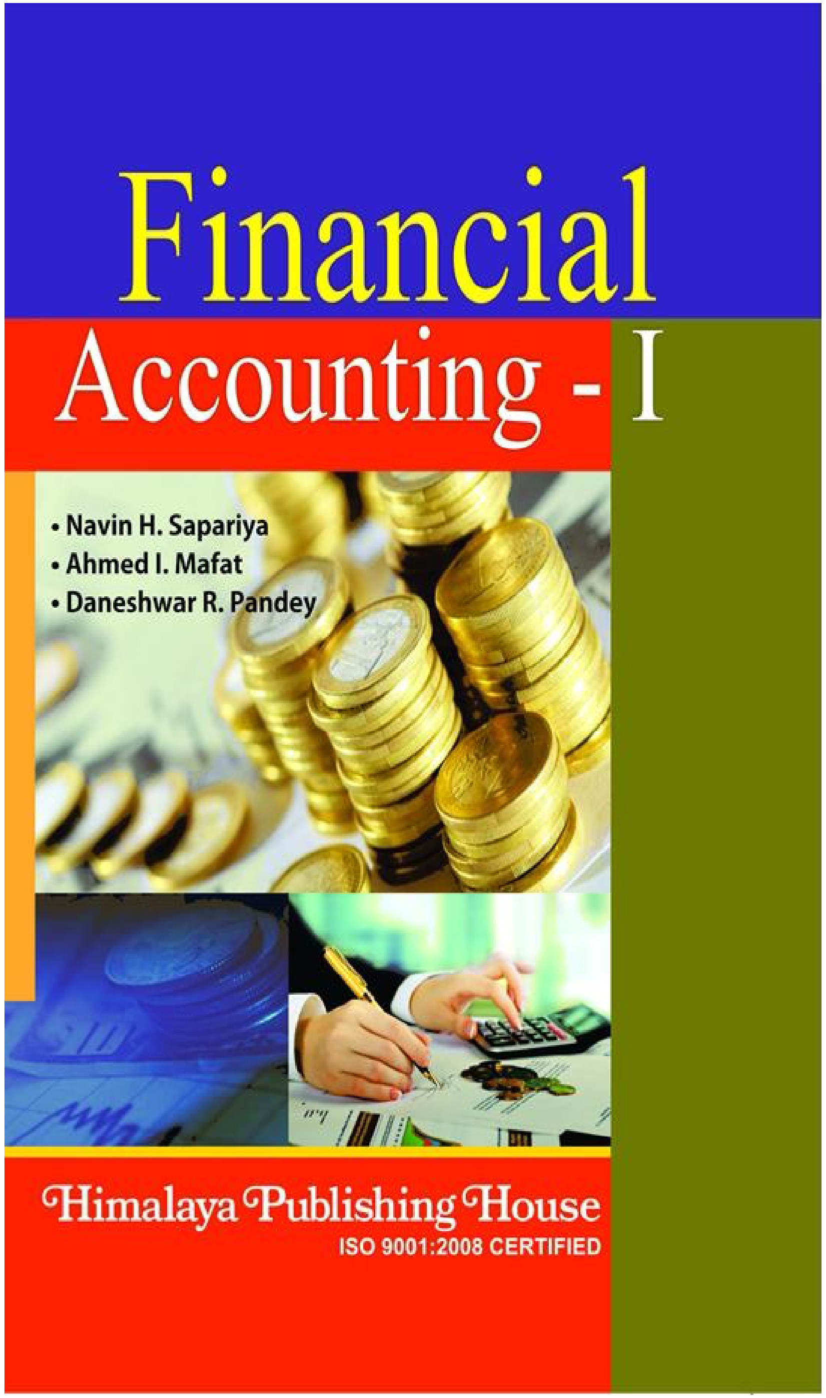


FINANCIAL ACCOUNTING - I

F.Y. B. B. A. Semester-I

Prof. Navin H. Sapariya
B.Com., MBA,
Assistant Professor
Vidyabharti Trust College of BBA & BCA, Umrakh, Bardoli.

Prof. Ahmed I. Mafat
M.Com., B.Ed. (Gold Medalist),
Shri Manilal Kadakia College of
Management and Computer Studies,
Ankleshwar.

Prof. Daneshwar R. Pandey
M.Com., Ph.D. (Accountancy) (Pursuing),
Assistant Professor,
S.S. Agrawal College of Arts,
Commerce and Management,
Navsari.

Himalaya Publishing House
MUMBAI • NEW DELHI • NAGPUR • BENGALURU • HYDERABAD • CHENNAI • PUNE • LUCKNOW
• AHMEDABAD • ERNAKULAM • BHUBANESWAR • INDORE • KOLKATA • GUWAHATI

FIRST EDITION : 2014

Published by : Mrs. Meena Pandey for **Himalaya Publishing House Pvt. Ltd.,** "Ramdoot", Dr. Bhalerao Marg, Girgaon, **Mumbai - 400 004.** Phone: 022-23860170/23863863, Fax: 022-23877178
E-mail: himpub@vsnl.com; Website: www.himpub.com

Branch Offices :

New Delhi : "Pooja Apartments", 4-B, Murari Lal Street, Ansari Road, Darya Ganj, New Delhi - 110 002. Phone: 011-23270392, 23278631; Fax: 011-23256286

Nagpur : Kundanlal Chandak Industrial Estate, Ghat Road, Nagpur - 440 018. Phone: 0712-2738731, 3296733; Telefax: 0712-2721215

Bengaluru : No. 16/1 (Old 12/1), 1st Floor, Next to Hotel Highlands, Madhava Nagar, Race Course Road, Bengaluru - 560 001. Phone: 080-32919385; Telefax: 080-22286611

Hyderabad : No. 3-4-184, Lingampally, Besides Raghavendra Swamy Matham, Kachiguda, Hyderabad - 500 027. Phone: 040-27560041, 27550139; Mobile: 09390905282

Chennai : No. 8/2, Madley 2nd Street, Ground Floor, T. Nagar, Chennai - 600 017. Phone: 044-28144004/28144005; Mobile: 09345345051

Pune : First Floor, "Laksha" Apartment, No. 527, Mehunpura, Shaniwarpeth, (Near Prabhat Theatre), Pune - 411 030. Phone: 020-24496323/24496333; Mobile: 09370579333

Lucknow : House No 731, Shekhupura Colony, Near B.D. Convent School, Aliganj, Lucknow - 226 022. Mobile: 09307501549

Ahmedabad : 114, "SHAIL", 1st Floor, Opp. Madhu Sudan House, C.G. Road, Navrang Pura, Ahmedabad - 380 009. Phone: 079-26560126; Mobile: 09377088847

Ernakulam : 39/176 (New No: 60/251) 1st Floor, Karikkamuri Road, Ernakulam, Kochi - 682011, Phone: 0484-2378012, 2378016; Mobile: 09344199799

Bhubaneswar : 5 Station Square, Bhubaneswar - 751 001 (Odisha). Phone: 0674-2532129, Mobile: 09338746007

Indore : Kesardeep Avenue Extension, 73, Narayan Bagh, Flat No. 302, IIIrd Floor, Near Humpty Dumpty School, Indore - 452 007 (M.P.). Mobile: 09301386468

Kolkata : 108/4, Beliaghata Main Road, Near ID Hospital, Opp. SBI Bank, Kolkata - 700 010, Phone: 033-32449649, Mobile: 09883055590, 07439040301

Guwahati : House No. 15, Behind Pragjyotish College, Near Sharma Printing Press, P.O. Bharalumukh, Guwahati - 781009, (Assam). Mobile: 09883055590, 09883055536

DTP by : Sudhakar Shetty (HPH Pvt. Ltd., Bhandup)

Printed at : Rose Fine arts, Mumbai. On behalf of the HPH Pvt. Ltd.

CONTENTS

PREFACE

We have great pleasure in placing this book on **Financial Accounting - I** (F.Y. BBA, Semester-I, as per CBCS syllabus of Veer Narmad South Gujarat University, Surat) into the hands of esteemed readers. Although several books are available on the subject, the need for a comprehensive volume covering all the important aspects of Financial Accounting has been felt for a long time.

This prescribed book serves as a foundation for the basic principles of Accountancy. By introducing the subject at the college level, great care has been taken to emphasize on minute details to enable the students to grasp the concepts with ease. The vocabulary and terminology used in the text book is in accordance with the comprehension and maturity level of the students.

Our long experience in teaching and the knowledge we have acquired over these years has made it possible for us to satisfy this need. The book is written in a simple and lucid style. At the end of the each chapter, a few theoretical questions and exercises are given to test the understanding ability of students. This book meets the requirements of BBA and BCA.

The author takes this opportunity to express their sincere gratitude to his father Late Shri Hanshrajbhai H. Sapariya. The author is also grateful to Dr. A.V. Shah, Head of Vidyabharti Trust College of BBA and BCA, Umrakh (VTCBB) for their inspiration and encouragement. The author expressed his thanks to all colleagues who have assist in writing the book.

We will be failing in our duty if we do not thank Mr. Nagendra Acharya, Himalaya Publishing House Pvt. Ltd. in taking active interest in the publication.

We are greatly indebted to all trustee members for their valuable support.

— AUTHORS

SYLLABUS

VEER NARMAD SOUTH GUJARAT UNIVERSITY

FINANCIAL ACCOUNTING-I

F.Y. BBA Semester-I　　　　Effective from June 2011

Unit	Topic	Weightage
1	**INTRODUCTION OF FINANCIAL ACCOUNTING AND IT'S CONCEPTS** r Meaning, Functions and Limitations of Financial Accounting r Meaning of Accounting Concepts and Conventions r Basic Accounting Concepts and Conventions r Fundamental Accounting Assumptions	**15%**
2	**STOCK/INVENTORY VALUATION** r Methods of Valuation of Inventory r FIFO, LIFO and Average Method of Stock/Inventory Valuation	**20%**
3	**DEPRECIATION** r Meaning, Objectives and Methods of Depreciation r Examples of Depreciation calculation (only Straight Line and Diminishing Balance Method)	**30%**
4	**BOOK KEEPING** r Journal r Ledger r Various Subsidiary Books r Bank Reconciliation Statement r Trial Balance	**35%**

Note: 1. Problem carrying not less than 70% of marks shall be asked.
2. Practical in the Computer accounting is prescribed, *i.e.*, one period per week.

CHAPTER 1

INTRODUCTION TO ACCOUNTING

NEED FOR ACCOUNTING

Business is one of the sources of earning income. Whenever a business is started, it requires investment of certain amount which is called as capital. With this amount of capital, the businessman may deal either with trading business or manufacturing business. In a trading business, he will buy goods at a lesser price and sells the same to others at a higher price. In case of manufacturing business, he has to buy raw materials and incur other expenses in the form of wages and salaries, rent, power, insurance, tax, transport, postal and telephone expenses and so on, in the course of production and distribution of goods.

In a small sized business, the transactions are simple and less in number. But in a large sized business, the transactions are numerous. These business transactions enable the businessman to know the result of his business which can be profit or loss for a given period of time. In order to know the result of his business, a businessman has to remember all the transactions of his business. However, owing to lack of memory, it is not possible for anybody to remember all the transactions over a period of time. This has given rise to maintenance of a set of accounting books in which business transactions are chronologically recorded. The systematic recording of business transactions enable the businessman to account for every transaction without missing any item. Such a system of maintenance of a set of accounting books to record business transactions is known as bookkeeping system.

ORIGIN OF BOOKKEEPING

The practice of record keeping existed ages before the formal recording of history. Barbarians began to keep records by scratching

them on rocks. From their crude forms of picture writing, the process of rudimentary bookkeeping began. The Italians were the leading bookkeepers and record makers for centuries. As early as 813 A.D., Bookkeepers were recognised in Italy and from these men came many of the fundamentals of the modern double entry bookkeeping.

In 1911, a Florentine banker devised the first complete bookkeeping system as distinguished from the simple devices previously used. It had all the rudiments of a set of books including a rough plan of cross entries. The first known system of complete double entry was discovered in Genoa in 1340. The first text book on bookkeeping was written in 1414 by Pacioli, a monk of the order of St. Francis at Venice. Many present-day methods were described by this old world mathematician and the ideas he expressed have lived to the present day. Pacioli's treatise is based on the premise that where one wishes to conduct his business properly, he must first have sufficient cash or credit. Secondly, he must be a good bookkeeper. Thirdly, he must possess a proper bookkeeping system.

The years following Pacioli's treatise were marked by the refinement of the double entry bookkeeping system and by the use of the position of the accountant in the commercial world. Publications were released and some accountants association were formed, but it was not until the 19th century that accounting really became a profession.

It was not until the dawn of the 20th century that the invention and perfection of the business machines of today took the business of record keeping from the "Shadow of the Pen". A new conception of accounting valuation began to take form and the bookkeeper really became an Accountant. The keeping of books was no longer restricted to the preparation of financial statement. Because of the ease with which facts could be recorded, accumulated and analysed, the accountant began to devote his time to the interpretation of "booked" facts and as a result, became a member of management's team.

INTRODUCTION OF ACCOUNTING

Financial accountancy (or financial accounting) is the field of accountancy concerned with the preparation of financial statements for decision-makers, such as stockholders, suppliers, banks, employees, government agencies, owners and other stakeholders.

Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power. The central need for financial accounting is to reduce the various principal-agent problems, by measuring and monitoring the agents' performance and thereafter reporting the results to interested users.

Financial accountancy is used to prepare accountancy data for people outside the organisation or for those, who are not involved in the mundane administration of the company. Management accounting provides accounting information to help managers make decisions to manage and enhance the business.

In short, financial accounting is the process of summarising financial data, which is taken from an organisation's accounting records and publishing it in the form of annual or quarterly reports, for the benefit of people outside the organisation.

Financial accountancy is governed not only by local standards but also by international accounting standard.

DEFINITION OF ACCOUNTING

The American Accounting Association defines accounting as "the process of identifying, measuring, and communicating economic information to permit informed judgements and decisions by users of the information".

This definition highlights the following aspects:

(a) Identifying the Business Transactions: Identification of transactions are useful for proper recording of them in books of accounting without missing any of the transactions.

(b) Measurement of Business Performance: Measurement or evaluation of business performance is necessary to know the progress of business.

(c) Communication of Information: Communication of information relates to reporting the results of business to all those interested in the business. This enables them to judge the efficiency of the business and to take suitable decisions to improve the business.

According to the American Institute of Certified Public Accountants Terminology Committee,

"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."

This definition emphasises the following aspects:

(*a*) It is an art.

(*b*) It involves recording transactions in a set of books.

(*c*) Classifying which refers to grouping of transactions according to their similarities.

(*d*) Summarising the transactions facilitates easy understanding of results by management of the business and others interested in the business. This step involves preparation of two important statements known as (*i*) Trading and Profit and Loss Account and (*ii*) Balance Sheet.

(*e*) Accounting is concerned with transactions capable of expressing in terms of money value. All business transactions of different nature are expressed in respect of money. Thus, all assets such as land and building, plant and machinery, stock of goods etc., when expressed in terms of money can give total value of business. The value of a business can be compared with the value of another business.

(*f*) Only transactions of financial characters are recorded in the books of accounts. For example, the good health of a general manager is very essential for the success of a business. But this transaction is not recorded in accounting books. Similarly, cooperation of employees, good working environments etc. are essential for the success of a business. But they are not recorded as they are not of a financial character.

(*g*) Interpreting the results helps in evaluating and in making a rational judgement about the performance of business. For example, an accountant will estimate the advertising required for increasing the sales.

Subsequently, he will judge whether the advertisement expenses yielded the desired sales. This will help him to decide whether the same amount of advertising expense result in the desired sales for the forthcoming years.

MEANING OF BOOKKEEPING

Bookkeeping includes recording of journal, posting in ledgers and balancing of accounts. All the records before the preparation of trial balance are the whole subject matter of bookkeeping. Thus, bookkeeping may 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.

The art of recording business transactions in a systematic manner is termed as bookkeeping. It is the name given to a system which is concerned with recording and summarising business transactions accurately so as to know the true state of affairs of a business.

DEFINITIONS OF BOOKKEEPING

R.N. Carter in his book on *Advanced Accounting* defines bookkeeping as "the science and art of correctly recording in books of accounts all those business transactions that result in the transfer of money or money's worth". This definition reveals the following features of bookkeeping.

"Bookkeeping is the art of recording business transactions in a systematic manner."

— A.H. Rosenkamph

"Bookkeeping is the science and art of correctly recording in books of accounts all those business transactions that result in the transfer of money or money's worth."

— R.N. Carter

(a) It is a Science: Bookkeeping is a science as it represents systematised knowledge. It is based upon a set of well-defined principles which are followed throughout so that the reason for recording a transaction in a particular manner can be explained fully.

(b) It is an Art: Bookkeeping is an art as it deals with a system in which human skills and ability is involved in recording the business transaction according to principles of bookkeeping.

(c) Money Consideration: This implies recording of all transactions which can be expressed in terms of money.

Kohler in his "Dictionary for Accountants" defined bookkeeping as "the process of analysing, classifying, and recording transactions in accordance with preconceived plan". This definition brings forth the following three aspects of accounting.

(***a***) **Analysis:** It refers to identifying various expenses incurred during a period of time.

(***b***) **Classification:** It refers to grouping of like items of expenses into a common group.

(c) Recording: It refers to entering transactions in the basic books and later on posting them into another set of book known as ledger.

B.G. Vickery in his book 'Principles and Practice of Bookkeeping' defines bookkeeping as ***"the art of recording pecuniary or business transactions in a regular and systematic manner".*** This definition emphasizes the recording of monetary transactions of the business on day-to-day basis and in a systematic manner, *i.e.*, according to the set rules and regulations of bookkeeping.

OBJECTIVES OF ACCOUNTING

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

(i) To keep 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 accounts.

(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 same 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 up-to-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 etc. 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.

ESSENTIAL ASPECTS OR FEATURES OF ACCOUNTING

(i) **Identifying:** Identifying is an essential aspect of accounting. Identifying means determining the business transactions to be recorded in the books of accounts.

(ii) **Measuring:** Measuring means expressing the value of business transactions in terms of money.

(iii) **Recording:** Recording means recording business transactions in the book or books of original entry.

(iv) **Classifying:** Classifying means the classification of the entries in the journal or subsidiary books into appropriate accounts in the ledger. In short, it means the preparation of the necessary ledger accounts.

(v) **Summarising:** Summarising means the presentation of the information found in the ledger accounts in the form of financial statements like the profit and loss account and the balance sheet at the end of the accounting period. In short, it means the preparation and presentation of financial statements.

(vi) **Analysis and Interpretation:** Analysis and interpretation means rearrangement of the information found in the financial statements in a suitable manner, and drawing meaningful conclusions about the profit, the financial position and the future prospects of the business.

(vii) **Communicating:** Communicating means communicating the results of interpretation of financial statements to the end-users for decision-making.

FUNCTIONS OF ACCOUNTING

Financial Accounting performs the following nature functions:

(i) **Maintaining systematic records:** Business transactions are properly recorded, classified under appropriate accounts and summarised into financial statements — income statement and the balance sheet.

(ii) **Communicating the financial results:** Accounting is used to communicate financial information in respect of net profits (or loss), assets, liabilities etc., to the interested parties.

(iii) **Meeting legal needs:** The provisions of various laws such as Companies Act, Income Tax and Sales Tax Acts require the submission of various statements, *i.e.*, annual account, income tax returns, returns for sales tax purposes and so on.

(iv) **Protecting business assets:** Accounting maintains proper records of various assets and thus enables the management to exercise proper control over them with the help of following information regarding them:

(*a*) How much is balance of cash in hand and cash at bank?

(*b*) What is the position of the inventories?

(*c*) How much money is owed by the customers?

(*d*) How much money is owing to the creditors?

(*e*) What is the position of various fixed assets and how these are being used?

(v) **Accounting assists the management in the task of** planning, control and coordination of business activities.

(vi) **Stewardship:** In the case of limited companies, the management is entrusted with the resources of the enterprise. The managers are expected to act as true trustees of the funds and the accounting helps them to achieve the same.

(vii) **Fixing responsibility:** Accounting helps in the computation of the profits of different departments of an enterprise. This would help in fixing the responsibility of departmental heads.

ADVANTAGES OF BOOKKEEPING

From the above objectives of bookkeeping, the following advantages can be noted:

(i) **Permanent and reliable record:** Bookkeeping provides permanent record for all business transactions, replacing the memory which fails to remember everything.

(ii) **Arithmetical accuracy of the accounts:** With the help of bookkeeping, trial balance can be easily prepared. This is used to check the arithmetical accuracy of accounts.

(iii) **Net result of business operations:** The result (profit or loss) of business can be correctly calculated.

(iv) **Ascertainment of financial position:** It is not enough to know the profit or loss; the proprietor should have a full picture of his financial position in business. Once the full picture (say for a year) is known, this helps him to plan for the next year's business.

(v) **Ascertainment of the progress of business:** When a proprietor prepares financial statements every year, he will be in a position to compare the statements. This will enable him to ascertain the growth of his business. Thus, bookkeeping enables a long-range planning of business activities besides satisfying the short-term objective of calculation of annual profits or losses.

(vi) Calculation of dues: For certain transactions, payments may be made later. Therefore, the businessman has to know how much he has to pay others.

(vii) Control over assets: In the course of business, the proprietor acquires various assets like building, machines, furniture, etc. He has to keep a check over them and find out their values year after year.

(viii) Control over borrowings: Many businessmen borrow from banks and other sources. These loans are repayable. Just as he must have a control over assets, he should have control over liabilities.

(ix) Identifying do's and don'ts: Bookkeeping enables the proprietor to make an intelligent and periodic analysis of various aspects of the business such as purchases, sales, expenditures and incomes. From such analysis, it will be possible to focus his attention on what should be done and what should not be done to enhance his profit earning capacity.

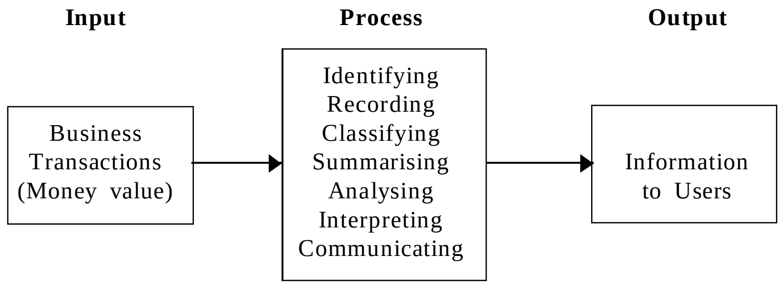
(x) Fixing the selling price: In fixing the selling price, the businessmen have to consider many aspects of accounting information such as cost of production, cost of purchases and other expenses. Accounting information is essential in determining selling prices.

(xi) Taxation: Businessmen pay sales tax, income tax, etc. The tax authorities require them to submit their accounts. For this purpose, they have to maintain a record of all their business transactions.

(xii) Management decision-making: Planning, reviewing, revising, controlling and decision-making functions of the management are well aided by bookkeeping records and reports.

(xiii) Legal requirements: Claims against and for the firm in relation to outsiders can be confirmed and established by producing the records as evidence in the court.

PROCESS OF ACCOUNTING



In order to accomplish its main objective of communicating information to the users, accounting embraces the following functions.

(i) Identifying: Identifying the business transactions from the source documents.

(ii) Recording: The next function of accounting is to keep a systematic record of all business transactions, which are identified in an orderly manner, soon after their occurrence in the journal or subsidiary books.

(iii) Classifying: This is concerned with the classification of the recorded business transactions so as to group the transactions of similar type at one place, *i.e.*, in ledger accounts. In order to verify the arithmetical accuracy of the accounts, trial balance is prepared.

(iv) Summarising: The classified information available from the trial balance are used to prepare profit and loss account and balance sheet in a manner useful to the users of accounting information.

(v) Analysing: It establishes the relationship between the items of the profit and loss account and the balance sheet. The purpose of analysing is to identify the financial strength and weakness of the business. It provides the basis for interpretation.

(vi) Interpreting: It is concerned with explaining the meaning and significance of the relationship so established by the analysis. Interpretation should be useful to the users, so as to enable them to take correct decisions.

(vii) Communicating: The results obtained from the summarised, analysed and interpreted information are communicated to the interested parties.

LIMITATIONS OF ACCOUNTING

One of the major limitations of accounting is that it does not take into account the non-monetary facts of the business like the competition in the market, change in the value for money etc.

The following limitations of financial accounting have led to the development of cost accounting:

1. No clear idea of operating efficiency: You will agree that, at times, profits may be more or less, not because of efficiency or inefficiency but because of inflation or trade depression. Financial accounting will not give you a clear picture of operating efficiency when prices are rising or decreasing because of inflation or trade depression.

2. Weakness not spotted out by collective results: Financial accounting discloses only the net result of the collective activities of a business as a whole. It does not indicate profit or loss of each department, job, process or contract. It does not disclose the exact cause of inefficiency, *i.e.*, it does not tell where the weakness is because it discloses the net profit of all the activities of a business as a whole. Say, for instance, it can be compared with a reading on a thermometer. A reading of more than 98.4° or less than 98.4° discloses that something is wrong with the human body but the exact disease is not disclosed. Similarly, loss or less profit disclosed by the profit and loss account is a signal of bad performance of the business in whole, but the exact cause of such performance is not identified.

3. Not helpful in price fixation: In financial accounting, costs are not available as an aid in determining prices of the products, services, production order and lines of products.

4. No classification of expenses and accounts: In financial accounting, there is no such system by which accounts are classified so as to give relevant data regarding costs by departments, processes, products in the manufacturing divisions, by units of product lines and sales territories, by departments, services and functions in the administrative division. Further, expenses are not attributed as to direct and indirect items. They are not assigned to the products at each stage of production to show the controllable and uncontrollable items of overhead costs.

5. No data for comparison and decision-making: It will not provide you with useful data for comparison with a previous period. It also does not facilitate taking various financial decisions like introduction of new products, replacement of labour by machines, price in normal or special circumstances, producing a part in the factory or sourcing it from the market, production of a product to be continued or given

up, priority accorded to different products and whether investment should be made in new products etc.

6. No control on cost: It does not provide for a proper control of materials and supplies, wages, labour and overheads.

7. No standards to assess the performance: In financial accounting, there is no such developed system of standards, which would enable you to appraise the efficiency of the organisation in using materials, labour and overhead costs. Again, it does not provide you any such information, which would help you to assess the performance of various persons and departments in order that costs do not exceed a reasonable limit for a given quantum of work of the requisite quality.

8. Provides only historical information: Financial accounting is mainly historical and tells you about the cost already incurred. As financial data is summarised at the end of the accounting period, it does not provide day-to-day cost information for making effective plans for the coming year and the period after that.

9. No analysis of losses: It fails to provide complete analysis of losses due to defective material, idle time, idle plant and equipment. In other words, no distinction is made between avoidable and unavoidable wastage.

10. Inadequate information for reports: It does not provide adequate information for reports to outside agencies such as banks, government, insurance companies and trade associations.

11. No answer to certain questions: Financial accounting will not provide you with answers to such questions as:

(*a*) Should an attempt be made to sell more products or is the factory operating to its optimum capacity?

(*b*) If an order or contract is accepted, is the price obtainable sufficient to show a profit?

(*c*) If the manufacture or sales, of product X were discontinued and efforts made to increase the sale of Y, what would be the effect on the net profit?

(*d*) Why the annual profit is of a disappointing amount despite the fact that output was increased substantially?

(*e*) If a machine is purchased to carry out a job, which at present is done by hand, what effect will this have on the profit line?

(*f*) Wage rates having been increased by 50 paisa per hour, should selling price be increased and if so, by how much?

IMPORTANCE OF ACCOUNTING

(i) Owners: The owners provide funds or capital for the organisation. 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, to 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 organisation, 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 shareholders' funds which is available in the accounting record maintained by the firm.

Other benefits are:

1. **Maintaining systematic records:** It is a primary function of accounting to keep a proper and chronological record of transactions and events, which provides a base for further processing and proof for checking and verification purposes. It embraces writing in the original/subsidiary books of entry, posting to ledger, preparation of trial balance and final accounts.
2. **Meeting legal requirements:** Accounting helps to comply with the various legal requirements. It is mandatory for joint stock companies to prepare and present their accounts in a prescribed form. Various returns such as income tax, sales tax are prepared with the help of the financial accounts.
3. **Protecting and safeguarding business assets:** Records serve a dual purpose as evidence in the event of any dispute regarding ownership title of any property or assets of the business. It also helps prevent unwarranted and unjustified use. This function is of paramount importance, for it makes the best use of available resources.
4. **Facilitates rational decision-making:** Accounting is the key to success for any decision-making process. Managerial decisions based on facts and figures take the organisation to heights of success. An effective price policy, satisfied wage structure, collective bargaining decisions, competing with rivals, advertisement and sales promotion policy etc. all owe it to well set accounting structure. Accounting provides the necessary database on which a range of alternatives can be considered to make managerial decision-making process a rational one.
5. **Communicating and reporting:** The individual events and transactions recorded and processed are given a concrete form to convey information to others. This economic information derived from financial statements and various reports is intended to be used by different groups who are directly or indirectly involved or associated with the business enterprise.

BASIS OF ACCOUNTING

The business enterprises use accounting to calculate the profit from the business activities at the end of given period. There are two basis of calculating the profit, namely, the cash basis and accrual basis.

(i) Cash basis of accounting: In this basis of accounting, the income is calculated as the excess of actual cash receipts in respect of sale of goods, services, properties, etc., over actual cash payments regarding purchase of goods, expenses on rent, electricity, salaries, etc. Credit transactions are not considered at all including adjustments for outstanding expenses and accrued income items. This method is useful for professional people like doctors, engineers, advocates, chartered accountants, brokers and small traders. It is simple to adopt because there are no adjustment entries. But this basis does not disclose the true profits because it does not consider the income and expense items which relate to the accounting period but not paid in cash.

Moreover, this method is not applicable where the number of transactions is very large and expenditure on fixed assets is high. The income or profit is calculated with the help of receipts and payments account.

(ii) Accrual basis of accounting: Under this method, the items of income (revenue) are recognised when they are earned and not when the money is actually received later on. Similarly, expense items are recognised when incurred and not when actual payments are made for them. It means revenue and expenses are taken into consideration for the purpose of income determination on the basis of the accounting period to which they relate. The **accrual basis** makes a distinction between actual receipts of cash and the right to receive cash for revenues and the actual payments of cash and legal obligations to pay expenses. It means that income accrued in the current year becomes the income of current year whether the cash for that item of income is received in the current year or it was received in the previous year or it will be received in the next year. The same is true of expense items. Expense item is recorded if it becomes payable in the current year whether it is paid in the current year or it was paid in the previous year or it will be paid in the next year.

The advantages of this system are: (*a*) it is based on all business transactions of the year and, therefore, discloses the current profit or loss; (*b*) the method is used in all types of business units; (*c*) it is more scientific and rational application; (*d*) it is most suitable for the application of matching principle. The **disadvantages** are: (*a*) it is not

DIFFERENCE BETWEEN ACCRUAL BASIS OF ACCOUNTING AND CASH BASIS OF ACCOUNTING

Basis of Difference	*Accrual Basis of Accounting*	*Cash Basis of Accounting*
1. Prepaid, Outstanding and received in advance items	There may be outstanding expense, prepaid expenses, laccrued income and income received in advance in the Balance Sheet.	There is no outstanding expense, prepaid expenses, accrued income and income received in advance in the Balance Sheet.
2. Effect on income of prepaid expenses and accrued income	Income statement will show relatively higher income if there are items of prepaid expenses and accrued income.	Income statement will show relatively lower income if there are items of prepaid expenses and accrued income.
3. Effect of outstanding expenses and unearned income	Income statement will show a lower income if there are items of outstanding expenses and unearned income.	Income statement will show a higher income if there are items of outstanding expenses and unearned income.
4. Legal Position	Companies Act 1956 recognises this basis of accounting.	Companies Act 1956 does not recognise this basis of accounting.
5. Option regarding valuation of inventories and methods of depreciation	The business unit has the option to value the inventories at cost or market, whichever is less of depreciation.	No such option is available in regard to inventory valuation and method of depreciation.
6. Reliable	It is a reliable basis of accounting as it records all cash as well credit transactions. It ascertains true profit or loss.	It is not a reliable basis of accounting as only cash transactions are recorded. It fails to ascertain true profit or loss.
7. Users	A business unit with a profit motive ascertains its profit or loss as per accrual basis.	Professional people, small ventures of temporary nature, some Not-for-profit organisations ascertain their profit or loss as per cash basis.

simple one and requires the use of estimates and personal judgement; (*b*) it fails to disclose the actual cash flows.

(iii) Mixed or hybrid basis of accounting: Under this method, revenues (items of income) are recognised on cash basis while the expenses are recorded on accrual basis. The purpose is to remain cautious, safe and hundred per cent certain for revenue items and make adequate provisions for expenses.

USERS OF ACCOUNTING INFORMATION

Financial accounting is primarily concerned with preparation of accounting information for the outsiders who do not have direct excess to the accounting records. They obtain accounting information of business enterprises from their annual reports, data published by Government departments and information published in financial newspapers, *e.g.*, the Economic Times, Financial Express etc., or business magazines, *e.g.*, Business India, Business World, The Economist, etc. In the following paragraphs, the users of accounting information have been grouped into a number of major headings and the requirements for each considered therein:

1. **Creditors and short-term lenders:** Creditors include suppliers of goods and services on credit. Short-term lenders such as commercial banks supply money for short period to business organisations. Bankers and suppliers inspect the accounting information before making loans or granting credit. They want to know whether or not the enterprise will be able to meet its financial repayment obligations in time. Their specific interest lies in solvency, liquidity and profitability positions of the business enterprise. Accounting serves their purpose by disclosing true and fair view of current assets in the balance sheet and profitability position in the income statement so as to assure the creditors and lenders that their debts would be paid in time.
2. **Investors:** Under this category are included the existing shareholders and future shareholders. Basically, they will be interested in the dividends that are paid. They are also interested about the future prosperity of their enterprise. But the income statement and the balance sheet of one year will not be helpful to guide the investors about the future prospects. So, the accounting information must provide the details of the profits and financial position of business so that the investors can find out the progress of the past few years and it may be assumed that this progress will be maintained in future as well. At present, such information is generally given in the

published accounts. The statement of the Chairman in the annual reports also provides some indication about the future progress.
3. **Long-term lenders:** This category of users includes debenture holders and those providing long-term loans, say; industrial banks, financial institutions, etc. They are interested in knowing that they will get the interest due to them and that the same will be paid when it is due and payable. They will also see to it that their principal amount is also paid on due date. So, their main interest is in the profitability for interest payments and liquidity for the repayment of the loan amount. The availability of cash flow statements in addition to income statement and balance sheet has considerably helped users to evaluate the liquidity position of a business enterprise.
4. **Management:** The owners are not the only persons within the business enterprise who are interested in various aspects of the operations of a business. With the separation of management and ownership (particularly in a limited company), the managers are responsible for carrying on the operations of the business enterprises. The type of accounting information needed by managers may vary with the size of the enterprise. The manager of a small business may need relatively little accounting information. As the business enterprises grows in size, the manager loses direct contact with daily operations. As a result, information about the various aspects of the business enterprise must be supplied by accounting. Some of their needs for accounting information relate to: (*i*) setting objectives or targets for future periods and devising methods to attain those objectives; (*ii*) observing and measuring the performance of the various departments of the business as also the enterprise as a whole; (*iii*) evaluating the performance in relation to the targets set up; highlighting the deviations from the planned targets; and (*iv*) taking such corrective action as may be necessary to overcome the shortfalls.
5. **Employees (Labour unions):** In .this category are included both individual employees and groups of them represented by labour unions. Employees want more salary and other benefits such as overtime payments, bonus, housing, medical facilities and so on. The bargaining power of the unions is increased if workers' demands are based on facts and figures. In addition, some companies regularly issue certain reports containing financial information about the employers for a better understanding of the business by the employees. These

reports highlight what the companies are doing for the welfare of their employees and what they intend to do in future.

6. **Government and regulatory agencies:** In recent years, the government has become one of the most important users of accounting information. The Central, State and local governments have the responsibility of allocating the resources for different uses. Naturally, they are interested in the activities of business enterprises such as sales, profits, dividend policies, investments, etc. Moreover, the Government activities are financed through the collection of tax. Thus, the accounting information about business activities is very helpful in the collection of income tax, excise duties, customs duties, sales tax, etc. Each tax requires a special tax return based on necessary accounting information of various business enterprises. Any distortion in the accounting information needed by the Government agencies would adversely affect the welfare policies of various types of governments. Similarly, a number of regulatory agencies like Securities and Exchange Board of India (SEBI), the Insurance Regulatory Authority, the Reserve Bank of India etc. need accounting information for the efficient operation of capital markets.

7. **Individuals and society**: People are affected by the operations of a business enterprise in their localities. They want to know through the accounting information the trends in the prosperity of the enterprise and also the range of activities. This would enable them to assess the employment opportunities in their local areas. Society as a whole is concerned with the environment pollution. The accounting information would disclose how much money has been allocated to control such pollution. This has come to be known as social responsibility accounting.

RELATIONSHIP OF ACCOUNTANCY WITH OTHER DISCIPLINES

The need for and importance of accounting is felt by all the organisations — whether trading or non-trading. The relationships of accounting with various disciplines are explained below:

(a) Accounting and Business

Business organisations are run with an object of earning profit. They deal with various persons and other organisations. Unless all the business transactions are properly recorded, it is not possible to know the true result of the business. Similarly, unless all assets and liabilities are properly recorded, it will not be possible to prepare the financial

position of the business. The importance of accounting is so much felt in large sized business, wherein accounting is considered as a separate function of the business. Hence, a separate department by name accounting department is created which is in charge of the Chief Accountant.

(b) Accounting and Government

Government which is considered as the biggest form of organisation also makes use of accounting discipline. Budgeting which is one of the important aspects of accounting is prepared by every State and Central government. Every government is interested in knowing the total revenue and total expenditure and the balance amount available in the government treasury. In case of deficit balance, the government can raise funds through issue of bonds, bills, etc., for financing projects of national importance. In case of surplus funds, it can divert to other key sectors where it lacks adequate funds. The importance of accounting is so much felt by the government that in modern days a new branch of accounting called as government accounting is involved and adopted by most of the governments.

(c) Accounting and Medical Science

Medical science also heavily relies upon accounting information. Hospitals and clinics will maintain accounting books in order to know the rates to be charged to patients. They record all the expenses incurred and revenue received for a given period to know whether hospitals and clinic is run with profit or otherwise.

(d) Accounting and Research

Research organisations also will maintain a set of accounting books to know the research expenses in conducting various experiments. They will evaluate the success of the research activities by knowing the corresponding benefit derived by the production and sale of new products.

(e) Accounting and Education

The promoters of education and educational institutions also will maintain detailed accounts of various expenses incurred under different heads such as library, laboratory, sports and cultural activities, salaries payable etc. They also record the fees and donations received from students so as to know maintenance cost of educational institutions.

ROLE OF ACCOUNTANT IN SOCIETY

The accountancy profession is considered to be one of the noblest professions and is held in high esteem in public eyes. By making use of science and art of accountancy, an accountant will enable public to know the exact position of a business. The profession of accountancy also enables the management to discharge its functions efficiently based upon the information provided by Accountant. The Accountant also serves the society by virtue of his education, training, analytical mind and experience. A modern Accountant can render useful service not only in the field of taxation, costing, management accounting and company legislation, but also in allied areas such as finance, budgeting, and economic aspects.

The various services rendered by an accountant are summarised below:

1. Maintenance of Books of Accounts

By maintaining the books of accounts, it is possible to know the result of the business and its financial position. In the process of maintaining the books of accounts, an accountant renders the following services:

(*a*) Helps management in planning, decision-making and controlling.

(*b*) Facilitate comparative study to know the efficiency or otherwise of the business.

(*c*) In calculating the tax liability of the business.

(*d*) To furnish evidence in court in terms of conflict.

(*e*) To ascertain purchase price of business when it is sold to outsiders.

(*f*) To deal on behalf of an insolvent business.

2. To Conduct Statutory Audit

Auditing the accounts of a Joint Stock Company is compulsory. A Chartered Accountant serves as an auditor to verify the correctness of accounts of a Joint Stock Company.

3. To Conduct Internal Audit

Internal audit is conducted to know whether there is any leakage of revenue or misappropriation of property of the business.

4. Taxation

An Accountant can represent the business or person before tax authorities and settle the tax liability as per the Income Tax Act.

5. Management Accounting

A Management Accountant assists management in performing various functions by way of collecting, analysing, interpreting and presenting all accounting information which is useful to the management.

6. Financial Service

These include:

(*a*) Investment

(*b*) Insurance

(*c*) Business expansion, mergers, acquisitions etc.

(*d*) Investigation, which includes:

- (*i*) Make or buy decision
- (*ii*) Detecting fraud
- (*iii*) Valuation of shares
- (*iv*) Achieve greater efficiency on management
- (*v*) Pension and provident fund scheme
- (*vi*) Use of mechanical equipments.

7. Management Consultancy Service

This includes:

(*i*) Management information service

(*ii*) Expenditure control and evaluation

(*iii*) MBO

(*iv*) Management of working capital and its best possible use

(*v*) Advising management about O&M studies for effective delegation and planning of work

(*vi*) Formulating long-term plan and setting up objectives of the business

(*vii*) Assist management in conducting feasibility study of new projects

(*viii*) Advise management on the benefits of mechanised accounting system

(*ix*) Use of statistical techniques for business forecasting.

8. Other Services

This includes:

(*a*) Registering share transfers and new issues

(*b*) Company formation

(*c*) Liquidation

(*d*) Arbitration.

QUESTIONS

1. Define Accounting. What are the advantages of Accounting?
2. Who are the different parties interested in accounting information?
3. What are the major functions of accounting?
4. Define accounting? Explain its characteristics.
5. State the limitations of accounting.

QUESTIONS FROM VEER NARMAD SOUTH GUJARAT UNIVERSITY EXAM

Write short notes on:

1. Limitations of Financial Accounting.
   [2013 April (Old course)]), [October 2009]
2. Functions of Accounting. *[2013 April (Old course)], [October 2011], [March 2011], [March 2011 (Old course)], [October 2004]*
3. Functions and Limitations of Financial Accounting.
   [2012 October (CBCS)]

n n n n n