CHAPTER

1

Scope and Meaning of Accounting

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1.1 INTRODUCTION

Accounting is an ancient art, as old as money itself. In the beginning, accounting has been elementary. The modern system of accounting owes its origin to Pacoili who lived in Italy in 18th Century. Pacioli codified rather than invented the system of accounting and he is widely regarded as the "Father of Accounting". Even in our country, Chanakya has clearly indicated the need of Accounting and Auditing in his book "Arthashastra". The Indian system of accounting is as scientific and systematic as the one developed in the West. We do not lag behind the West in the origin and development of accounting.

1.2 NEED AND ROLE OF ACCOUNTING

Many consider accounting has a role to play only in business and not in domestic life. This is not, factually, correct. In fact, we see the beginning of accounting in every wise housewife. In case, a housewife records her domestic transactions, connected with money, regularly, she can collect a lot of valuable information. Many intelligent housewives, though not literate, maintain a small dairy to record receipts on one page and all payments on the other page. Receipts are not always many, either in the form of income of the husband, her supplementary earnings, gifts from relations etc. List of payments is relatively more on different items say milk, education, entertainment, food, and clothing and, finally, planned commitments on savings etc. She can conveniently find out how much she has spent on the different items of expenditure, at the end of the month. This exercise helps her in planning her expenditure as income is, often, beyond her control. The family, not she alone, can learn useful lessons, when they review, where they have gone wrong in estimating or not controlling their spending. It would, equally, facilitate the family to plan and achieve their dreams, together, be it owning a home, car to drive, long term goals of children's education, retirement life and many more things, they wish to achieve.

Yes, the need of Accounting is more for business.

Accounting is the language of business.

The main purpose of language is communication of ideas. Similar is the purpose and role of accounts for a business is. A businessman has to keep a systematic record of the financial activities of his firm so that he can know the financial position. What it owns are assets and what it owes are the liabilities. It is necessary for every businessman to know where he stands in many respects:

(i) What he owns?

(ii) What he owes?

(iii) Whether he has earned profit or suffered loss over a period?

(iv) What is his financial position? Is he better off or moving towards bankruptcy?

Only accounts give answers to these questions.

Currently, the form of business has been joint stock company, in many growing areas, these days. By law, these firms have to keep the books of accounts to meet the requirements of Companies Act.

The purpose of accounting is narrow to many. Many consider the role of accounting is limited to maintain books of accounts for a limited purpose of filing income-tax return to satisfy the curiosity income-tax department. This is only a part of the full story.

> **The chief objective of maintaining books of accounts is to ascertain the operational results and find the financial position of the organisation.**

But, the above is not the end; rather it is only a beginning, in the modern era.

The role and importance of accounting in a firm depends more on the person who heads the role. Many think the role of accounting is to record transactions in books of accounts. With the pace of computerisation, the role of accounting for recording the transactions has diminished.

> **Importance of analysis of accounts along with control, coordination and achievement of the objectives of the firm has occupied more importance.**

Need of accounting is not limited to business organisations. Even the non-profitable firms like clubs, charitable institutions, hospitals, and education institutions maintain books of accounts to know their state of affairs.

Now a days, the combined role of accounting and finance has assumed more importance than the individual role of accounting. It is no surprise the finance manager can change the fortunes of the organisation, if he is, really, competent. For this reason, he is associated with every decision-making process, from recruitment of staff to the final stage, liquidation. No wonder, the organisation may sink, if he fails to deliver that is expected of him. A good finance manager, normally, is an asset to the firm he works in, while he becomes a liability, if he is not practical in making the objectives of accounting and finance to tailor the needs of business!

1.3 MEANING OF BOOK-KEEPING AND ACCOUNTANCY

Some people take both the terms 'Book-keeping' and 'Accountancy' as synonymous terms. Both the terms are different from each other. However, there is no universally accepted line of demarcation or division between the two.

> **Book-keeping is the art of recording business transactions in a set of books of accounts.**

Transaction means any dealing, expressed in terms of money. The books in which the transactions are recorded are called **'Books of Accounts'**. Book-keeping is concerned with preparation of vouchers, recording transactions in a journal and posting in the ledger. Book-keeper arrives at the final balances of different accounts, after totaling the accounts. The job of a book-keeper is to the extent of preparing trial balance, duly tallied. Book-keeping is mainly of clerical nature.

Any one who has basic knowledge of the principles of book-keeping can maintain the books of accounts. On the other hand, accountancy requires deep knowledge of the principles and their application. Though, book-keeping and accountancy are different in several aspect, they are supplementary to each other.

Book-keeping and accounting are not synonymous (inter-changeable) terms.
The job of an accountant commences where the work of a book-keeper ends.

Accountant guides a book-keeper and reviews the job, done by him. Normally, a book-keeper works under the supervision of an accountant. The functions of an Accountant can be summarised as under:

(i) Examination of entries made in the books of accounts
(ii) Verification of trial balance
(iii) Rectification of errors, if any, in accounts
(iv) Recording the adjustments
(v) Preparation of trading account
(vi) Preparation of profit and loss account
(vii) Preparation of balance sheet
(viii) Analysis of results and
(ix) Deriving conclusions and communication of the results.

An accountant is required to have much higher skill and knowledge, compared to a Book-keeper. The larger the firm, higher is the responsibility of an accountant.

1.4 ACCOUNTING — SCIENCE OR ART

Accounting is a science as well as an art.

It is a science as accounts are prepared in accordance of with certain basic principles and laws, which are universally accepted. However, accounting is not a perfect science like Physics or Chemistry, where experiments can be conducted in a laboratory and specific conclusions are drawn. Some people have reservations to treat accountancy as science.

Accounting is, definitely, an art. Art is a technique, which helps in achieving the desired objectives. Accounting has some definite objectives to be fulfilled. Accounting is an art because it prescribes the process through which the objectives are fulfilled. The American Institute of Certified Public Accountants also defines accounting as an art.

Accountancy involves recording the transactions and maintaining books of accounts in the prescribed manner, regularly, according to certain rules and regulations for achievement of the objectives of the firm.

1.5 DEFINITION AND EXPLANATION OF ACCOUNTING

The American Institute of Certified Public Accountants, which has played a noble part in the development of Accounting, defines the concept "Accounting" as follows:

> **"Accounting is the art of recording, classifying and summarising in a significant manner and in terms of money, transactions and events which are, in part, at least, of a financial character, and interpreting the results thereof".**

Once, we break the definition for better understanding, we find the term 'Accounting' contains the following components:

(A) Recording: Recording is the basic function of Accounting. Events and transactions, which are of financial character, either fully or partly, are recorded in an orderly manner in books of accounts. The transactions are recorded in a journal, as and when they happen or occur. Journal is further sub-divided into cash journal or cash-book (for recording cash transactions), Purchases Journal (for recording credit purchases) and Sales Journal (for recording credit sales). All these books are called subsidiary books. If subsidiary books are maintained, the transactions are not recorded in the journal and are recorded in these books, directly. Only those transactions that do not find a place in subsidiary books are recorded in the journal.

After recording all transactions in the journal, if they are, later, posted into different accounts of the ledger, work-load would be heavy. In fact, work is duplicated too. To reduce the avoidable work-load, each firm maintains subsidiary books, depending upon its individual requirements.

> **Subsidiary books would serve the function of a journal as well as a ledger. They are a journal as each transaction is recorded, individually, and a ledger as the total of the account is shown.**

It is not necessary to record all financial transactions, first, in the journal, if the concerned subsidiary book is maintained, before posting is made into the concerned accounts. Say, cash transactions are posted into the cash-book, directly, without posting them in the journal.

(B) Classifying: All similar transactions are grouped and posted in one book, which is called a 'Ledger'.

> **The objective of classification is to find a summary of the entries of same nature at one place.**

This book 'Ledger' contains different nature of accounts. For example, there may be separate heads of accounts such as Salaries, Traveling Expenses, Repairs, Printing and Stationery etc. We are interested to know the total amount under each head of account for our understanding and control. All accounts find a place in the ledger. Transactions belonging to one account are posted in that account in the ledger. Each head of account gives the individual details of the entries and its total.

(C) Summarising: When posting is complete in the ledger, totals are made for debit and credit side in each head of account and final balance (heavier balance), be it debit or credit, is arrived.

The individual accounts find a place in a summarised manner, which is called 'Trial Balance'.

Income statement (Trading and Profit and Loss account) and Balance Sheet are prepared from the Trial Balance.

(D) Deals with Financial Transactions: Accounting transactions, which are of financial character only, are recorded in books of accounts. In other words, if a transaction cannot be expressed in terms of money, they are not recorded in accounting books.

It is well accepted trusted and devoted employees are the real assets of any firm as its success or failure depends on their efforts and, finally, results. However dedicated the employees are, the employees do not appear in books of accounts. But, their presence/absence appear in the operational results of the firm.

However, payments made to employees (Salaries), their contribution (Sales) and, ultimately, profits appear in accounting books as they are expressed in terms of money. Again, expenses incurred on their welfare, in recognition of their efforts, be it Bonus or Medical Aid, also appear in books of accounts.

(E) Analysis and Interprets: This is the final and important function of accounting. A distinction is to be made between the two terms — Analysis and Interpretation. Analysis refers to methodical classification of data. If unconnected data are grouped together, understanding is not possible. All assets belonging to current assets are to be grouped together, similarly all current liabilities. If current assets and current liabilities are mixed together, data would be confusing.

Interpretation means drawing conclusions from the data and explaining the conclusions in a simple language, easy to understand and plan further course of action. **Analysis and interpretation are complementary to each other.**

Interpretation is not possible without analysis. Analysis is of no use unless followed by interpretation.

(F) Communicates: Communication is the final product of accounting. Financial statements i.e. Profit and Loss account and Balance Sheet are the means of communication.

Financial Statements are vital as they are public documents, available for every one to read, if the firm is a joint stock company.

Accounting reports, normally in the form of accounting ratios, graphs, diagrams, funds flow statement are the additional information, which are made available to management for decision-making. Modern management wants the data in a simple form, easy to understand and ready to act, immediately. Even the modern management wants cooked food, just like our students!

1.6 USERS OF ACCOUNTING

There are several end users of accounting. Apart from the people who are at the helm of the affairs of the institution, there are many interested parties in the financial statements.

The advantages depend on the users as their purposes are different.

(A) Creditors: A number of suppliers make supplies on credit. Creditors are interested to know whether they would get their dues, as assured by the firm. Firm may promise for early payment. Analysis of the financial accounts of the previous year may reveal the abnormal delay in the payments schedule. Once the past picture is known from the analysis of accounts, no creditor would place reliance just on words for making supplies.

(B) Shareholders: In case of joint stock company, shareholders know the financial results of the company only through the annual statements, sent by the company to them. From the newspaper reports too, they know the results as periodical publication of the results has been made mandatory, now. If the firm is a proprietary business, the proprietor alone is interested to know its profitability and financial health. In case of a joint stock company, the shareholders are providers of capital, who assume the role of a proprietor. Instead of one proprietor, there are several proprietors, who are interested about the return for their money invested.

(C) Government: Government is interested to know the amount of tax it can collect, based on the financial statements of the organisations. Required financial data can be collected for compiling statistics.

(D) Investors: Those who are interested to invest their money can make their decisions based on the study of the financial statements. Potential shareholders take lot of interest in the financial statements for their decisions in investing. Even the financial magazines as well as brokers read and analyse the financial statements to forecast and provide required guidance to their readers and clients, respectively, suitably.

(E) Lenders: Those who want to lend money, financial institutions or banks, are interested to read to make their decisions, before lending. After lending, they would be able to assure themselves about the safety of the funds, after a careful analysis of the statements.

(F) Management: Management is the basic user of accounts. They understand the financial results and position of the firm from the accounts. They are interested in every aspect of accounting as their uses are diverse for different purposes.

The financial data serves the interests of different persons concerned in different manner, as their objectives are different.

In order to serve the interests of the different parties, interested in the accounting information, different branches of accounting have developed.

1.7 SCOPE/BRANCHES OF ACCOUNTING

The different branches of accounting are:

(i) Financial Accounting: Financial accounting is the original form of accounting. It is mainly limited to the preparation of financial statements i.e. Profit and Loss Account and Balance Sheet. Here, the preparation is made on historical basis i.e. after the happening of the event.

All the persons who deal with the joint stock company want to know information about the financial health of the company.

Profit and Loss account provides information how the business has been conducted and final position about the profit or loss of the firm for a specified period. Balance sheet shows the financial position of the firm on a particular date.

(ii) Cost Accounting: Cost Accounting has developed on account of the limitations of the Financial Accounting.

Cost Accounting is, basically, concerned with the estimation of costs, in advance, and their subsequent detailed analysis for the purpose of control.

Management is interested to know the costs of the different products they make for the purpose of determining the price. Secondly, management has to take suitable decision, when they receive a special order at a lower price than the current market price, for acceptance or rejection. When resources are scare, every one is interested to use the resources and manufacture that product, in priority, which gives them more profits than other products**.**

Cost accounting helps the management in achieving the profits they plan to achieve.

(iii) Management Accounting: Management Accounting is accounting for the Management. Management wants information to discharge its functions in forecasting, budgeting, control over costs and strategy formation.

Persons engaged in management are not always familiar with accounts. Management Accounting helps them in the creation of the policy. Further, Management Accounting assists them with the supply of relevant information, at appropriate time, for decision-making and exercise effective control on the operations of the undertaking.

Management accounting is a branch of accounting, which furnishes useful data to the management in carrying out the various functions such as planning, decision-making and controlling the activities of the business enterprise. Accounting information is presented in an easy and ready to understand manner to the management. Here, the emphasis is on application of accounting techniques in planning and controlling the activities of the business enterprise and assisting the management in decision-making.

1.8 SYSTEMS OF ACCOUNTING

There are two systems of accounting for recording transactions—Single Entry System and Double Entry System. This is one type of classification.

(A) Single Entry System: Single entry system sounds economical, but it is, really, costly. In fact, it is rather a lack of system. This system is adopted where the business is run on cash basis only. It is not a scientific system and final accounts cannot be easily prepared on the basis of this system. Small businesses and organisations that do not require ascertainment of profit, follow this system.

(B) Double Entry System: The only real system is the double entry system.

> **Double Entry System recognises the fundamental factor that every transaction is double-sided affair.**

According to this system, for every debit, there is a corresponding credit. This system is universally followed in accounting. On the basis of this system, accuracy of accounting can be maintained and arithmetical correctness can easily be established. Financial statements i.e. Profit and Loss Account and Balance Sheet are easily prepared, once the concern follows the double entry system of accounting.

Another type of classification is as under:

(A) Cash System: It is used where only cash transactions take place and the object of the concern is not to make profit.

> **In this system of accounting, entries are made only when cash is received. No entry is made when receipt or payment is due.**

In case of club, library, educational institute, religious trust etc., the objective of the concern is not to make profits. Only Cash Book is kept under this system.

Some professionals like doctors, lawyers and chartered accountants follow this system of accounting. It is interesting to know why these professionals follow it? With these professionals, there is no certainty of receipt. Once treatment is received and fee is not collected immediately, how many patients would remember the doctor (till the next ailment) to pay the fee, later? Even before the actual receipt, if books of accounts show the fee amount as income, tax has to be paid on the income not received. If the fee is not received at all, tax would be paid on the income, not earned! One more point. Bad debts would be more, if the fee is not collected, immediately, after rendering the services. In these professions, it is better to recognise income only on actual cash receipt.

(B) Mercantile System of Accounting: In this system of accounting, accounting entries are made when payment or receipt is merely due. It is not necessary that the actual receipt or payment has to take place. For instance, when service is received and actual payment is not made, and books of accounts are to be closed for the year - end, payment due is recognised and recorded for the services received. To illustrate, repairs have been made for machinery. Bill is received, but not paid. Books of accounts are to be closed as the year has come to an end. Payment due for the services received is recorded, before the books are closed. In other words, repairs though not paid, are recognised as expense and liability is created. Even if the bill is not received, repairs are estimated and the relative amount is provided as expense. Similarly, when sale is made and sale proceeds are not received, amount due on sale is recorded as an asset and income is recognised. The idea is to record all the transactions as if they are completed in all aspects. The objective is to ascertain the correct profit position of the firm.

1.9 OBJECTIVES/ADVANTAGES OF ACCOUNTING

The following are the objectives of financial accounting:

1. To keep systematic records

Accounting is done to keep a systematic record of all the financial transactions. If they are not recorded, the transactions have to be remembered. It is not practically possible to remember and it is unnecessary strain to the human brain.

2. To ascertain the results of operations, that is, profit or loss

Business is conducted for making profits. Every business is interested to know the operational results of the efforts made.

> **Accounting helps in ascertaining the net profit earned or loss suffered on account of carrying on the business.**

For the purpose, a statement called the Income Statement or the Profit and Loss Account is prepared. In this account, the revenues resulting from the transactions of the period and the consequent expenses incurred are recorded. A comparison of the two shows whether there has been a profit or loss. If revenue exceeds expenses, there is profit. On the other hand, if expenses exceed income, there is loss. It is necessary to know, periodically, to take corrective steps, in time. Accounting helps to provide the information about the operational results of the firm. In the absence of information, how action can be initiated at all?

Profit and loss statement is useful for the management, lenders, investors, the proprietor or the partners or the shareholders, tax authorities and workers, etc. For example, from its study, one can decide upon the possible courses of action, such as increasing the scale of production, introducing a new product, a revision in the selling price or the advertising policy, etc. Lenders can know, from a study of it, how their amounts have been utilised. Investors may decide on its basis whether or not they should keep their money invested in the firm. Shareholders can evaluate the efficiency, success, etc. of the management.

3. To ascertain the financial position of the business

For a businessman, it is not sufficient to ascertain profit or loss only. It is also necessary to know the financial health of the firm. For this purpose, a statement listing assets, liabilities and the owner's capital is prepared. Such a statement is called the Balance Sheet. Some people call it 'Position Statement'.

> **A doctor feels the pulse of a person and knows, prima facie, whether he is enjoying good health or not. In the same manner, by looking at the balance sheet, one can know whether the firm is solvent or not. If the assets exceed liabilities, it is solvent; in the reverse situation, it would be insolvent.**

Balance Sheet serves as a barometer for ascertaining the financial health of a business.

4. To provide control and protect business assets

Accounting helps in knowing information and exercising control over the properties of the business and their proper utilisation. Accounting provides information to the manager or the proprietor regarding the following:

(i) How much capital stands invested in the business on a particular date?
(ii) What are the different forms of capital that has been raised?
(iii) What is the cash balance in hand?
(iv) How much balance is there in the bank?
(v) What is the stock of goods (Raw materials, Work-in-progress and Finished goods) on hand?
(vi) How much money is receivable from the customers?
(vii) How much money is owing to the creditors?
(viii) How much money stands invested in fixed assets?

The answers to the questions enable the firm to see that no moneys are kept idle or under utilized.

> **It is necessary for the business to protect and use the assets in an efficient manner to achieve the planned objectives.**

It should be noted that the objectives stated above are those of financial accounting alone. The other branches of accounting—Cost Accounting and Management Accounting—have their own objectives, which are of assistance to management in the functions of planning, control and making decisions.

5. To provide information to the tax authorities

Almost everyone who has income, above the prescribed limit, is liable to pay tax, be it Income Tax or Sales Tax. Tax authorities require regular, accurate and prompts returns, otherwise there may be penalties. Financial Accounting enables the firm to send the required returns, in time. In case, tax authorities levy more tax, business firm would be in a position to reduce the unnecessary tax liability, by showing the supporting accounting records.

6. To facilitate rational decision-making

Management can delegate any function, but not decision-making. Production, sales, purchase, finance, even research and development can be delegated.

> **Decision-making is the basic function of the management that cannot be delegated.**

In the absence of accounts, there is no information about the past. In the absence of information, there is no basis for taking any decision and planning for future.

The following are the advantages of book-keeping and accounting:

Advantages of Book-keeping:

1. Trial balance can be prepared.
2. Errors can be revealed by the preparation of trial balance.

Advantages of Accounting:

1. A firm can know the exact profit or loss made by it in a particular period.
2. The reasons leading to profit or loss can also be ascertained.
3. The financial position of the business concern can be assessed.
4. The firm can know the amount due by debtors and amount due to creditors.
5. The efficiency/performance of the department/section can be ascertained.
6. The approximate cost of production of goods manufactured can be known.
7. Based on the financial results, it can decide which products are to be manufactured, which activities should be continued and which should be dropped.
8. Accounting is useful in submitting the statutory returns like Income Tax, Sales Tax, Commercial Tax etc., to the government in time.

1.10 LIMITATIONS

Accounting has many advantages, as stated above. Significant information is available from financial accounting such as profit earned or loss suffered during a particular period and the financial position at the end of a specified period. But, it has some limitations too. These limitations must be kept in mind when information provided by financial accounting is used. Some of the limitations arise from the fundamental principles, concepts and assumptions.

The limitations are as follows:

(i) Profit shown in Financial Accounting is not fully exact

Most of the transactions are recorded on actual basis such as sale or purchase or receipt and payment of cash. Some estimates have also to be made for ascertaining profit or loss. The estimates may relate to useful life of an asset, likely bad debts and the probable market price of the stock of goods.

In the absence of actual information, certain estimates have to be necessarily made in respect of expenditure incurred for which bills have not, yet, been received, before the closure of books of accounts etc.

People are bound to have different opinions in respect of such things and the estimates, naturally, differ from person to person. This may also lead to a different figure of profit or loss being shown by different persons. Thus, the profit figure cannot be treated as exact.

(ii) Financial Accounting does not indicate what the business will realise, if sold

It is not to be presumed that the balance sheet shows the amount of cash, which the firm may realise, by the sale of all the assets. This is because fixed assets are not meant for sale. They are purchased for the purpose of carrying on the business. They are meant for use to earn profit and are shown at cost less depreciation that has been written off. Once the fixed assets are sold, they may or may not realise the values shown in the balance sheet.

(iii) Financial Accounting does not tell the whole story

It is known that in the books of accounts only such transactions and events are recorded that can be expressed in terms of money. There are, however, many other important factors, which, though not recorded in the books of account, may make or mar the firm such as relations with workers, popularity of the goods produced, quality and caliber of the management, integrity, farsightedness etc. They are invisible, in value, and play a significant role in the success or failure of the company. Unless such factors are kept in mind, it would be very difficult to assess the future of the firm.

(iv) Accounting statements may be drawn up differently

Due to different methods being employed say for valuing closing stock; it is possible to arrive at different figures of profits and give different financial picture. There are different methods for providing depreciation, which is treated as expenditure in arriving at the profits of the company.

Different methods of treatment give different amounts of profit, even if the other factors are the same between two firms.

If one firm adopts straight-line method while the other adopts written down method for providing depreciation, the operational results of both the firms would be different, even though other factors are same. Also, in spite of the various principles, there have been attempts in the past to show a false financial position. This is chiefly done by deliberately entering wrong figures so as to either inflate profits or to deflate them. One should therefore, always apply some checks to establish whether or not the financial statements can be taken to be reasonably correct. It is better to get them audited. Audited accounts present a reliable picture.

(v) All assets are not shown in financial statements

Human resources are an important factor for the success of the concern. Devotion, sincerity and integrity of the employees are very valuable for any firm.

The most important asset, human resources, is not accounted in the balance sheet.

(vi) Manipulation

Accounting results are based upon the information supplied to it. If the management is biased, it may feed manipulated information to prove its point of view. Accountants can show the result of business, as desired by the owners of the business. This may be done by omitting certain amounts, under-estimating or over-estimating the value of the assets. For example, if machinery is debited to purchases accounts, profits of the business will be reduced. Accountants, at the instance of management, may manipulate accounts.

(vii) Impact of Inflation

Due to inflation, many of the figures appearing in the financial statements are out of date.

1.11 TERMINOLOGY OFTEN USED — SOME BASIC TERMS

The following terms are often used. For proper understanding, they are explained in an easy language.

1. **Capital:** Capital is the amount, initially, invested while commencing the business. Capital need not be in the form of cash, alone. Capital can be introduced in the form of goods or any type of assets. Even after commencement of business, additional capital can be introduced. Additional capital is, normally, introduced for the purpose of expansion.

   Profit in the business is added to capital. Loss made in business is reduced from capital. So, if the business is profitable, capital would be on increase, year after year. However, drawings may be made in the course of business. If the concern is sustaining continuous losses, capital would be on decrease, year after year.

The term 'Capital' is defined as the excess of assets over liabilities. Suppose, assets are Rs.1,00,000 and liabilities are Rs.40,000, capital is Rs.60,000 (Rs.1,00,000 – Rs.40,000).

Capital = Assets – Liabilities

Assuming, the firm has made a profit of Rs.20,000. After profits, the balance in the capital account is Rs.80,000 (Rs.60,000 + Rs.20,000).

2. Drawings: Drawings is the amount withdrawn from the business by the proprietor or partner in a partnership firm. Drawings can be, again, cash or goods.

Drawings are reduced from the capital amount. 'Drawings' reduces the balance in the capital account.

Comparison of capital between two periods is an indication whether the business is profitable or not, if there is no introduction of capital or withdrawal in the form of drawings, during the period of comparison.

3. Turnover: The total amount of sales during a particular period is called 'Turnover'. The turnover can be cash sales or credit sales or both.

4. Discount: The allowance or concession granted to a retailer by the wholesaler/dealer is called 'discount'. It is of two types:

(A) Trade discount (B) Cash discount

(A) Trade discount: Trade discount is allowed by a dealer to the retailer or buyer to induce him to buy more from him. Normally, the retailer is in the habit of buying say 50 or 100 pieces at the most, at one time. If the normal price of goods is Rs.100, the dealer may offer the retailer or buyer 10% if he buys say 200 pieces, at one time. Here, the trade discount is offered to him to lure him to buy more, at one time. The buyer may be tempted to buy more to take advantage of the trade discount, though such huge quantity may not be required to him, at one time, generally. **Trade discount is offered both on cash and credit sales.**

Invoice shows the list price or retail price. Where trade discount is allowed, the same is also shown in the invoice. Trade discount is allowed as a fixed % on the list price.

Net Price = List Price – Trade Discount

It is important to note that the net price is entered as sale value by the seller in the accounts. Equally, the net price is entered as purchase amount by the buyer in the accounts. **In other words, no entry is made for trade discount, separately, in books of accounts of the seller and buyer.** It has to be mentioned in the narration about the trade discount given on the list price.

(B) Cash discount: Cash discount is allowed by the seller to encourage the customer to make early payment, before the credit period expires. Suppose, a dealer has made a credit sale, offering one month period of credit. The buyer is within his total right to make the payment on the last date of credit period allowed. So, the buyer can make the payment on 30^{th} day from the date of purchase. To induce the buyer to pay before the expiry of credit period, seller may offer him 1% cash discount, if the payment is made within 15 days from the date of sale. So, here, the buyer can enjoy the cash discount by paying the seller on 15^{th} day from the date of sale. If goods sold are Rs.500, buyer can pay only Rs.495, after enjoying the cash discount of Rs.5.

Entry for cash discount is, invariably, made in the accounts of the seller as well as buyer.

To the seller, it is 'Discount allowed', while the same is 'Discount received' for the buyer.

Cash discount comes into picture as and when credit sales are made. There is no cash discount on cash purchases. Many students, it is observed during teaching, wrongly think that cash discount is allowed on cash sales. This is not the case. **Cash discount comes into picture as and when sales are made on credit.**

Cash discount and Trade discount may be allowed, simultaneously, in one transaction. Their purposes are different.

5. **Debtor or Book Debt:** The person to whom goods or services are sold on credit is called 'Debtor'. The amount due from the debtor is called Book Debt. Another name is 'Accounts Receivable'.
6. **Creditor:** The person from whom goods or services are purchased on credit, is called creditor till the payment due to him is made.
7. **Bad Debts:** Amount that cannot be recovered from a debtor is called 'Bad Debt'. Bad debts result in reduction of profits of the firm. Bad debts are charged to the Profit and Loss account. In other words, bad debts are treated as an expenditure, as the amount due to be received would no longer be received.
8. **Transaction:** Transaction refers to exchange of goods and services, big or small, like purchase of machinery or pencil. The exchange of the dealing has to be expressed in terms of money. Transaction can be either for cash or on credit. If the payment is made immediate to the transaction, it is a cash transaction. If the payment is postponed or deferred for a future date, it is called a credit transaction.
9. **Voucher:** Voucher is a written document or paper containing the details of the transaction. The person who prepares the voucher, normally accountant, signs it. Person who verifies or checks the transaction also signs it, in token of its verification. Vouchers are important instruments for future reference. Voucher can be a debit voucher or credit voucher. Voucher is, normally, accompanied by the supporting documents as proof. For example, a voucher may be supported by the bill. Here, bill is the evidence of payment.
10. **Equity:** All claims against the assets of the firm are called as 'Equity'. The claim of the outsiders is called 'creditor's equity' or liabilities. The claim of the proprietor is called 'owner's equity' or capital.

11. Assets: Assets are the properties owned by the firm. Examples of Assets are Building, Plant and Machinery, Debtors, Bills Receivable, Goodwill, Preliminary expenses etc.

Assets can be divided into two categories—fixed assets and current assets. Fixed assets are the assets owned by the firm for the purpose of conducting business, using the fixed assets. Examples are Building, Plant and Machinery etc. In the normal course, the firm does not sell them. Current assets are those assets, which are held by the firm for the purpose of carrying on business. Current assets, normally, change their form. Examples are Cash, Bank, Finished Goods, Debtors, Bills Receivable, Accrued income etc.

Whether an asset is a fixed asset or current asset depends on the nature of the business that is carried on. Normally, car is a fixed asset, say, to a wholesale cloth merchant. For a second hand car dealer, cars are meant for sale. So, they are current assets to him. It is necessary to know whether the asset is meant for sale or used for conducting the business. If the asset is meant for sale, it is a current asset. If the same asset is used in business to earn profits to that business, the same asset is a fixed asset.

12. Liabilities: Liabilities are the amounts that are payable. Advances or loans received have to be repaid. Till date of repayment, they are liabilities. Goods or services when bought on credit are shown as creditors, which are also liabilities.

Capital invested by proprietor or partner is also a liability as the business firm is independent from them, so far as accounting is concerned.

This is the reason why capital is shown on the liability side in the balance sheet. Capital, loan, outstanding expenses and bills payable are some of the examples of liabilities.

13. Debit: The entry made on the debit side of the account is called 'Debit'. The abridged form is 'Dr'.

14. Credit: The entry made on the credit side of the account is called 'Credit'. The abridged form is 'Cr'.

15. Entry: The record made in the books of accounts in respect of a transaction or an event is called an entry.

16. Books of Account: The registers or books maintained by any business firm or institution for recording the business transactions are called "Books of Account".

Check Your Understanding

State whether the following statements are True or False

(i) Joint stock companies, by law, have to keep the books of accounts to meet the requirements of Companies Act.

(ii) Capital is decreased by profits and increased by losses.

(iii) The chief objective of maintaining books of accounts is to ascertain the operational results and find the financial position of the organisation.

(iv) The term 'Book-keeping' means recording the transactions and maintaining books of accounts in the prescribed manner, regularly, according to certain rules and regulations.

(v) Accounting is a science as well as an art.

(vi) Book-keeping and accounting are synonymous (inter-changeable) terms.

(vii) Accounting records transactions, which are of financial character.

(viii) Accounting is useful to record business transactions only.

(ix) Income statement (Trading and Profit and Loss account) and Balance Sheet are prepared from the Trial Balance.

(x) Transactions that cannot be expressed in terms of money are also recorded in accounting books.

(xi) Balance Sheet serves as a barometer for ascertaining the financial health of a business.

(xii) Financial statements of a joint stock company are not accessible to the public.

(xiii) Analysis and interpretation of financial statements are complementary to each other.

Answers

(i) True (ii) False (iii) True (iv) True (v) True (vi) False (vii) True (viii) False (ix) True (x) False (xi) True (xii) False (xiii) True

Q: Point out the correct equation

(a) Assets = Liabilities – Capital
(b) Assets = Liabilities + Capital
(c) Liabilities = Assets + Capital
(d) Capital = Assets + Liabilities

Ans. (b)

Pick up the Most Appropriate

1. The prime function of book-keeping is to:
   (a) Record economic transactions.
   (b) Provide information for action.
   (c) Classifying and recording business transactions.
   (d) Attain non-economic goals.
2. The following is the original form of accounting:
   (a) Financial Accounting
   (b) Cost Accounting
   (c) Management Accounting
   (d) Inflation Accounting
3. This system is universally followed in accounting:
   (a) Single Entry System
   (b) Double Entry System
   (c) Cash Accounting
   (d) Cost Accounting

4. In this system of accounting, entries are made only when cash is received:
   (a) Cash accounting (b) Double entry system
   (c) Inflation system (d) Deflation system
5. Management Accounting is a valuable aid to management in respect of:
   (a) Presentation of accounting data (b) Recording of accounting data
   (c) Recording of costing data (d) None.
6. The basic function of financial accounting is to:
   (a) Assist the management in performing managerial functions.
   (b) Record all business transactions.
   (c) Controlling business.
   (d) Analysis and interpretation of financial data.
7. Book-keeping is mainly concerned with:
   (a) Preparation of financial statements.
   (b) Recording financial data relating to business operations in books of accounts.
   (c) Summarising the recorded data.
   (d) Interpreting the data for internal and external end users.
8. Whether the following terms are synonymously used in accounts?
   (A) Receipt (B) Revenue
   (C) Income
   These are the following options:
   (a) A and B (b) B and C
   (c) A, B and C (d) None

Answers

1. (c) 2. (a) 3. (b) 4. (a) 5. (a) 6. (d) 7. (b) 8. (c)

Recall your Memory

1. Book-keeping is a part of accounting.
2. Accounting is an exact science.
3. Approach for subjects “Accounting” and “Accounting for Managers” is one and the same.
4. There has been mention of Accounting in ‘Arthashastra’ written by Chanakya.
5. Amount owed to outsiders (excluding the proprietor) is called ‘Capital’.
6. Comparison of capital between two periods is an indication whether the business is profitable or not, if there is no introduction of capital or withdrawal in the form of drawings during the period of comparison.
7. Trade discount is allowed only on cash sales and not on credit sales.

8. Cash discount and trade discount are not allowed, simultaneously, in one transaction.
9. Total assets minus capital is equal to liabilities.
10. An increase in assets is necessarily due to profits.
11. 'Drawings' reduces capital.
12. Liabilities are decreased by losses and increased by profit.

Answers

1. True 2. False 3. False 4. True 5. False 6. True 7. False 8. False 9. True 10. False 11. True 12. False

Objective Questions

1. Detail the origin of 'Accounting'. Do you consider that accounting is needed only for business? Is there any change in the approach towards accounting in the modern era? **(1.1 and 1.2)**
2 Why accounting is said to be the language of business? **(1.2)**
3. Define Accounting? How the functions Accounting differ from Book-keeping? **(1.5 and 1.3)**
4. "Accountancy starts where Book-keeping ends" - Explain? **(1.3)**
5. Define and explain 'Accounting'? **(1.5)**
6. Describe the different branches of Accounting? **(1.7)**
7. Accountancy is Science or Art? Explain with reasons? **(1.4)**
8. Explain the various systems of Accounting? **(1.8)**
9. Distinguish between Book-keeping and Accounting? **(1.3)**
10. Write a brief note about 'Accounting' and on different users of accounting? **(1.3 and 1.6)**
11. What are the objectives/advantages of accounting? **(1.9)**
12. Are there any limitations to accounting? **(1.10)**
13. "A doctor feels the pulse of a person and knows whether he is enjoying good health or not. In the same manner, by looking at the balance sheet, one can know whether the firm is solvent or not" – In the light of this statement, detail the objectives of Accounting? **(1.2 and 1.9)**
14. Write briefly on the following:
    (D) Difference between Trade Discount and Cash Discount
    (E) Capital
    (F) Drawings
    (G) Bad debts
    (H) Debtors and Assets
    (I) Creditors and Liabilities **(1.11)**

Interview Questions

Q.1. How Mercantile system of accounting is different from cash accounting?

Ans. In mercantile system of accounting, all expenses and incomes are provided and recorded in books of accounts, irrespective of their actual payment and receipt. If the expenditure is due, it is provided. Similarly, if the right to receive has arisen for the amount, the amount is recognised as revenue. In cash accounting, only actual cash payments and receipts are recorded.

Q.2. What is the purpose of Accounting?

Ans. The basic objectives of accounting are to find out the operational results (Profit or Loss) and financial position of the organisation. Through accounting, the required records are maintained to achieve the above objectives.

Accounting is done to keep a systematic record of all the financial transactions. It is not virtually possible to remember all financial transactions.

Many think the role of accounting is limited to record transactions in books of accounts. With the pace of computerisation, the role of accounting for recording the transactions has diminished. Importance of analysis of accounts, along with control and achievement of the objectives of the firm has occupied more importance.

Now a days, the combined role of accounting and finance has assumed more importance than the individual role of accounting.

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