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ACCOUNTING - AN INTRODUCTION

Whenever your mother asks you to go to the nearby grocery store to buy items of daily use like match box, candle stick, soap cake, coffee, spices etc. you need not pay for these items immediately. When you buy these items, the store owner immediately opens the page of a note book on which your father's name is written. He records the value of items purchased. At the end of the month, your father goes to him. He again opens the same page tells the total amount to be paid and records when your father makes the payment. In a similar manner, he keeps the record of other customers also. Whenever he gets commodities from suppliers he records the same and also records the payment he makes to them. Similarly, every business small or big, sole proprietor or a firm keeps the record of the business transactions. Have you ever thought why do they keep record of business transactions? If they do not keep the record how will they know how much, when and to whom they have to make payments or from whom, how much and when they have to receive payments or what they have earned after a particular period and so on. Recording of transactions by a businessman in proper books and in a systematic manner is known as accounting. In this lesson you will learn about this in detail.

OBJECTIVES

After studying this lesson you will be able to

- explain the meaning of Book-Keeping;
- state the meaning and nature of accounting;
- distinguish between book keeping and accounting;
- explain the advantages & limitations of accounting;
- explain the branches of accounting;

- state the functions and objectives of financial accounting;
- explain accounting as an information system for decision making by the interested users and
- explain various accounting terms.

Notes

1.1 BOOK KEEPING AND ACCOUNTING

A business undertakes number of transactions. Can you estimate the number of transactions a business undertakes? It depends upon the size of a business entity. Every day business transactions may be around hundreds/thousands. Can a businessman remember all these transactions in every respect? Not at all. So it becomes necessary to record these business transactions in details and in a systematic manner. Recording of business transactions in a systematic manner in the books of account is called book-keeping. Book-Keeping is concerned with recording of financial data. This may be defined as.

> "The art of keeping a permanent record of business transactions is book-keepng".

From books of accounts important details such as total sales, total purchases, total cash receipts, total payments, etc. may be ascertained. As you know the main objective of business is to earn profits. In order to ascertain the profit earned during a period, mere recording of business transactions is not enough. Accounting involves not only book keeping but also many other activities. In 1941, the American Institute of Certified Public Accountants (AICPA) defined accounting as

> "The art of recording, classifying, summarising, analysing and interpreting the business transactions systematically and communicating business results to interested users in accounting"

Accounting is identified with a system of recording of business transactions that create economic information about business enterprises to facilitate decision making. The function of accounting is to provide quantitative information, primarily financial in nature, about economic entities, that is intended to be useful in making economic decisions.

The American Accounting Association defined accounting as :

> "It is the process of identifying, measuring, recording and communicating the required information relating to the economic events of an organisation to the interested users of such information.

In order to appreciate the nature of accounting it is necessary to understand the following relevant aspects of the definition of accounting:

- **Economic events :** It is the occurring of the consequence to a business organisation which consists of transactions that are measurable in monetary terms. Purchase of a Machinery, installing and keeping it ready for manufacturing is an economic event which consists of a number of financial transactions. These transactions are (a) buying the machine, (b) transporting the same, (c) preparing the site for its installation and (d) incurring expenditure on installing the same.

- **Identification, Measurement, Recording and Communication :**

  Identification implies determining what transactions are to be recorded i.e. items of financial character are to be recorded. For example, goods purchased for cash or on credit will be recorded. Items of non-financial character such as changes in managerial policies, etc. are not recorded in the books of accounts.

  Measurement means quantification of business transactions into financial terms by using monetary unit. If an event cannot be quantified in monetary terms, it is not considered fit for recording in the books of the firm. That is why important items like appointment, signing of contracts, etc. are not shown in the books of accounts.

  Recording : Having identified and measured the economic events in financial terms, these are recorded in the books of accounts in monetary terms date wise. The recording of the business transactions is done in such a manner that the necessary financial information is summarized according to well established accounting practices.

  Communication : The economic events are identified, measured and recorded in such a manner that the necessary relevant information is generated and communicated in a certain form to the management and other internal and external users of information. The financial information is regularly communicated through accounting reports.

- **Organisation :** refers to a business enterprise whether for profit or not for profit motive.

- **Interested users of information.** Many **users** need financial information to make important decisions. These users can be investors, creditors, labour unions, Trade Associations, etc.

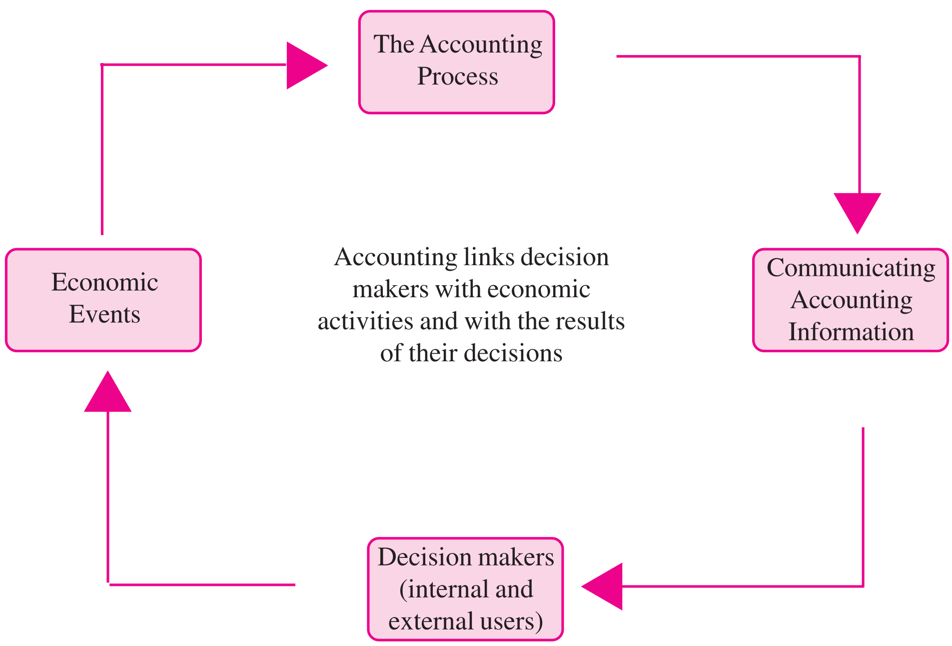
Evolution of Accounting

As per Indian mythology Chitra Gupta is responsible for maintaining accounts in God's court.

A book on Arthashasthra written by Kautilya who was a minister in Chandra Gupta's kingdom twenty three centuries ago mentions about the accounting practices in India. It describes how accounting records have to be maintained. In China and in Egypt accounting was used for maintaining revenue records of the government treasury.

A book on Arithmetica Geometrica, Proportion at Proportionality (Review of Arithmetic and Geometric proportion) by an Italian Luca Pacioli is considered as the first authentic book on double entry book keeping. In his book he used the present day popular terms of accounting Debit (Dr.) and Credit (Cr). He also discussed the details of memorandum, journal, ledger and specialised accounting procedures. He also stated that, "all entries have to be double entries, i.e. if you make one creditor you must make some debtor.

Accounting process can be summarised as



Accounting Process

Difference between book keeping and accounting : Book keeping and accounting can be differentiated on the basis of nature, objective, function, basis, level of knowledge, etc.

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Difference between Book Keeping and Accounting

Basis of Difference	Book-keeping	Accounting
Nature	It is concerned with identifying financial transactions; measuring them in monetary terms; recording and classifying them.	It is concerned with summarizing the recorded transactions, interpreting them and communicating the results.
Objective	It is to maintain systematic records of financial transactions.	It aims at ascertaining business income and financial position by maintaining records of business transactions.
Function	It is to record business transactions. So its scope is limited.	It is the recording, classifying, summarizing, interpreting business transactions and communicating the results. Thus its scope is quite wide.
Basis	Vouchers and other supporting documents are necessary as evidence to record the business transactions.	Book-keeping works as the basis for accounting information.
Level of Knowledge	It is enough to have elementary knowledge of accounting to do book-keeping.	For accounting, advanced and in-depth knowledge and understanding is required.
Relation	Book-keeping is the first step to accounting.	Accounting begins where book-keeping ends.

INTEXT QUESTIONS 1.1

I. Fill in the blanks with suitable word/words:

i. Keeping systematic record of business transactions is known as ____________.

ii. The next step after classification of recorded transactions is ____________.

iii. The whole process of recording, classifying, summarizing and interpreting the business transactions systematically and communicating business results to the interested users of financial information is known as ____________.

iv. Interested users of accounting information are ____________.

II. Identify transactions related to book-Keeping or accounting and write B for book-keeping and A for accounting against the space provided:

i. Credit Sales/Purchases (................)

ii. Cash Purchases/Sales (................)

iii. Calculation of business profits (................)

Notes

iv. Find out total debtors (................)

v. Find out financial position of the business enterprise (..................)

1.2 BRANCHES AND OBJECTIVES OF ACCOUNTING

Branches of Accounting

The changing requirements of the business over the centuries have given rise to specialized branches of accounting and these are :

Financial Accounting

It is concerned with recording the transactions of financial character, summarising and interpreting them and communicating the results to the users. It ascertains profit earned or loss incurred during a period (usually one year as accounting year) and the financial position as on the date when the accounting period ends. It can provide financial information required by the management and other parties. The word accounting and financial accounting are used interchangeably. At present we are concerned with financial accounting only.

Cost Accounting

It analyses the expenditure so as to ascertain the cost of various products manufactured by the firm and fix the prices. It also helps in controlling the costs and providing necessary costing information to management for decision making.

Management Accounting

It is concerned with generating information relating to funds, cost and profits etc. This enables the management in decision making. Basically, it is meant to assist the management in taking rational policy decisions and to evaluate the impact of its decisions and actions and the performance of various departments.

Tax Accounting

This branch of accounting has grown in response to the difficult tax laws such as relating to income tax, sales tax etc. An accountant is required to be fully aware of various tax legislations.

Social Accounting

This branch of accounting is also known as social reporting or social responsibility accounting. It discloses the social benefits created and the costs incurred by the enterprise. Social benefits include such facilities as medical, housing, education, canteen, provident fund and so on while the social costs may include such matters as exploitation of employees, industrial interest, environment pollution, unreasonable terminations, social evils resulting from setting up industries etc.

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Objectives and Functions of Financial Accounting

The main objectives of financial accounting are as under :

Finding out Various Balances

Systematic recording of business transactions provides vital information about various balances like cash balance, bank balance, etc.

Providing Knowledge of Transactions

Systematic maintenance of books provides the details of every transactions.

Ascertaining Net Profit or Loss

Summarisation in form of Profit and Loss Account provides business income over a period of time.

Depicting Financial Position

Balance sheet is prepared to depict financial position of business means what the business owns and what it owes to others.

Information to All Interested Users

After analysis and interpretation, business performance and position are communicated to the interested users.

Fulfilling Legal Obligations

Vital accounting information helps in fulfilling legal obligations e.g. sales tax, income tax etc.

Functions of Accounting

The function of accounting is to provide quantitative information primarily financial in nature about economic entities, which is intended to be useful in making economic decisions. Financial accounting performs the following major functions:

Maintaining SystematicRrecords

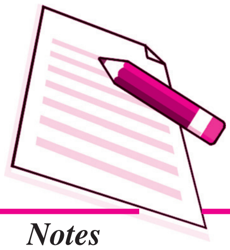
Business transactions are properly recorded, classified under appropriate accounts and summarized into financial statements.

Communicating the financial results

It is used to communicate financial information in respect of net profits (or loss), assets, liabilities etc. to the interested parties.

Meeting Legal Requirements

The provisions of various Laws such as Companies Act, 1956 Income Tax and Sales/ VAT Tax Acts, require the submission of various statements i.e. Annual accounts, Income Tax returns, Returns for VAT etc.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Fixing responsibility

It helps in computation of profits of different departments of an enterprise. This facilitates the fixing of the responsibility of departmental heads.

Decision making

It provides the users the relevant data to enable them make appropriate decisions in respect of investment in the capital of the business enterprise or to supply goods on credit or lend money etc.

Advantages of Accounting

1. **Financial Information about Business :** Financial performance during the accounting period, *i.e.,* profit or loss and also the financial position at the end of the accounting period is known through accounting.
2. **Assistance of Management :** The management makes business plans, takes decision and exercise control on affairs on the basis of accounting information.
3. **Replace Memory :** A systematic and timely recording of transactions obviates the necessity to remember the transactions. The accounting record provides this necessary information.
4. **Facilitates Comparative Study :** A systematic record enables a businessman to compare one year's results with those of other years and locate significant factors leading to the change, if any.
5. **Facilitates Settlement of Tax Liabilities :** A systematic accounting record immensely helps settlement of income tax, sales tax, VAT and excise duty liabilities since it is a good evidence of the correctness of transactions.
6. **Facilitates Loans :** Loan is granted by the banks and financial institutions on the basis of growth potential which is supported by the performance. Accounting makes available the information with respect to performance.
7. **Evidence in Court :** Systematic record of transactions is often accepted by the Courts as good evidence.
8. **Facilitates Sale of Business :** If someone desires to sell his business, the accounts maintained by him will enable the ascertainment of the proper purchase price.
9. **Assistance in the Event of Insolvency :** Insolvency proceedings involve explaining many transactions that have taken place in the past. Systematic accounting records assist a great deal in such a situation.

10. Helpful in Partnership Accounts : At the time of admission of a partner, retirement or death of a partner and dissolution of the firm, accounting records are of vital importance and use. It is so because such records provide the basis to reach a settlement.

Limitations of Accounting

1. **Accounting information is expressed in terms of Money :** Non-monetary events or transactions are completely omitted.

2. **Fixed assets are recorded in the accounting records at the original cost :** Actual amount spent on the assets like building, machinery, plus all incidental charges is recorded. In this way the effect of rise in prices is not taken into consideration. As a result the Balance Sheet does not represent the true financial position of the business.

3. **Accounting information is sometimes based on estimates:** Estimates are often inaccurate. For example, it is not possible to predict the actual life of an asset for the purpose of depreciation.

4. **Accounting information cannot be used as the only test of managerial performance on the basis of mere profits :** Profit for a period of one year can readily be manipulated by omitting certain expenses such as advertisement, research and development, depreciation etc. i.e. window dressing is possible.

5. **Accounting information is not neutral or unbiased :** Accountants ascertain income as excess of revenue over expenses. But they consider selected revenue and expenses for calculating profit of the concern. They also do not include cost of such items as water, noise or air pollution i.e. social cost, they may also use different methods of valuation of stock or depreciations.

INTEXT QUESTIONS 1.2

I. Following are the statements relating to various branches of accounting. Write against each the name of the branch of accounting to which the same belongs:

i. It analyses the expenditure so as to ascertain the cost of products manufactured by the concern.

ii. Accounting that discloses the social benefits and the costs incurred by the business enterprises.

iii. Accounting that is concerned with generating information that will enable the management in decision making.

II. How each of the following statements is a limitation of accounting?

i. Fixed assets are recorded in the accounting records at the original cost.

ii. Accounting information is sometimes based on estimates.

iii. Accounting information cannot be used as the only test of managerial performance on the basis of mere profit.

iv. Accounting information is expressed in terms of money.

III. How each of the following statements is an advantage of Accounting :

i. Evidence in Court

ii. Replaces Memory

iii. Financial Information about Business.

1.3 ACCOUNTING AS AN INFORMATION SYSTEM AND ITS USERS

In 1970, the Accounting Principles Board of The American Institute of certified Public Accountants (AICPA) emphasized that the function of accounting is to provide quantitative information, primarily financial in nature, about economic entities, that is intended to be useful in making economic decisions. Accounting is often called the **"Language of Business"**. It is the common language used to communicate financial information to individuals, organisations, government agencies about various aspects of business such as financial position, operating results (i.e. Profit or loss) and cash flows. **Users**, both inside and outside the business, have to make decisions concerning the allocation of limited economic resources. In order to ensure that resources are allocated in an efficient and effective manner, **users require financial information** for the purpose of making decisions. Accounting provides information that is useful in making business and economic decisions. It is the primary means of communicating financial information to owners, lenders, managers,. Government and its regulatory agencies '-and -others- who have interest in an enterprise. It helps the users in taking better decisions by providing relevant, reliable and timely information on the financial and operational position of an enterprise.

It is observed that almost all business enterprises maintain detailed accounting records. Even the most intelligent manager with a sharp memory would find it difficult to remember the daily transactions simply by observing them. So he/she must rely upon the accounting process which begins with the recording of business transactions and ends up with the preparation of summarized financial statements. Thus, Accounting as an information system is necessitated by great complexity of modern business organisations.

Accounting as a Source of Information

"*Accounting is a service activity. It's function is to provide qualitive information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions.*"

As an information system, accounting collects data and communicates economic information about the organisation to a number of users whose decisions and actions are related to its performance. Accounting begins with the identification of transactions of financial nature and ends with the preparation of financial statements (*i.e.,* Income Statement and Balance Sheet). Each step in the process of accounting generates information. Generation of information is not an end in itself, it is a way to facilitate the dissemination of information among users of accounting information. Accounting information is used for predicting, comparing and evaluating the earning power and financial position of a business enterprise. Therefore, dissemination of information is an essential function of accounting.

INTEXT QUESTIONS 1.3

State whether the following statements are True or False :

i. Systematic record of transactions is often accepted by the Courts as good evidence.

ii. The balance sheet makes available the information about the financial health of the enterprises.

iii. Creditors are internal users of accounting information

Users of Accounting Information

Users of Accounting Information may be categorised into Internal Users and External Users.

Internal Users

i. Owners : Owners contribute capital in the business and thus, are exposed to maximum risk. Naturally, they are interested in knowing the profit earned or loss suffered by the business besides the safety of their capital. The financial statements give the information about profit or loss and financial position of the business.

ii. Management : The management makes extensive use of accounting information to arrive at informed decisions such as determination of selling price, cost controls and reduction, investment into new projects, etc.

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iii. **Employees and Workers :** Employees and workers are entitled to bonus at the year end, which is linked to the profit earned by an enterprise. Therefore, the employees and workers are interested in financial statements. Besides, the financial statements also reflect whether the enterprise has deposited its dues into the provident fund and employees state insurance accounts, etc., or not.

External Users

i. **Banks and Financial Institutions :** Banks and financial institutions are an essential part of any business as they provide loans to the businesses. Naturally, they watch the performance of the business to know, whether it is making progress as projected to ensure the safety and recovery of the loan advanced. They assess it by analysing the accounting information.

ii. **Investors and Potential Investors :** Investment involves risk and also the investors do not have direct control over the business affairs. Therefore, they rely on the accounting information available to them and seek answers to the questions such as - what is the earning capacity of the enterprise and how safe is their investment?

iii. **Creditors :** Creditors are those parties who supply goods or services on credit. Before granting credit, creditors satisfy themselves about the credit worthiness of the business. The financial statements help them immensely in making such an assessment.

iv. **Government and Its Authorities :** The government makes use of financial statements to compile national income accounts and other informations. The information so available to it enables them to take policy decisions.

Government levies varied taxes such as Excise Duty, VAT, Service Tax and Income Tax. These government authorities assess the correct tax dues from an analysis of financial statements.

v. **Researchers :** Researchers use accounting information in their research work.

vi. **Consumers :** Consumers require accounting information for establishing good accounting control so that cost of production may be reduced with the resultant reduction of the prices of products they buy. Sometimes, prices of some products are fixed by the government, so it needs accounting information to fix fair prices so that consumers and producers are not exploited.

vii. **Public :** They want to see the business running since it makes substantial contribution to the economy in many ways, *e.g.*, employment of people, patronage to suppliers, etc. Thus, financial accounting provides useful financial information to various user groups for decision-making.

Qualitative Characteristics of Accounting Information

Two fundamental characteristics of financial statements are their truth and fairness. An auditor of the enterprise has to make a statement in his report whether, in his opinion, the financial statements give a true and fair view. It means that the Balance Sheet should give a true and fair view of the state of affairs and the Profit and Loss Account should give the true and correct profit or loss for the period. Besides the above fundamental characteristics, there are other qualitative characteristics (attributes) that make the information content of the financial statements meaningful to its users. There are:

1. Reliability;
2. Relevance;
3. Understandability and
4. Comparability.

Let us discuss these characteristics in detail:

1. **Realiability :** Accounting information must be reliable. the foremost factors that make it reliable are that

   i. it should be verifiable. It means, transactions should be evidenced by documents. For example, purchases be evidenced by bills of purchases, sales be evidenced by sales bills, etc.

   ii. it should be free from personal bias. It means, where personal judgement is to be exercised, it should be independent and free from bias.

   Reliability of the accounting information depends on:

   i. *Neutrality :* Neutrality means that the accounting information made available does not suffer from bias.

   ii. *Prudence :* The accounting information prepared on the principle of prudence (conservatism) means that the accounting information is prepared by providing all prospective losses while leaving all prospective profits.

   iii. *Completeness :* The accounting information given should be complete in all respects as incomplete information may lead to wrong interpretation.

   iv. *Substance Over Form :* The accounting information to be meaningful, should be governed by the substance of the information and not by its legal form alone.

2. **Relevance :** The accounting information, besides disclosing statutorily required disclosures, should disclose other informations, after judging its relevance to the

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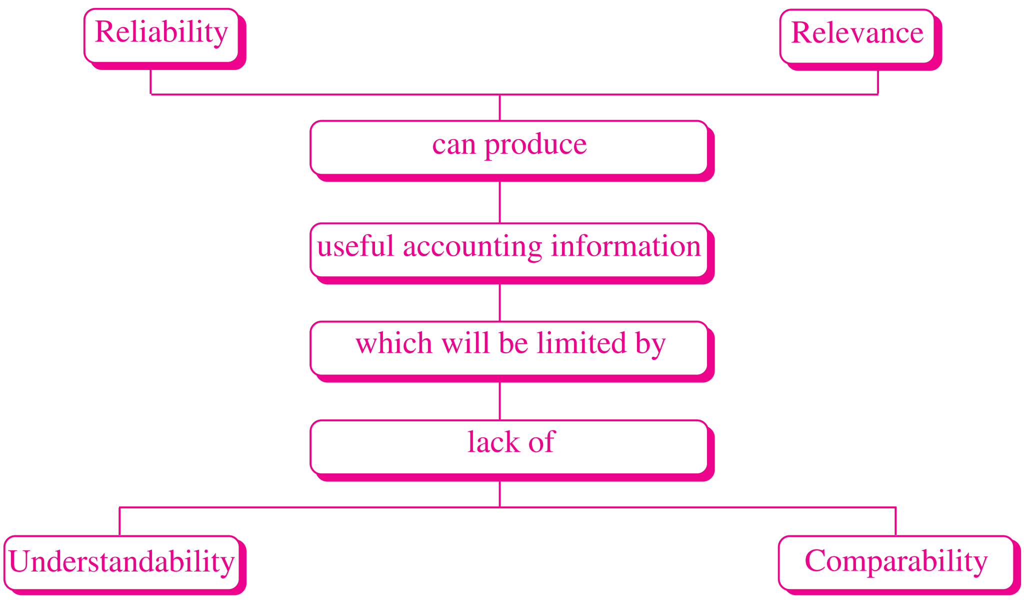
decision-making need of its users. For example, interest on borrowings is disclosed without stating the rate of interest. Users, therefore, cannot link interest cost to different types of borrowed funds. In the process, they fail to appreciate the rationality of financing decisions. Generally, only the statutory (legal) required information is disclosed. The information disclosure requirements are set after a public debate reflecting the views of cross-sections of users. But, what is relevant information in a particular circumstance cannot be generalised and specified. The management of the enterprise is in the best position to decide the contents of the information. It may be noted that relevance of the information is always guided by the principle of materiality.

3. **Understandability :** Understandability means that the information provided through the financial statements be presented in a manner that the users are able to understand it in the manner it should be. However, if an information is considered relevant for the users' decision-making it must be disclosed even if the information is complex and not readily understandable by common users. The information disclosure requirement of law must be fulfilled howsoever complex such information may be.

4. **Comparability :** Comparability means that the users should be able to compare the accounting information of an enterprise of the period either with that of other periods, known as intra-firm comparison or with the accounting information of other enterprises, known as inter-firm comparison. It is, therefore, necessary to follow standardised accounting policies consistently to the extent possible.

Accounting information to be useful should have all the above characteristics. The accounting information produced in the light of Reliability and Relevance Qualitative Characteristics can be useful but its usefulness shall be limited if it lacks understandability and comparability. We may explain this with the help of a diagram :



1.4 ACCOUNTING TERMS

Transaction

It is an event which involves exchange of some value between two or more entities. It can be purchase of stationery, receipt of money, payment to a supplier, incurring expenses, etc. It can be a cash transaction or a credit transaction.

Purchases

This term is used for goods to be dealt-in i.e. goods are purchased for resale or for producing the finished products which are meant for sale. Goods purchased may be Cash Purchases or Credit Purchases. Thus, Purchase of goods is the sum of cash purchases and credit purchases.

Sundry Creditors

Creditors are persons who have to be paid by an enterprise an amount for providing goods and services on credit.

Sales

Sales are total revenues from goods or services provided to customers. Sales may be in cash or in credit.

Sundry Debtors

Persons who have to pay for goods sold or services rendered or in respect of contractual obligations. It is also termed as debtor, trade debtor, and accounts receivable.

Revenue (Sales)

Sales revenue is the amount by selling products or providing services to customers.

Other items of revenue common to many businesses are: Commission, Interest, Dividends, Royalties, and Rent received, etc.

Expenses

Costs incurred by a business in the process of earning revenue are called expenses. In general, expenses are measured by the cost of assets consumed or services used during the accounting period. The common items of expenses are: Depreciation, Rent, Wages, Salaries, Interest, Cost of Heating, Light and water and Telephone, etc.

Income

The difference between revenue and expense is called income. For example, goods costing ₹ 25000 are sold for ₹ 35000, the cost of goods sold, i.e. ₹ 25000 is expense, the sale of goods, i.e. ₹ 35000 is revenue and the difference. i.e. ₹10000 is income. In other words, we can state that

Income = Revenue - Expense

Gain

Usually this term is used for profit of an irregular nature, for example, capital gain.

Loss

It means something against which the firm receives no benefit. It is a fact that expenses lead to revenue but losses do not, such as theft.

Profit

It is the excess of revenue of a business over its costs. It may be gross profit and net profit. Gross profit is the difference between sales revenue or the proceeds of goods sold and/or services provided over its direct cost of the goods sold. Net profit is the profit made after allowing for all types of expenses. There may be a net loss if the expenses exceed the revenue.

Expenditure

Spending money or incurring a liability for some benefit, service or property received is called expenditure. Payment of rent, salary, purchase of goods, purchase of machinery, etc. are some examples of expenditure. If the benefit of expenditure is exhausted within a year, it is treated as revenue expenditure. In case the benefit of expenditure lasts for more than one year, it is treated as an asset and also known as capital expenditure. Expenditure is usually the amount spent for the purchase of assets. It increases the profit earning capacity of the business. Expense, on the other hand, is an amount to earn revenue. Expenditure is considered as capital expenditure unless it is qualified with words like revenue expenditure on rent, salaries etc., while expense is always considered as a revenue expense because it is always incurred to earn revenue.

Drawings

It is the amount of money or the value of goods which the proprietor takes away from business for his/her household or private use.

Capital

It is the amount invested in an enterprise by its owners e.g. paid up share capital in a corporate enterprise. It also refers to the interest of owners in the assets of an enterprise. It is the claim against the assets of the business. Any amount contributed by the owner towards the business unit is a liability for the business enterprise. This liability is also termed as capital which may be brought in the form of cash or assets by the owner.

Assets

These are tangible objects or intangible rights owned by the enterprise and carrying probable future benefits. Tangible items are those which can be touched and their physical presence can be noted/felt e.g. furniture, machine etc. Intangible rights are those rights which one possesses but cannot see e.g. patent rights, copyrights, goodwill etc. Assets are purchased for business use and are not for sale. They raise the profit earning capacity of the business enterprise.

Assets are broadly categorized as current assets and non-current assets/fixed assets. **Current assets** are those assets which are held for a short period generally one year's time. The balance of such items goes on fluctuating i.e. it keeps on changing throughout the year. The balance of cash in hand may change so many times in a day. Various current assets are cash in hand/at bank, debtors, bills receivable, stock, pre-paid expenses.

Non-current assets : Those assets are acquired for long term use in the business. Such assets raise the profit earning capacity of the business enterprise. Expenditure on such assets is non-recurring and of capital nature. Expenses incurred on acquiring these assets are added to the value of the assets.

Liability

It is the financial obligation of an enterprise other than owners' funds.

Liabilities : Liabilities mean the amount which the business owes to outsiders, that is, except the proprietors. In the words of **Finny and Miller,** *"Liabilities are debts, they are amounts owed to creditors."* Thus, the claims of those who are not owners are called **Liabilities.** This can be expressed as :

Liabilities = Assets – Capital

In business, transactions are recorded taking business to be an entity distinct from its owners. Thus, capital invested by the proprietors is a liability but an internal liability. On the other hand, *external liability* is a liability that is payable to outsiders, *i.e.,* other than the proprietors.

External liability arises because of credit transactions or loans raised. Examples of external liabilities are creditors, bank overdraft, bills payable, outstanding liabilities.

Liabilities can be classified into the following :

i. *Long-Term Liabilities :* These are those liabilities which are payable after a long-term, (generally more than a year). Examples of Long-Term Liabilities are long-term loans, debentures, etc.

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ii. *Short-Term/Current Liabilities :* These are liabilities which are payable in the near future (generally within a year). Examples of Current Liabilities are creditors, bank overdrafts, bills payable, short-term loans, etc.

Account : Account is a summarised record of relevant transactions at one place relating to a particular head. It records not only the amount of transactions but also their effect and direction.

Stock or Inventory : Stock is the tangible property held by an enterprise for the purpose of sale in the ordinary course of business or for the purpose of using it in the production of goods meant for sale or services to be rendered. Stock may be *opening stock* or *closing stock*. In case of a manufacturing concern, Closing Stock comprises raw materials, Work-in-Progress (*i.e.,* semi-finished goods) and finished goods in hand on the closing date. Similarly, Opening Stock (beginning inventory) is the amount of stock at the beginning of the accounting period.

Goods : They refer to items forming part of the Stock-in-Trade of an enterprise, which are purchased or manufactured with a purpose of selling. In other words, they refer to the products in which an enterprise is dealing. For an enterprise dealing in home appliances such as T.V., fridge, A.C., etc., these are goods. Similarly, for a stationer, stationery is goods, whereas for others, it is an item of expense (not purchases). An enterprise may purchase assets for use in furtherance of business or stationery for use in the business, but they are not purchases of 'goods' but fixed asset and expense respectively.

Receivables : The term 'Receivables' includes the outstanding amount due from others. Sometimes, a debtor may accept a Bill of Exchange, which is payable after a certain period. Such a bill is known as **Bill Receivable**. Sometimes, a debtor promises to pay the specific amount in writing after a specified period. Such a promise is known as a **Promissory Note** and is recorded as *note receivable.* The term – *accounts receivable* includes trade debtors as well as bills receivable and promissory notes receivable. The term *receivable* includes all the amounts due from others.

Payables : The term 'Payables' include the amounts due to other. *Accounts Payable* includes trade creditors as well as bills payable and promissory notes payable. The term payable includes all the amounts due to others.

Bill Receivable : Bill Receivable means a Bill of Exchange accepted by a debtor the amount of which will be received on the specified date.

Bill Payable : Bill Payable means a Bill of Exchange, the amount of which will be payable on the specified date.

Event : Any transactions in an organisation can be called as an event. Transactions in an organisation have documentary evidence and will create a change in revenue, expense, assets, liabilities and capital.

Cost : It is the amount of expenditure incurred on or is attributed to a specified article; product or activity.

Voucher : It is proof of a business transaction. Cash Memo, Bill/Invoice, Credit/Debit notes etc. are examples of voucher.

Discount : Some customers are allowed reduction in the price of goods by the business. It is called a Discount.

Trade Discount : It is the reduction allowed by the seller to the buyer at the time of sale on the list price of goods. Trade discount is allowed on bulk purchases. Normally, trade discount is deducted from the list price and only the balance is accounted for. Therefore, trade discount will not be shown in the books of accounts.

Cash Discount : It is the deduction allowed by the creditor to the debtor on the amount due by the latter. This concession is given only to those who settle their accounts within a stipulated period. Therefore, cash discount encourage prompt settlement of accounts. For the debtor who pays the amount, it is an income. For creditor, cash discount is an expense.

INTEXT QUESTIONS 1.4

Fill in the blanks :

i. Stock is a ___________ asset.

ii. Liabilities = Assets - ___________

iii. Debentures are ___________ term liabilities.

iv. Creditors are ___________ term liabilities.

Role of an Accountant in Society

The accountant with his specialized knowledge, extensive training and experience is not merely responsible for preparing accounts, rather he/she is the best equipped person to provide other related services normally required by the management. This helps the management to discharge their duties more effectively thereby providing for efficient utilization of resources. The accountants' role in the society includes the following :

- To maintain the proper books of accounts which portray the true and fair view of the results of the business.
- To provide information and reports to management to enable them to discharge their duties more effectively.

- To act as auditor for attestation of accounts as per the requirement of law.
- To act as an internal auditor to assist and strengthen the hands of the management.
- To act as tax consultant to handle the tax matters of the business.
- To act as management consultant to provide services regarding financial planning of the business to their clients.

Notes

INTEXT QUESTIONS 1.5

I. Write against the following statements the terms for which these are made in reference to accounting information.

i. It is a common language used to communicate financial information.

ii. Managing Director, functional managers, shareholders etc using the accounting information.

iii. Ability of the firm to meet all its short term or current obligations as and when they fall due.

II. State in each case, whether the items are to be regarded as goods or assets.

i. Furniture purchased by Makhan Singh, a dealer in furniture.

ii. Automatic Machine purchased by a workshop for manufacturing products.

iii. Machine manufactured by a firm for sale to a mill.

iv. Furniture purchased by Malti, a stationery shop-owner.

III. Multiple Choice Questions :

i. Goods in hand at the end of a year is called ____________.

a) Purchases b) cost c) stock d) profit

ii. A Bill of Exchange is considered as _________ from the view point of creditors.

a) Bills receivable b) Bills payable

c) Discounting d) None of the above

iii. A Bill of Exchange is _______________ from the view point of debtors.

a) Bills Receivable b) Bills Payable

c) Endorsement d) None of the above

iv. ______________ are reductions allowed either on selling price or on the amount due.

a) Discount b) Cost

c) Bills d) All of the above

WHAT YOU HAVE LEARNT

- Accounting is the art of recording, classifying and summarizing in terms of money transactions and events of a financial nature and interpreting the results thereof. It is the process of collecting, recording, summarizing and communicating financial information. It is an information system which generates information for decision making by the interested parties.
- Recording of business transactions in a systematic manner in the books of accounts is called book keeping.
- Accounting consists of economic events which are identified, measured, recorded and communicated.
- Branches of accounting : Financial accounting, cost accounting and management accounting are some of the branches of accounting.
- Accounting in modern times is treated as an information system which has transaction, accounting process, decision useful financial information as the necessary ingredients.
- The accountant with his specialised knowledge extensive training and experience helps the management and plays an important role in the society.
- Important accounting terms are : Business entity, transactions, purchases, sales, debtors, creditors, etc.

TERMINAL EXERCISE

1. What is accounting? What are its objectives and limitations?
2. Distinguish between book-keeping and accounting.
3. Explain the different branches of accounting.
4. Explain the role of an accountant in the society.
5. Explain accounting as a system of information. Enlist the parties that are interested in the accounting information.

Notes

6. What is expense? Explain with example.
7. What is meant by liability? Explain with the help of examples.
8. State the meaning of the term 'Asset' with examples.

ANSWERS TO INTEXT QUESTIONS

1.1 I. i. Book keeping ii. Analysing
iii. Accounting iv. Investors, Creidtors etc.

II. i. B ii. B iii. A iv. A v. A

1.2 I. i. Cost accounting ii. Social accounting
iii. Management accounting

II. i. The effect of rise in price is not taken into consideration
ii. Estimates are sometimes inaccurate
iii. Profit can be manipulated by window dressing
iv. Non monetary transactions are completely omitted.

III. i. Systematic records are accepted as evidence in court.
ii. Systematic record keeping replaces memory.
iii. Accounting provides the financial information for decision making.

1.3 i. T ii. T iii. F

1.4 i. current ii. capital iii. long iv. short

1.5 I. i. Accounting ii. users iii. language of business

II. i. Goods ii. Assets iii. Goods iv. Assets

III. i. c ii. a iii. b iv. a

ACTIVITY

One day you have visited your friend Shiva who runs a grocery shop and casually talked about the accounts he maintains of his business unit. You were surprised to note that he did not maintain accounts. Enquire from other businessmen you know about their accounting records and about the uses and purposes of accounting. Explain them to your friend Shiva to motivate him to maintain accounts of his business unit.