Accounting for Management

Unit: 1

Conceptual Framework

Topics:

- **Meaning of Accounting**
- **Objectives of Accounting**
- **Scope of Accounting**
- **Areas of Accounting**
- **Business Transactions**
- **Classification of Accounts**
- **Rules of Debit and Credit**
- **Difference between Capital Expenditure and Revenue Expenditure**
- **Difference between Capital Income and Revenue Income**
- **Basic Accounting Terms :**

Assets	**Purchase**
Liabilities	**Sales**
Capital	**Loss**
Expenses	**Profit**
Expenditure	**Voucher**
Debtors	**Discount**
Creditors	**Transaction**
Goods	**Drawing**
Cost	**Depreciation**
Gain	**Reserves**
Stock	**Provisions**

➢ Meaning & Definition of Accounting:

Accounting is the language of business. The affairs and the results of the business are communicated to others through accounting information, which has to be systematically recorded and presented.

According to American Institute of Certified Public Accountants (AICPA) , 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, atleast of a financial character, and interpreting the result thereof."

Accounting can be defined as the process of identifying, measuring, recording and communicating the economic events of an organization to the interested users of the information.

According to the definition given by the American Accounting Association :" Accounting is the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of accounts."

Thus, Accounting is a process of systematically recording in the books of accounts, the monetary transactions of a person relating to a definite period of time. Accounting is a diverse and dynamic discipline. The accountant's responsibility is to provide reliable and relevant information that is useful in making business decisions. Accounting is the measurement of financial results; guide-post for all internal and external users.

➢ Characteristics of Accounting:

1) **It is an art :** Accounting is an art. The writer of books of account must use his skill. Rules of accounting cannot be mechanically used and it is helpful to the management in taking important decision.

2) **It is a Science:** Accounting is a science also, as a systematic knowledge, which has a definite rule. Transactions are recorded on the basis of these rules of accounting.

3) **Only Financial Transactions:** In accounting, only financial transactions are recorded which are related to business transaction and which are valued into money or money's worth.

4) **Recorded in Terms of Money:** The transactions are recorded in terms of money only. 6 chairs & 3 tables in the office first we have to give money value of them & then record in the books

5) **Recorded in special Books:** The transactions to be recorded are first classified and then special books are kept and recorded in respective books only.

6) **Records made with particular objective:** Records made in books of accounts are summarized from time to time and important conclusions are drawn. Thus, books of account are written with particular objectives in mind.

7) **Records are correctly made:** The records made must be correct arithmetically and there should be no error of principle.

8) **Records are continuous:** The business transactions are continuously recorded in order of dates and no transaction is left out unrecorded.

9) **Service transaction:** Not only transactions relating to the goods are recorded but even service transactions are recorded.
   Example : Fees to Lawyer

➢ Objectives of Accounting:

Objective of accounting may differ from business to business depending upon their specific requirements. However, the following are the general objectives of accounting.

1. **To keeping systematic record:** It is very difficult to remember all the business transactions that take place. Accounting serves this purpose of record keeping by promptly recording all the business transactions in the books of account.
2. **To ascertain the results of the operation:** Accounting helps in ascertaining result i.e., profit earned or loss suffered in business during a particular period. For this purpose, a business entity prepares either a Trading and Profit and Loss account or an Income and Expenditure account which shows the profit or loss of the business by matching the items of revenue and expenditure of the some period.
3. **To ascertain the financial position of the business:** In addition to profit, a businessman must know his financial position i.e., availability of cash, position of assets and liabilities etc. This helps the businessman to know his financial strength. Financial statements are barometers of health of a business entity.
4. **To portray (show) the liquidity position:** Financial reporting should provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, cash dividends and other distributions of resources by the enterprise to owners

and about other factors that may affect an enterprise's liquidity and solvency.

5. **To protect business properties:** Accounting provides upto date information about the various assets that the firm possesses and the liabilities the firm owes, so that nobody can claim a payment which is not due to him.
6. **To facilitate rational decision – making:** Accounting records and financial statements provide financial information which help the business in making rational decisions about the steps to be taken in respect of various aspects of business.
7. **To satisfy the requirements of law:** Entities such as companies, societies, public trusts are compulsorily required to maintain accounts as per the law governing their operations such as the Companies Act, Societies Act, and Public Trust Act etc. Maintenance of accounts is also compulsory under the Sales Tax Act and Income Tax Act.

➢ Scope of Accounting:

The above definitions clearly bring out the scope of accounting. This can now be outlined as follows :

1. Accounting is concerned with financial transactions and events which bring about a change in the resources (or wealth) position of the business firm. Such transactions have to be **identified** first, as and when they occur. It is not difficult because. there will be proof in the form of a bill or receipt (called vouchers). With the help of these bills and receipts identification of a transaction is easy. For example, when you purchase something you get a bill, when you make payment you get a receipt.

2. These transactions are to be **measured** or expressed in terms of money, if not done already. Generally, this problem will not arise, because the statement of proof expresses the transaction in terms of money. For example, if ten books are purchased at the rate of Rs. **20** each, then the bill is prepared for Rs. **200.** But, if an event cannot be expressed in monetary terms, it will not come under the scope of accounting.

3. The transactions which are identified and measured are to be **recorded** in a book called journal or in one of its sub-divisions.

4. The recorded transactions are to be **classified** with a view to group transactions of similar nature at one place. The work of classification is done in a separate book called ledger. In the ledger, a separate account is opened for each item so

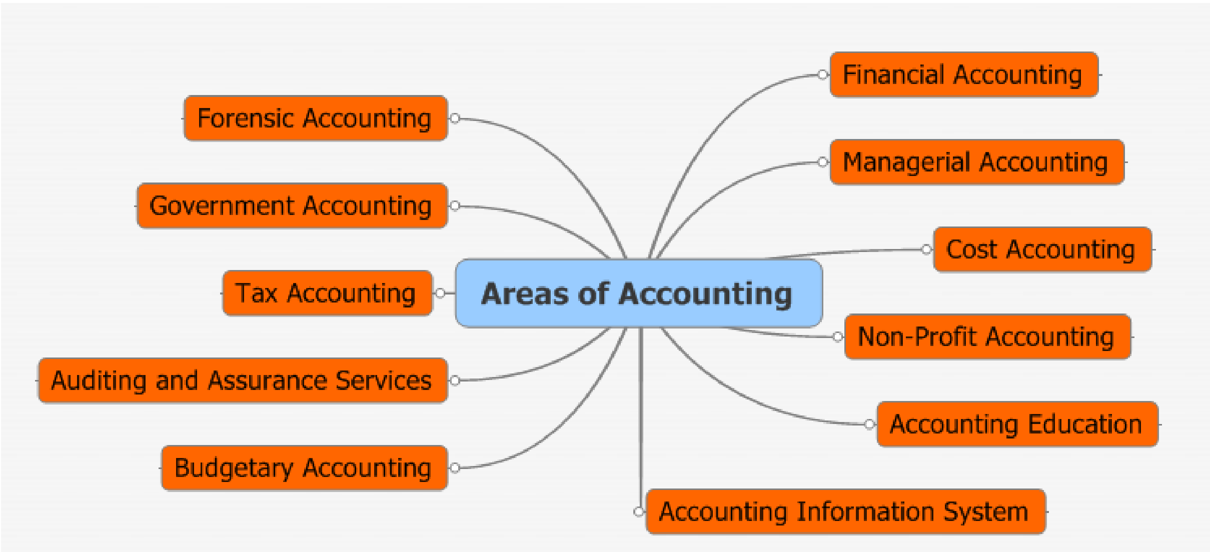
that all transactions relating to it can be brought to one place. For example, all payments of salaries are brought to salaries account.

5. The recording and classification of many transactions will result in a mass of financial data. It is, therefore, necessary to **summarise** such data periodically (at least once a year) in a significant and meaningful form. The summarization is done in the form of profit and loss account which reveals the profit made or loss incurred, and the balance sheet which reveals the financial position.

6. The summary results will have to be **analysed, interpreted** (critically explained) and **communicated** to interested parties. Accounting information is generally communicated in the form of a 'report'. Big organisations generally present printed reports, called published accounts.

➢ Areas of Accounting

Commonly, accounting is misinterpreted and perceived to only be about recording of business transactions, also known as bookkeeping. However, accounting is beyond recording or bookkeeping and it's a diversified profession. It has many areas and specialized fields which are all useful in catering the needs of a business or non-profit organizations. Bookkeeping, or the process of recording business transactions, is only one of the areas of accounting. In fact, it is the less complex and most basic subject of accounting.



1. Financial Accounting

Financial accounting is an area of accounting that deals with the recording, classifying, reporting and interpreting of a business financial performance and economic conditions to interested users or stakeholders. The primary purpose of financial accounting is to provide a report in the economic performance and condition of an entity for use of stakeholders.
Example of activities and tasks in financial accounting includes bookkeeping and preparation of reports called financial statements.

2. Managerial Accounting

Managerial Accounting is an area of accounting that deals with accumulation of financial information and preparation of reports for internal users only, like the company's management or executives. Reports prepared and submitted may vary on a weekly, monthly, quarterly and yearly basis depending on the needs and desire of the internal users. These reports are usually confidential and exclusively used for internal purposes and decision making. Different to financial accounting, wherein the basis of reporting is historical cost, in managerial accounting the basis of reporting is future and forecasting value.

Example of tasks and reports includes sales forecasting reports, budget and comparative analysis, merger and consolidation reports, etc.

3. Cost Accounting

Cost Accounting is an area of accounting that captures and accumulates manufacturing or production costs for internal use of an entity's management, used in decision making purpose. The reports prepared in cost accounting are helpful tools for management use in budgeting, product costing or pricing, which can improve the future net margins or profits of the business.

Example of cost accounting reports and tasks includes marginal costing, cost-volume-profit analysis, activity-based accounting, standard cost accounting, lean accounting, etc.

4. Budgetary Accounting

Budgetary Accounting is an area of accounting that deals in setting up a tool or control device to help management measure performance against its approved budget or plan. Its primary purpose is to control expenditures of the business or organization. Unlike financial accounting which is based on historical cost, budget accounting looks forward with future values, similar to managerial accounting. It measures the cost of planned acquisitions and the use of economic resources in the future.

5. Auditing and Assurance Services

Auditing and Assurance Services is an area of accounting that deals with providing independent opinion on the completeness and fairness of the financial statements of a business or organization. Also, it involves testing the internal controls of the business or organization's accounting system.

Auditing and assurance services is an independent professional service with the goal to improve the financial information, being reported to internal or external users, in order to make a better and risk-free decision making. An example of assurance services includes internal and external auditing.

6. Tax Accounting

Tax Accounting is an area of accounting that provides the preparation and filing of required tax returns of a business or organization imposed by local, state and federal government. It also includes understanding of tax amendments and determination of tax consequences of business decisions or future plans. Tax rules and regulations are governed by the specific country's Internal Revenue.

7. Government Accounting

Government Accounting is an area of accounting that focuses on the accounting development and communication of government agencies financial affairs. It uses an accounting system based on fund accounting system. It has a separate set of accounts used for managing resources or funds that are assigned to specific government unit for specific purposes based on regulations and limitations.

Government accounting is different on financial accounting because it focuses on measuring inflow and outflow of government financial resources rather than measuring the economic activities. It also has different way of measuring financial performance because it records revenue when there's cash available to pay liabilities while records expense when funds are drained.

8. Non-Profit Accounting

Non-Profit Accounting is an area of accounting with primary purpose of recording and reporting financial information of a business or organization formed for other purposes other than profit. Similar to government accounting, its accounting system is based on fund accounting. Example of Not for Profit Organization are cooperatives, charities, medical institutes, non-profit hospitals, etc.

9. Forensic Accounting

Forensic Accounting is an area of accounting which provides accounting and auditing analysis used in litigation or public dispute in suitable courts. It's a specialized field of accounting which includes an understanding of business information and financial reporting systems, accounting and auditing standards and procedures, evidence gathering and investigative techniques, and litigation processes and procedures.

10. International Accounting

International Accounting is an area of accounting that focuses on the accounting issues related to international business activities and foreign operations. It is concerned on accounting international trade and multinational companies. It includes matters such as accounting principles and reporting practices in different countries, patterns of accounting development based on international and regional accounting regulations, foreign currency translation, foreign exchange risk, performance evaluation of foreign subsidiaries, and many more.

11. Accounting Information System

Accounting Information System is an area of accounting which deals in the collection, analysis, design and implementation of accounting and management information system. It is generally a computer-based method for recording accounting information's using information technology resources. Once in place, the main purpose of accounting information system is to collect, store and process financial and accounting information to be used by internal and external users in decision making.

12. Inflation Accounting

Adjusting financial statements show a firm's real financial position in inflationary imes. It aims to indicate how rising prices and lower purchasing power of the currency affect a firm's cost of refinancing its productive assets, and of its ability to maintain an adequate level of profit on the capital employed. One method is to adjust every figure in the balance sheet on the basis of a price index (such as consumer price index) which reflects the current purchasing power of the currency. Another method suggests revaluing tangible assets at their replacement cost. In valuation of an inventory, inflation accounting treatment can affect the firm's taxable income, cash position, and reported earnings, depending on whether the firm uses FIFO or LIFO methods. FIFO method shows a higher profit, therefore higher tax burden and a decrease in net cash flow. LIFO method lowers the profit and tax burden and increases the net cash flow.

13. Environment Management Accounting:

There is growing awareness and concern on the impact of human activity on the ecosystem. This concern at global level about the impact of the human activities on the environment.

The environmental accounting at the corporate level helps the management to know whether corporate has been discharging its responsibilities towards sustainable development while meeting business objectives. Environmental accounting addresses the following:

- Meeting regulatory requirements
- Operate its factory in a way that environmental damages do not occur
- Promote a culture and attitude of environmentally safe working amongst its employees
- Disclosure to shareholders the amount and nature of the preventative measures taken by the management
- Ensures safe handling and disposal of hazardous waste

14. Accounting Education

Accounting Education is an area of accounting that deals with upgrading, researching and teaching accounting knowledge to students, aspiring accountants or accounting professionals seeking continuous education and updates.

➢ Business Transactions:

Business transactions are recorded in the books of account. A transaction is an exchange of money, goods and services between two persons. Exchange means to give and take such things which have equal value. Many transactions takes place in a day but only economic transactions are recorded , while non-economic transaction are not recorded in the books of accounts.

Types of Transactions

Economic Transaction

Non-Economic Transaction

Exchange of goods

(1)Assets

(2)Services

Exchange of cash for

(1)Goods

(2)Services

(3)Assets

(4)Debts

Exchange of Debts for

(1) Debt

Economic Transaction:

Those transactions in which money is exchanged or such things or services are exchanged which can be measured in terms of money are called economic transactions. They are recorded in the books of account of business.

(1) **Exchange of goods for Assets** :
In such type of transaction, we get an assets and give goods against it or we may give an assets and receive goods for it. For e.g we purchased a machine worth Rs. 2500 and in exchange give goods of equal amount.

(2) **Exchange of goods for Services** :
In such type of transaction, goods are given for services rendered to the business. For e.g. if an employee’s salary is Rs. 3000 p.m and we give him cloth produced in factory for his salary.

(3) **Exchange of cash for goods** :
In such a transaction , we receive or give goods against cash For e.g sold cloth 20 meteres for cash Rs. 600.

(4) **Exchange of cash for Services** :
In some transactions, we avail of service some person and give cash for it. For e.g paid Rs. 4000 for Lawyer fees.

(5) **Exchange of cash for Assets** :
When we pay cash for purchasing some asset for business, cash goes out and an assets comes into the business for e.g purchased furniture of Rs. 6000 for cash.

(6) **Exchange of cash for Debts** :
In business, we may receive cash for debts owed to us by a customer or we may pay cash for debts which we owe to some creditor. For e.g Paid Rs. 750 to Praful for amount due to him.

(7) **Exchange of a debt for a debt** :
There are a few transactions in which one debt exchange for another debt. For e.g if Suresh owes us Rs. 1000 and if we owe Rs. 1000 to Naresh , then we may ask Naresh to recover Rs. 1000 from Suresh.

Non-Economic Transaction:

Those transaction in which money is not exchanged or there is an exchange of such things which cannot be measured in money, are called non-economic transactions. They are not recorded in the books of account of business. For example : Gift from friend on Inauguration of Shop, Order placed for 1000 chairs etc.

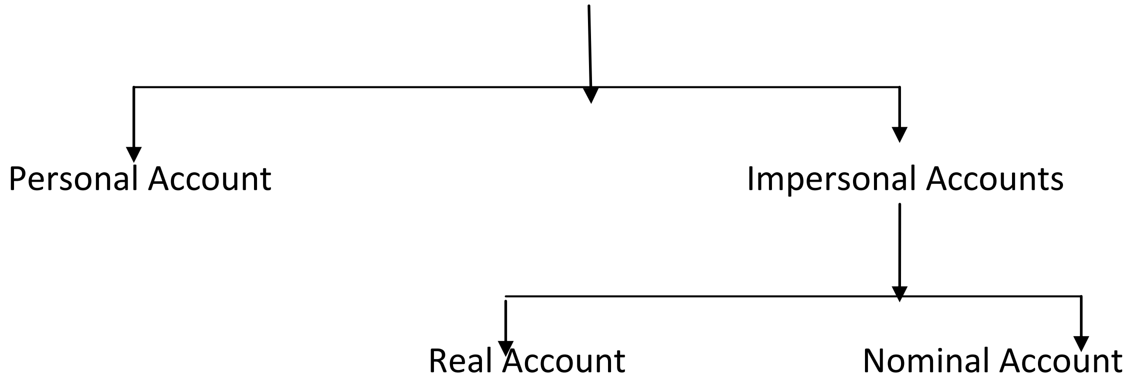
Another classification are as follows :

(i) Cash transaction
(ii) Credit transaction

1) Cash Transaction : A transaction in which there is a receipt or payment of cash is a cash transaction. Cash balance is affected by such a transaction. For e.g Paid salary Rs. 3,000 is a cash transaction as cash balance is reduced. If bank balance is affected due to some transaction, then also is considered as a cash transaction. For e.g A cheque of Rs. 1000 received from the customer is paid into the bank. This is a cash transaction because bank balance increases.

2) Credit Transaction: In Credit Transaction, there is no receipt or payment of cash immediately, but it is postponed to some future date. It is a transaction in which no cash is exchanged. For e.g Goods of Rs. 4000 purchased on credit from XYZ stores. Is a credit transaction.

- **Classification (Types) of Accounts :**



Personal Accounts: Accounts recording transactions with a person or group of persons are known as personal accounts. These accounts are necessary, in particular, to record credit transactions. Personal accounts are of the following types:

(a) Natural persons: An account recording transactions with an individual human being is termed as a natural persons' personal account. eg., Kamal's account, Mala's account, Sharma's accounts. Both males and females are included in it

(b) Artificial or legal persons: An account recording financial transactions with an artificial person created by law or otherwise is termed as an artificial person, personal account, e.g. Firms' accounts, limited companies' accounts, educational institutions' accounts, Co-operative society account.

(c) Groups/Representative personal Accounts: An account indirectly representing a person or persons is known as representative personal account. When accounts are of a similar nature and their number is large, it is better tot group them under one head and open representative personal accounts

When a person starts a business, he is known as proprietor. This proprietor is represented by capital account for all that he invests in business and by drawings accounts for all that which he withdraws from business. So, capital accounts and drawings account are also personal accounts.

Following are characteristics of Personal Account

- Living individuals are of Personal Account
- Partnership Firm/Co/Club/Co-op society etc.
- Exist in the eye of Law
- Who can file a sue or can be sued
- Who can buy & sell asset
- Debtors & creditors

Following are the few example of Personal Account

- Shantibhai's Account
- Anand Municipal Corporation Account
- Shreeji Stores Account
- G.E.B.
- Life Insurance Co.
- Arpit Co. Ltd.
- Bank of Baroda Account
- Capital Account (related to owner)
- Drawing Account (related to owner)
- S.P.University Account

Real Accounts: Accounts relating to goods and other property are known as real account. If the dealer of furniture purchases the furniture it is recorded in Goods Account. Business divides goods account into Purchase Account, Sales Account, Goods Return Account etc.

Real account can be grouped into two parts:

1. Accounts relating to Goods

- Sales Account
- Purchase Account
- Sales Return Account
- Purchase Return Account
- Goods burnt by Fire Account
- Goods Distributed as Samples Account
- Goods Stolen Account
- Goods withdrawn for personal use Account

2. Accounts relating to Assets

- Accounts relating to fixed assets like Machine Account, Furniture Account etc.
- Accounts relating to Current Assets like cash Account, Bills receivables etc.
- Accounts relating to loan & advances
- Investment Accounts

Nominal Accounts: Accounts relating to income, revenue, gain expenses and losses are termed as nominal accounts. These accounts are also known as fictitious accounts as they do not represent any tangible asset.

Income Accounts like,

- Rent received Account
- Interest Account
- Dividend Received Account

Expense Accounts like,

- Salary Account
- Wages Account
- Rent Account
- Commission Account
- Postage & Telegram Account
- Depreciation Account
- Insurance Premium Account
- Advertisement Account
- Carriage Account
- Railway Freight Account
- Customs & Octroi Account
- Repairs Accounts
- Factory Power Account
- Office Electricity Account
- Printing & Stationary Account
- Bad Debts Accounts
- Discount Allowed Accounts
- Salesman's Salary Account
- Commission Account

➢ Rules for Debit (Dr.) & Credit (Cr.) :

Rule for Personal Accounts

Dr. the Receiver
Cr. the Giver

Example : Heena Paid Rs. 500 to Meena

Meena's Account Dr.		500
To Heena's Account	500	

Rule for Nominal Accounts

Dr. all Expenses / Losses
Cr. all Income/Gains
Example : Paid Salary of Rs. 800

Salary Account Dr. 800
To Cash Account 800

Rule for Real Accounts

Dr. What comes in
Cr. What goes out

Example : Rs. 3000 paid to vanita in cash

Vanita Account Dr. 3000
To Cash Account 3000

➢ Difference Between Capital and Revenue Expenditures:

Capital Expenditures		Revenue Expenditures	
1	Its effect is long term i.e., it is not exhausted within the current account year. Its benefit is enjoyed in future year or years also. In a word, its effect is reduces gradually.	1	Its effect is temporary, i.e., it is exhausted within the current accounting year.
2	An asset is acquired or the value of an asset is increased as a result of this expenditure.	2	Neither an asset is acquired nor is the value of an asset increased.
3	It does not occur again and again - it is non-recurring and irregular.	3	It occurs repeatedly - It is recurring and regular.
4	Generally, it has physical existence i.e., it can be seen with eyes.	4	It has no physical existence, i.e., it cannot be seen with eyes.
5	This expenditure improves the position of the concern	5	This expenditure helps to maintain the concern
6	A portion of this expenditure is shown in the trading and profit and loss account or income and expenditure account as	6	The whole amount of this expenditure is shown in trading and profit and loss account or income and expense account. But deferred

	depreciation.		revenue expenditures and prepaid expenses are not shown.
7	It appears in balance sheet until its benefit is fully exhausted.	7	It does not appear in balance sheet. Deferred revenue expenditure, outstanding expenditure, outstanding expenses and prepaid expenses, however, temporarily shown in the balance sheet.
8	It does not reduce the revenue of the concern. Purchase of fixed assets does not affect revenue. Example : Purchase of Machinery	8	It reduces revenue. Payment of salaries to employees decreases Example : Maintenance of Machinery

➢ Difference between Capital Income and Revenue Income :

<u>Capital Income</u>

The term "Capital Income" means an income which does not grow out or pertain to the running of the business proper.

Example :

Cost of the Building – 1,00,000/-
Selling Price of the Building – 1,50,000/-
Capital Profit = 50,000/-

<u>Revenue Income</u>

"Revenue Income means an income which arises out of and in the course of regular business transactions of a concern".

Example

The profit made on sale of goods, income received from letting out of business property, dividends received. All such incomes are revenue incomes. From Accounting angle Revenue Profit &Revenue Income gets the same treatment

Revenue Profit

"The profit realised over and above the book value of the asset till it does not exceed the original cost of the asset should be taken as revenue profit".

Example:
Cost Price of Plant = 1,00,000/-
Book Price of Plant (After Depreciation)= 70,000/-
Selling Price = 1,20,000/-
Profit = 1,20,000 – 70,000 = 50,000/-
So here Profit has two components namely
Capital Profit + Revenue Profit = 20,000 + 30,000

- **Basic Accounting Terms :**

1) Assets : Assets are all those things or rights which are owned by business and have monetary value. They are properties which help to run the business. They include amounts due to business from others e.g. cash, machinery, stock, furniture, debtors etc are all assets. Business liabilities can be paid with the help of assets.

Assets are of two types : 1) Fixed Assets are those which are not purchased for resale, which help running of the business and whose benefit is available for long time e.g. building, machinery, furniture etc. 2) Current Assets are those assets which are constantly converted into cash or other assets and whose values go on changing everyday e.g stock, debtor, cash etc.

Assets can also, be classified as : 1) Tangible Assets are those which have physical existence i.e. which can be seen and touched e.g machinery, stock etc. 2) Intangible assets have no physical existence i.e they cannot be seen or touched but they have monetary value e.g goodwill, patents, copyrights etc.

There are Fictitious Assets also. It is items grouped under assets in a balance sheet which has no real value e.g debit balance of the profit and loss statement. For e.g preliminary expenses, advertisement campaign expenses, development expenses etc.

The assets which are constantly converted into cash or which is in the form of cash are called liquid Assets e.g stock, debtors, cash, bank balance etc.

Those assets which go on reducing due to use are called Wasting Assets e.g coal mine, oil fields etc.

2) Liabilities: In financial accounting, a **liability** is defined as an *obligation* of an entity arising from *past* transactions or events, the settlement of which may result in the transfer or use of assets, provision of services or other yielding of economic benefits in the future. A liability is defined by the following characteristics:

- Any type of borrowing from persons or banks for improving a business or personal income that is payable during short or long time;
- A duty or responsibility to others that entails settlement by future transfer or use of assets, provision of services, or other transaction yielding an economic benefit, at a specified or determinable date, on occurrence of a specified event, or on demand;
- A duty or responsibility that obligates the entity to another, leaving it little or no discretion to avoid settlement; and,
- A transaction or event obligating the entity that has already occurred.

Liabilities in financial accounting need not be legally enforceable; but can be based on equitable obligations or constructive obligations. An **equitable obligation** is a duty based on ethical or moral considerations. A **constructive obligation** is an obligation that is implied by a set of circumstances in a particular situation, as opposed to a contractually based obligation.

$$Assets = Liabilities + Owner'sEquity$$

- ***Long term liabilities*** are those that are usually payable after a period of one year, for example, a term loan from financial institution or debentures (bonds) issued by the company.
- ***Short term liabilities*** are obligations that are payable within a period of one year, for example, creditors (accounts payable), bills payable (notes payable), cash credit overdraft from a bank for a short period.

3) Capital : The amount invested by the proprietor in a business is called Capital. The owner of the business may bring not only cash but some other assets also by way of capital then then they are all a part of capital.

In financial accounting, the **capital account** is one of the accounts in shareholders' equity. Sole proprietorships have a single capital account in the owner's equity. Partnerships maintain a capital account for each of the partners. Joint Stock Company have Capital in form of Share Capital.

4) Expenses : It is the money spent in conducting the business. It is paid for some services rendered by others. There are two types of expenses : 1) Revenue expenses 2) Capital Expenses. Revenue Expenses are the expenses incurred from day today running the business. E.g salary, rent, insurance premium etc. Some expenses which are spent for acquiring assets or for installing assets are also called Capital Expenditure.

Expenses are relates to

1. Purchase of goods or relating to production of goods in the factory like railway freight, octroi, carriage etc.
2. Some of the expense relate to the Office & Administrative like salary, printing & postage etc.
3. Some expense relate to Selling & Distribution of goods like advertisement, discount allowed etc.
4. Some Expense are financial expense like interest on loan, bank charges etc.

5) Expenditure: Incurring a liability, disbursement of cash or transfer of property for the purpose of obtaining assets, goods or services.

Expenditure is a payment or disbursement. The expenditure may be for the purchase of an asset, a reduction of a liability, a distribution to the owners, or it could be an expense. For instance, expenditure to eliminate a liability is not an expense, while expenditures for advertising, salaries, etc. will likely be recorded immediately as expenses.

Here’s another example to illustrate the difference between an expense and expenditure. A company makes an *expenditure* of Rs.255,000 to purchase equipment. The expenditure occurs on a single day and the equipment is placed in service. Assuming the equipment will be used for seven years, the cost of the equipment will be reported as depreciation *expense* of Rs. 100 per day for the next 2,555 days (7 years of service with 365 days each year).

Expenditure is of long term in nature. Therefore, its benefit is to be derived in future. *For example*: capital expenditure.

6) Debtors: A debtor is an entity that owes a debt to another entity. The entity may be an individual, a firm, a government, a company or other legal person. If goods sold to a person on credit, or if we have rendered services to a person for whom he has not made payment or if we have lent money to a person, such person is called a 'Debtor'. That is if a person has received benefit from the business and has not given anything in return, he becomes a debtor. For e.g if we sell goods worth Rs 2,000 to A or We give loan of Rs 2000 to A then A become debtor.

7) Creditors: An entity (person or institution) that extends credit by giving another entity permission to borrow money if it is paid back at a later date. Creditors can be classified as either "personal" or "real." Those people who loan money to friends or family are personal creditors. Real creditors (i.e. a bank or finance company) have legal contracts with the borrower granting the lender the right to claim any of the debtor's real assets (e.g. real estate) if he or she fails to pay back the loan. A creditor is a person to whom debt is owed by business. He is a person to whom we have to pay money because we purchased goods from him on credit or he gave us services or we have borrowed money from him. It is a liability or debt of business to be paid in future. For e.g if we have purchased goods of Rs.2000 from B or if we take loan from B then B is our creditor.

8) Goods: The word 'goods' is used for those articles in which the business deals. For e.g cloth is goods for a cloth merchant. Furniture is goods for a dealer in furniture because he makes profit out of purchase and sale of furniture.

9) Cost: Cost is the amount of money that must be paid to take ownership of something; expense or purchase price. Cost is the monetary amount that needs to be paid to acquire something. In Business the cost may be one of acquisition, in which case the amount of money expended to acquire it is

counted as cost. In this case, money is the input that is gone in order to acquire the thing. This acquisition cost may be the sum of the cost of production as incurred by the original producer, and further costs of transaction as incurred by the acquirer over and above the price paid to the producer. Usually, the price also includes a mark-up for profit over the cost of production.

10) Gain: A monetary benefit, profit or advantage resulting from a transaction or group of transactions. In accounting, a gain is a change in the value of an asset (increase) or liability (decrease) resulting from something other than the earnings process. While gains are often associated with investments, derivatives and other financial instruments, they can also result from something as simple as selling a production asset (such as a machine) for more than its net book (accounting) value.

The difference between gains and profits lies in the intent to earn a profit. Thus, revenues result from the intentional producing and delivering of goods and/or rendering services, while gains can result from external factors such as the change in a stock's market price, a gift or a chance discovery.

Gain is the change in the equity (net worth) arising from change in the form and place of goods and holding of assets over a period of time whether realized or unrealized. It may either be of capital nature or revenue nature or both.

11) Stock : In accounting there are two common uses of the term *stock*. One meaning of stock refers to the goods on hand which is to be sold to customers. In that situation, stock means inventory. Stock (inventory) is a measure of something on hand-goods, spares and other items-in a business. It is called stock on hand.

In a trading concern, the stock on hand is the amount of goods which have not been sold on the date on which the balance sheet is prepared. This is also called closing stock (ending inventory). In a manufacturing company, closing stock comprises raw materials, semi-finished goods and finished goods on hand on the closing date.

Similarly, opening stock (beginning inventory) is the amount of stock at the beginning of the accounting year. Stock which is under process known as work-in-process.

12) Purchase : Purchases are all the goods procured by a business on credit and for cash, for use or resale. In a trading concern, purchases are made of merchandise for resale with or without processing. In a manufacturing concern, raw materials are purchased, processed further into finished goods and then sold. Purchases may be cash purchases or credit purchases.

13) Sales : Sales is the money generated by selling the goods of the company.

When an organization makes sale of goods then it is directly termed as sales. **Net sales** are operating revenues earned by a company for selling its products or rendering its services.

A sale requires the following elements to be valid:

- Competence of both the buyer and the seller to enter into a contract
- Something that is capable of being transferred (a good, an ownership title, entitlement to a certain service, etc)
- Mutual agreement on the terms of exchange
- Consideration in money (or its equivalent in value) paid or promised

14) Loss : Loss is when expenses exceed sales or revenue.

Loss is the gross decreases in the assets or gross increases in the liabilities. It is the excess of expenses over revenues. It represents reduction in owners' equity due to inability of the firm to recover the assets used in the business.

Losses can result from a number of activities such as; sale of an asset for less than its carrying amount, the write-down of assets, or a loss from lawsuits.

Also, loss occurs when any cost that not produce any benefit, Decrease in value, excess of cost over the net proceeds from a transaction.

For example, a firm spends Rs. 70,000 and generates revenue of Rs. 60,000, there is a loss of Rs. 10,000 which represents non-recovery of assets consumed in doing business.

15) Profit : Profit is excess of revenues over outlays in a given period of time. Profit is the excess of revenues over expenses during an accounting year. It increases the owner's equity. There are Gross profit, Operating Profit & Net Profit can be calculated for different purpose.

16) Voucher :The papers or documents supporting the transaction and establishing its validity are known as 'Vouchers'.

A voucher is an accounting document representing an *internal intent* to make a payment to an *external entity*, such as a vendor or service provider. A voucher is produced usually after receiving a vendor invoice, after the invoice is successfully matched to a purchase order. A voucher will contain detailed information regarding the payee, the monetary amount of the payment, a description of the transaction, and more. The Accounting Voucher is unique in that it brings to the producer the ability to design transactions and the Material Balance Report

17) Discount : If the businessman agrees to receive some amount less than the printed price or the amount shown in the invoice, the difference is called discount. There are two types of discount : 1) Trade discount 2) Cash discount

When a producer or a wholesaler allows some deduction on the catalogue price to the retailer, it is called trade discount.

Cash discount is an allowance made by the receiver of cash to the payer for making prompt payment. Cash discount is always recorded in the books of accounts while trade discount is not recorded.

18) Transaction : A transaction is an exchange of goods, services and cash between persons. It is an event and it gives rise to an entry to be made in the books of account. There are two types transactions : economic and non-economic transactions. Only economic transactions are recorded in the books of accounts.

19) Drawing : Drawing is the total amount withdrawn by the proprietor from his business for incurring his personal expenses.

A drawing account is helpful to business owners in tracking their businesses separately from their personal finances. It is particularly relevant in partnerships, where partners may wish to monitor withdrawals to ensure that a partner is not taking too much money out of the business. A drawing account is closed to the owners' equity account each year, and is not recorded as a business expense.

20) Depreciation : The gradual conversion of the cost of a tangible capital asset or fixed asset into an operational expense (called depreciation expense) over the asset's estimated useful life.

The objectives of computing depreciation are to (1) reflect reduction in the book value of the asset due to obsolescence or wear and tear, (2) spread a large expenditure (purchase price of the asset) proportionately over a fixed period to match revenue received from it, and (3) reduce the taxable income by charging the amount of depreciation against the company's total income.

In effect, charging of depreciation means the recovery of invested capital, by gradual sale of the asset over the years during which output or services are received from it. Depreciation is computed at the end of an accounting period (usually a year), using a method best suited to the particular asset. When applied to intangible assets, the preferred term is amortization.

21) Reserves : The portion of earnings , receipts or other surplus of a firm appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability. The reserves are primarily of two types : Capital Reserves and Revenue Reserves. These can be profits made by the business sometimes referred to as retained earnings and capital reserves which represent a perceived increase the value of some fixed assets such as land or buildings.

Reserves are any part of stockholders' equity, except for basic share capital. Reserves are amounts that are retained in the business and not distributed to the owners.

22) Provisions : Provision is that action of business in which business organisation reserves his money for future losses for safeguarding business ." Part of profit or money which we receive from sale or from debtors because money of sale , money of debtor and even money of other fixed asset which is saved and reserve for fulfilling losses due to bad debts , depreciation , income tax and other losses which we can not forecast . But for any loss we make different provision accounts like provision for doubtful debts , provision for depreciation , provision for income tax .

- **Difference between Cash Transaction and Credit Transaction :**

1) **In Cash Transaction, generally cash or cheque is exchanged, while in credit transaction there is no such exchange .**
2) **Cash transaction are recorded in cash book while credit transaction are recorded in sales or purchase book.**
3) **In cash transaction, there is mention of cash or both cash and the name of the person or no mention of cash or person while in credit transaction there is name of person involved is stated and there is no mention of cash or cheque.**
4) **In Cash transaction, One of the two accounts involved is always cash or bank account while in credit transaction one of the two accounts involved is always a personal account.**
5) **No debt is created in cash transaction while in credit transaction it created debt payable or receivable.**

1.5 Meaning of Debit and Credit

The term 'debit' is supposed to have derived from 'debit' and the term 'credit' from 'creditable'. For convenience 'Dr' is used for debit and 'Cr' is used for credit. Recording of transactions require a thorough understanding of the rules of debit and credit relating to accounts. Both debit and credit may represent either increase or decrease, depending upon the nature of account.

MEANING AND DEFINITION OF BOOK- KEEPING

1.2.1 Meaning

Book- keeping includes recording of journal, posting in ledgers and balancing of accounts. All the records before the preparation of trail balance is the whole subject matter of book- keeping. Thus, book- keeping many be defined as the science and art of recording transactions in money or money's worth so accurately and systematically, in a certain set of books, regularly that the true state of businessman's affairs can be correctly ascertained. Here it is important to note that only those transactions related to business are recorded which can be expressed in terms of money.

1.2.2 Definition

"Book- keeping is the art of recording business transactions in a systematic manner". A.H.Rosenkamph.

"Book- keeping is the science and art of correctly recording in books of account all those business transactions that result in the transfer of money or money's worth". R.N.Carter

1.2.3 Objectives of Book- keeping

i) Book- keeping provides a permanent record of each transactions.

ii) Soundness of a firm can be assessed from the records of assets and abilities on a particular date.

iii) Entries related to incomes and expenditures of a concern facilitate to know the profit and loss for a given period.

iv) It enables to prepare a list of customers and suppliers to ascertain the amount to be received or paid.

v) It is a method gives opportunities to review the business policies in the light of the past records.

vi) Amendment of business laws, provision of licenses, assessment of taxes etc., are based on records.

- **Methods of Accounting**

Business transactions are recorded in two different ways.

1.4.1 Single Entry

1.4.2 Double Entry

1.4.1. Single Entry: It is incomplete system of recording business transactions. The business organization maintains only cash book and personal accounts of debtors and creditors. So the complete recording of transactions cannot be made and trail balance cannot be prepared.

1.4.2 Double Entry: It this system every business transaction is having a two fold effect of benefits giving and benefit receiving aspects. The recording is made on the basis of both these aspects. Double Entry is an accounting system that records the effects of transactions and other events in atleast two accounts with equal debits and credits.

1.4.3 Steps involved in Double entry system

(a) Preparation of Journal: Journal is called the book of original entry. It records the effect of all transactions for the first time. Here the job of recording takes place.

(b) Preparation of Ledger: Ledger is the collection of all accounts used by a business. Here the grouping of accounts is performed. Journal is posted to ledger.

(c) Trial Balance preparation: Summarizing. It is a summary of ledge balances prepared in the form of a list.

(d) Preparation of Final Account: At the end of the accounting period to know the achievements of the organization and its financial state of affairs, the final accounts are prepared.

1.4.4 Advantages of Double Entry System

i) Scientific system: This system is the only scientific system of recording business transactions in a set of accounting records. It helps to attain the objectives of accounting.

ii) Complete record of transactions: This system maintains a complete record of all business transactions.
iii) A check on the accuracy of accounts: By use of this system the accuracy of accounting book can be established through the device called a Trail balance.
iv) Ascertainment of profit or loss: The profit earned or loss suffered during a period can be ascertained together with details by the preparation of Profit and Loss Account.
v) Knowledge of the financial position of the business: The financial position of the firm can be ascertained at the end of each period, through the preparation of balance sheet.
vi) Full details for purposes of control: This system permits accounts to be prepared or kept in as much detail as necessary and, therefore, affords significant information for purposes of control etc.
vii) Comparative study is possible: Results of one year may be compared with those of the precious year and reasons for the change may be ascertained.
viii) Helps management in decision making: The management may be also to obtain good information for its work, specially for making decisions.
ix) No scope for fraud: The firm is saved from frauds and misappropriations since full information about all assets and liabilities will be available.

Importance of Accounting

i) Owners: The owners provide funds or capital for the organization. They possess curiosity in knowing whether the business is being conducted on sound lines

- or not and whether the capital is being employed properly or not. Owners, being
- businessmen, always keep an eye on the returns from the investment. Comparing the
- accounts of various years helps in getting good pieces of information.
- **ii) Management:** The management of the business is greatly interested in
- knowing the position of the firm. The accounts are the basis, the management can
- study the merits and demerits of the business activity. Thus, the management is
- interested in financial accounting to find whether the business carried on is profitable
- or not. The financial accounting is the "eyes and ears of management and facilitates
- in drawing future course of action, further expansion etc."
- **iii) Creditors:** Creditors are the persons who supply goods on credit, or
- bankers or lenders of money. It is usual that these groups are interested to know the
- financial soundness before granting credit. The progress and prosperity of the firm,
- two which credits are extended, are largely watched by creditors from the point of

- view of security and further credit. Profit and Loss Account and Balance Sheet are
- nerve centres to know the soundness of the firm.
- **iv) Employees:** Payment of bonus depends upon the size of profit earned by
- the firm. The more important point is that the workers expect regular income for the
- bread. The demand for wage rise, bonus, better working conditions etc. depend upon
- the profitability of the firm and in turn depends upon financial position. For these
- reasons, this group is interested in accounting.
- **v) Investors:** The prospective investors, who want to invest their money in a
- firm, of course wish to see the progress and prosperity of the firm, before investing
- their amount, by going through the financial statements of the firm. This is to
- safeguard the investment. For this, this group is eager to go through the accounting
- which enables them to know the safety of investment.
- **vi) Government:** Government keeps a close watch on the firms which yield
- good amount of profits. The state and central Governments are interested in the
- financial statements to know the earnings for the purpose of taxation. To compile
- national accounting is essential.
- **vii) Consumers:** These groups are interested in getting the goods at reduced
- price. Therefore, they wish to know the establishment of a proper accounting control,
-
- which in turn will reduce to cost of production, in turn less price to be paid by the
- consumers. Researchers are also interested in accounting for interpretation.
- **viii) Research Scholars:** Accounting information, being a mirror of the
- financial performance of a business organization, is of immense value to the research
- scholar who wants to make a study into the financial operations of a particular firm.
- To make a study into the financial operations of a particular firm, the research scholar
- needs detailed accounting information relating to purchases, sales, expenses, cost of
- materials used, current assets, current liabilities, fixed assets, long-term liabilities and
- share-holders funds which is available in the accounting record maintained by the

- firm.
-
- **Objectives of Accounting:**

Objective of accounting may differ from business to business depending upon their specific requirements. However, the following are the general objectives of accounting.

i) To keeping systematic record: It is very difficult to remember all the business transactions that take place. Accounting serves this purpose of record keeping by promptly recording all the business transactions in the books of account.

ii) To ascertain the results of the operation: Accounting helps in ascertaining result i.e., profit earned or loss suffered in business during a particular period. For this purpose, a business entity prepares either a Trading and Profit and Loss account or an Income and Expenditure account which shows the profit or loss of the business by matching the items of revenue and expenditure of the some period.

iii) To ascertain the financial position of the business: In addition to profit, a businessman must know his financial position i.e., availability of cash, position of assets and liabilities etc. This helps the businessman to know his financial strength. Financial statements are barometers of health of a business entity.

iv) To portray the liquidity position: Financial reporting should provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, cash dividends and other distributions of resources by the enterprise to owners and about other factors that may affect an enterprise's liquidity and solvency.

v) To protect business properties: Accounting provides upto date information about the various assets that the firm possesses and the liabilities the firm owes, so that nobody can claim a payment which is not due to him.

vi) To facilitate rational decision – making: Accounting records and financial statements provide financial information which help the business in making rational decisions about the steps to be taken in respect of various aspects of business.

vii) To satisfy the requirements of law: Entities such as companies, societies, public trusts are compulsorily required to maintain accounts as per the law governing their operations such as the Companies Act, Societies Act, and Public Trust Act etc. Maintenance of accounts is also compulsory under the Sales Tax Act and Income Tax Act.

ADVANTAGES OF ACCOUNTING

The following are the advantages of a properly maintained accounting system.

1 **Replaces memory:** Since all the financial events are recorded in the books, there is no need
to rely on memory The **books** of account will serve as historical records. Any information
required at any time **can** be had from these records.
2 Provides control over assets: Accounting provides information regarding balance of cash
in hand and at bank. the stock of goods on hand, the amount receivable from various parties,
the amount invested in various other assets, etc. Information about these matters help owner(s)
and management to make use of the assets in the best possible way.
3 Facilitates the preparation of financial statements: With the help of information
contained in the accounting records, financial statements viz., Profit and Loss Account and
Balance Sheet can be easilv prepared. These statements enable the businessman to know the
net result of the business during an accounting period and its financial position.
4 Meets the informati011 requirements: Various interested parties such as owners,
management, lenden. creditors, etc. get the necessary information a! frequent intervals which
help them in their decision-making.
5 **Facilitates a comparative study:** The financial statements prepared will enable the
enterprise to compare its present position with that of its past, and with that of similar
organisations. This helps them to draw useful conclusions and improve its performance.
6 Assists the management in many ways: It is possible to identify reasons for the profit
earned or loss suffered. The identification of reasons helps in taking necessary steps to increase
profits further, or to avoid losses. Accounting information will also help in planning and
controlling the activities of the business.
7 Difficult to conceal fraud or theft: It is difficult to conceal fraud. theft, etc.. as there is an
automatic check in the form of periodic balancing of books of account. Further, in big
organisations the record keeping work is divided among many persons. so that chances of
committing fraud are minimised.
8 Tax matters: The Government levies various taxes such as customs duty, excise duty, sales
tax, and income tax. Properly maintained accounting records will help in the settlement of tax
matters with the tax authorities.

9 Ascertaining value of business: In the event of sale of a business firm, the accounting
records will help in ascertaining the value of business.

By now, you must have got an overview of accounting. We can now move into details. As a
first step, we intend to explain, in the next unit, some terms commonly used in accounting and
the basic accounting concepts.

7 Limitations of Accounting

i) Accounting is historical in nature: It does not reflect the current financial position or worth of a business.

ii) Transactions of non-monetary mature do not find place in accounting. Accounting is limited to monetary transactions only. It excludes qualitative elements like management, reputation, employee morale, labour strike etc.

iii) Facts recorded in financial statements are greatly influenced by accounting conventions and personal judgements of the Accountant or Management. Valuation of inventory, provision for doubtful debts and assumption about useful life of an asset may, therefore, differ from one business house to another.

iv) Accounting principles are not static or unchanging-alternative accounting procedures are often equally acceptable. Therefore, accounting statements do not always present comparable data

v) Cost concept is found in accounting. Price changes are not considered. Money value is bound to change often from time to time. This is a strong limitation of accounting.