SYSTEMS OF ACCOUNTING

(a) Double Entry System of Accounting

- Double entry system of accounting has two aspects—
Debit and Credit.
- At the time of recording a transaction,
- it is recorded once on the debit side and
- again on the credit side.

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SYSTEMS OF ACCOUNTING

For example, at the time of cash purchases, goods are acquired and in return cash is paid.

In this transaction, two aspects are involved

- receiving goods
- paying cash.

Under the Double Entry System, both these aspects are recorded.

This system is universally applied in accounting.

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SYSTEMS OF ACCOUNTING

(b) Single Entry System of Accounting

- Single Entry System of accounting may be defined as a system, which is an incomplete double entry system.
- In this system, all transactions are not recorded on the double entry basis.

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BASIS OF ACCOUNTING

Transactions are recorded in the books of account following either

- Cash Basis of Accounting; or
- Accrual Basis of Accounting

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BASIS OF ACCOUNTING

Cash Basis Of Accounting

Cash Basis of Accounting is a method in which

- income is recorded when cash is received, and
- expenses are recorded when cash is paid out.

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BASIS OF ACCOUNTING

Cash Basis Of Accounting

Advantages:

- (i) It is simple as adjustment entries are not required.
- (ii) This approach is more objective as very few estimates and judgments are required.
- (iii) This basis of accounting is suitable for those enterprises where most of the transactions are on a cash basis.

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BASIS OF ACCOUNTING

Cash Basis Of Accounting

Disadvantages

- (i) It does not give a true and fair view of the profit or loss and the financial position of an enterprise because
 - it ignores outstanding and prepaid expenses,
 - accrued incomes and incomes received in advance.
- (ii) It does not follow the matching principle of accounting.

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BASIS OF ACCOUNTING

Cash Basis Of Accounting

Disadvantages:

- (iii) actual cash inflows and outflows are considered. Therefore there is great possibility of profit manipulation.

BASIS OF ACCOUNTING

Accrual Basis of Accounting

- System of accounting is based on 'accrual concept'
- Revenue is recognized (recorded) when earned
- Expenses are recognized when incurred.

Under this system

- Income earned and expenditure incurred is recognised irrespective of cash received or cash paid.

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BASIS OF ACCOUNTING

Accrual Basis of Accounting

It is based on two basic accounting principles,

- Revenue Recognition Concept
- Matching Concept

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BASIS OF ACCOUNTING

Accrual Basis of Accounting

Revenue Recognition Concept

Accounting rule that revenue should be recorded only when the

(1) revenue generation process has been substantially

completed, and

(2) an exchange has taken place. It is a restatement of the

old maxim: "Don't count your chickens until they are

hatched."

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BASIS OF ACCOUNTING

Accrual Basis of Accounting

Matching Concept

- Fundamental concept of accrual basis accounting that offsets revenue against expenses on the basis of their cause-and-effect relationship.
- It requires that, in measuring net income for an accounting period,
- the costs incurred in that period should be matched against the revenue generated in the same period.

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BASIS OF ACCOUNTING

Accrual Basis of Accounting

Advantages:

- (i) It is more scientific compared to Cash Basis
- (ii) This basis of accounting shows a complete picture
- (iii) This system discloses correct profit or loss for a particular period and also exhibits true financial position of the business on a particular day.
- (iv) It reflects correct profit or loss during the accounting period

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BASIS OF ACCOUNTING

Disadvantages:

- (i) This system is not as simple as Cash Basis of Accounting.
- (ii) The accounting process under this basis is too elaborate.
- (iii) A quick appraisal of the profit/loss is not possible because many adjustments are required to ascertain the true financial position of the business.

Example

Illustration

During the financial year 2009 – 10, Ashok had cash sales of Rs. 3,90,000 and credit sales of Rs. 1,60,000.

His expenses for the year were Rs. 2,70,000

out of which Rs. 80,000 are yet to be paid.

Find out Ashok's income for 2009 – 10 under both the basis of Accounting.

(i)

When Cash Basis of Accounting is followed:

Solution

Revenue (inflow of Cash i.e. Cash Sale)	3,90,000
Less: Expenses (Outflow of Cash) (Rs.2,70,000 – Rs.80,000)	1,90,000
Net Income	2,00,000

Credit sales and outstanding expenses will not be considered under Cash Basis of Accounting.

(ii)

When Accrual Basis of Accounting is followed:

Solution		
Total Sales = Cash Sales (Rs.3,90,000) + Credit (Rs.1,60,000)	Sales	5,50,000
<i>Less:</i> Total Expenses for the Year		2,70,000
	Net Income	2,80,000

Note: Rs. 80,000 on account of expenses still to be paid relate to this year and hence are to be charged to the revenue of this year. Similarly, credit sales of Rs.1,60,000 is taken in the year in which sales transaction is done.

<http://crescent.education/university/schools/school-of-social-sciences-and-humanities/department-of-commerce/overview/#>

Thank You