ELEMENTS OF ACCOUNTANCY (NME)
UNIT-I

INTRODUCTION TO ACCOUNTING

Business entities and other organisations carry on activities which involve exchange of money or money's worth or economic resources. Where the volume of these activities are large in number it is necessary that these are recorded for the purpose of taking important decisions as to whether the activities are viable, gainful and are to be continued or not. Information about the business and other organisations is required not only to the proprietors and managers of business and other organisations but also to various other interested users such as the government, investors, customers, employees and researchers.

EVOLUTION OF ACCOUNTING:

In India, 23 centuries ago, **Chandragupta Maurya's Minister Kautilya** wrote a book named '**Arthashastra'**, wherein some references can be traced regarding the way of maintaining accounting records.

In the earliest days of civilisation, accounting was done by stewards who managed the properties of wealthy people. They rendered accounts periodically to the owners of property. The stewardship accounting is said to be the root of accounting. Records of debit and credit were found in the 12th century itself.

In **1494, Luca Pacioli** an Italian developed double-entry book-keeping system. Due to the industrial revolution in the 18th and 19th centuries, large scale operations were carried on and joint stock companies emerged as an important form of organisation which required separation of ownership from management. Hence, to safeguard the interest of owners and investors, the business establishments required detailed information about business which paved the way for development of comprehensive financial accounting information system.

MEANING AND DEFINITION OF ACCOUNTING

Accounting is the systematic process of identifying, measuring, recording, classifying, summarising, interpreting and communicating financial information. Accounting gives information on:
(i) The resources available
(ii) How the available resources have been employed and
(iii) The results achieved by their use.
The profit earned or loss incurred during the accounting period, value and nature of assets, liabilities and capital can be ascertained from the information recorded in accounts.

According to the **American Institute of Certified Public Accountants** "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 ".

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

ACCOUNTING CYCLE:

Accounting cycle is the sequence of steps involved in the accounting process. Accounting cycle starts with the identification and recording of financial transactions of an organisation and ends with the preparation of final accounts for the accounting year. The cycle continues for the next accounting year with the opening balances of assets and liabilities which are the closing balances of the preceding year. The steps involved are:

(i) Identifying the Transactions and Journalising

The first step in the accounting process is identifying the financial transactions of a business. All the monetary transactions are recorded in the books of original entry called journals. Recording the transactions in the journal is called journalising. Entries are made in the journals on the basis of source documents in the chronological order, i.e., the order of occurrence of the transactions.

(ii) Posting and Balancing

Transferring the entries from the journal to the ledger is called posting. In the ledger, entries are made in each account after classifying them under common heads. Finding the difference between the total of the debit column and credit column of all the ledger accounts is called balancing.

(iii) Preparation of Trial Balance

The list of ledger balances namely trial balance is prepared as the next step. On the basis of ledger balances the financial statements are prepared.

(iv) Preparation of Trading Account

Next step is preparation of trading account for a particular accounting period. All the direct revenues and direct expenses are transferred to trading account. The balance in the trading account is the gross profit or gross loss.

(iv) Preparation of Profit and Loss Account

Profit and loss account is prepared next for a particular accounting period. All the indirect revenues and indirect expenses along with gross profit or gross loss are transferred to profit and loss account. The balance in the profit and loss account is the net profit or net loss.

(vi) Preparation of Balance Sheet

A statement showing the balances of assets and liabilities namely balance sheet is prepared as the final step in the accounting process. It is prepared on a particular date normally on the last day of the accounting period. The closing balances of an accounting year are taken as the opening balances for the next accounting year. The transactions identified and recorded for the next year are followed by posting and other steps. The results are communicated to the users of accounting information for the purpose of analysis and decision making.

OBJECTIVES OF ACCOUNTING:

Following are the objectives of accounting:

(i) To keep a systematic record of financial transactions and events
(ii) To ascertain the profit or loss of the business enterprise
(iii)To ascertain the financial position or status of the enterprise
(iv) To provide information to various stakeholders for their requirements
(v) To protect the properties of an enterprise and
(vi) To ascertain the solvency and liquidity position of an enterprise

FUNCTIONS OF ACCOUNTING:

The main functions of accounting are as follows:

(i) Measurement

The main function of accounting is to keep systematic record of transactions, post them to the ledger and ultimately prepare the final accounts. Accounting works as a tool for measuring the performance of the business enterprises. It also shows the financial position of the business enterprises.

(ii) Forecasting

With the help of the various tools of accounting, future performance and financial position of the business enterprises can be forecasted.

(iii) Comparison

Accounting helps to compare the actual performance with the planned performance. It is also possible to compare with the accounting policies. Through comparison of the actual financial results of the business enterprises with projected figures and standards, effective measures can be taken to enhance the efficiency of various operations.

(iv) Decision Making

Accounting provides relevant information to the management for planning, evaluation of performance and control. This will help them to take various decisions concerning cost, price, sales, level of activity, etc.

(v) Control

As accounting works as a tool of control, the strengths and weaknesses are identified to provide feedback on various measures adopted. It serves as a tool for evaluating compliance of business policies and programmes.

(vi) Assistance to Government

Government needs full information on the financial aspects of the business for various purposes such as taxation, grant of subsidy, etc. Accounting provides relevant information about the business to exercise government control on business enterprises.

IMPORTANCE OF ACCOUNTING:

Accounting is a basic necessity for all enterprises. Importance of accounting is enumerated as below:

(i) Systematic Records

All the transactions of an enterprise which are financial in nature are recorded in a systematic way in the books of accounts. The records are classified under common heads and summaries are prepared.

ii) **Assessment of Progress**

Analysis and interpretation of financial data can be done to assess the progress made in different areas and to identify the areas of weaknesses. Management is provided with a complete picture of the liquidity, profitability and solvency of the business.

(iii) Aid to Decision Making

Management of a firm has to make routine and strategic decisions while discharging its functions. Accounting provides the relevant data to make appropriate decisions. Future policies and programmes can be planned by the management based on the accounting data provided.

(iv) Information to Interested Groups

Accounting supplies appropriate information to different interested groups like owners, management, creditors, employees, financial institutions, tax authorities and the government.

(v) Legal Evidence

Accounting records are generally accepted as evidence in courts of law and other legal authorities in the settlement of disputes.

(vi) Computation of Tax

Accounting records are the basic source for computation and settlement of income tax and other taxes.

(Vii) Settlement During Merger

When two or more business units decide to merger, accounting records provide information for deciding the terms of merger and any compensation payable as a consequence of merger.

DOUBLE ENTRY SYSTEM

Double entry system of book keeping is a scientific and complete system of recording the financial transactions of an organisation. According to this system, every transaction has a two fold effect. That is, there are two aspects involved, namely, receiving aspect and giving aspect. It is denoted by debit (Dr.) and credit (Cr.). The basic principle of double entry system is that for every debit there must be an equivalent and corresponding credit. Debit denotes an increase in assets or expenses or a decrease in liabilities, income or capital. Credit denotes an increase in liabilities, income or capital or a decrease in assets or expenses.

Definition of Double Entry System

"Every transaction involving money or money's worth has two fold aspects, the receiving of a value on the one hand and the giving of the same value on the other. This two fold nature in all transactions must be recorded in the books and this gives rise to the term Double Entry Book keeping". – **Munro and Palmer**

"Every business transaction has a two-fold effect and that it affects two accounts in opposite directions and if a complete record is to be made of each such transaction it is necessary to debit one account and credit another account. It is this recording of two fold effect of every transaction that has given rise to the term Double Entry".**– J.R Batliboi**

Principles of Double Entry System

Following are the principles of double entry system:

(i) In every business transaction, there are two aspects.

(ii) The two aspects involved are the benefit or value receiving aspect and benefit or value giving aspect.

(iii) These two aspects involve minimum two accounts; at least one debit and at least one credit.

(iv) For every debit, there is a corresponding and equivalent credit. If one account is debited the other account must be credited

Meaning of Debit and Credit:

Debit:

The word Debit is derived from the Latin word Debitum which means **Due for that**. In short, the benefit receiving aspect of a transaction is known as debit.

Credit:

The word credit is derived from the Latin word Creder which means **Due to that**. The benefit giving aspect of a transaction is known as credit.

The abbreviation **'Dr'** for Debit and **'Cr'** Credit are usually used.

Advantages of Double Entry System

(i) Accuracy

In this system, the two aspects of each transaction are recorded in the books of accounts. This helps in checking the accuracy in accounting.

(ii) Ascertainment of Business Results

Details regarding expenses, losses, incomes, gains, assets, liabilities, debtors, creditors, etc., are readily available. This helps to ascertain the net profit earned or loss incurred during an accounting period and also to know the financial position as on a particular date.

(iii) Comparative Study

The business results of the current year can be compared with those of the previous years and also with other business firms. It facilitates business planning for future.

(iv) Common Acceptance

The business records maintained under this system are accepted by financial institutions, government and others, because it is a systematic and scientific system.

Types of Accounts:

Under double entry system of book keeping, for the purpose of recording the various financial transactions, the accounts are classified as personal accounts and impersonal accounts.

(i) **Personal Account:** Account relating to persons is called personal account. The personal account may be natural, artificial or representative personal account.

(a) Natural Person's Account: Natural person means human beings. Example: Vinoth account, Malini account.

(b) Artificial Person's Account: Artificial person refers to the persons other than human beings recognised by law as persons. They include business concerns, charitable institutions, etc. Example: BHEL account, Bank account.

(c) Representative Personal Accounts: These are the accounts which represent persons natural or artificial or a group of persons. Example: Outstanding salaries account, Prepaid rent account. When expenses are outstanding, it is payable to a person. Hence, it represents a person.

(ii) **Impersonal Accounts:** All accounts which do not affect persons are called impersonal accounts. These are further classified into a) Real accounts and b) Nominal accounts.

(a) Real Account: All accounts relating to tangible and intangible properties and possessions are called real accounts.

1. **Tangible Real Accounts:** These include accounts of properties and possessions which can be seen and touched. These have physical existence. Example: Plant, Machinery, Building, Furniture, Stock.

2. **Intangible Real Accounts:** These include accounts of properties and possessions which cannot be seen and touched. These do not have physical existence. Example: Goodwill, Patents, Copy rights.

(b) Nominal Account: The accounts relating to expenses, losses, revenues and gains are called nominal accounts. Example: Salaries, wages, rental income, interest income, etc. These are temporary accounts and are transferred to Trading and Profit and Loss account depending on whether these are direct or indirect respectively.

ACCOUNTING RULES:

All the above classified accounts have two rules each, one related to debit and another related to credit for recording the transactions which are termed as golden rules of accounting or rules of double entry system.

GOLDEN RULES OF DOUBLE ENTRY SYSTEM

ACCOUNTING TERMINOLOGY:

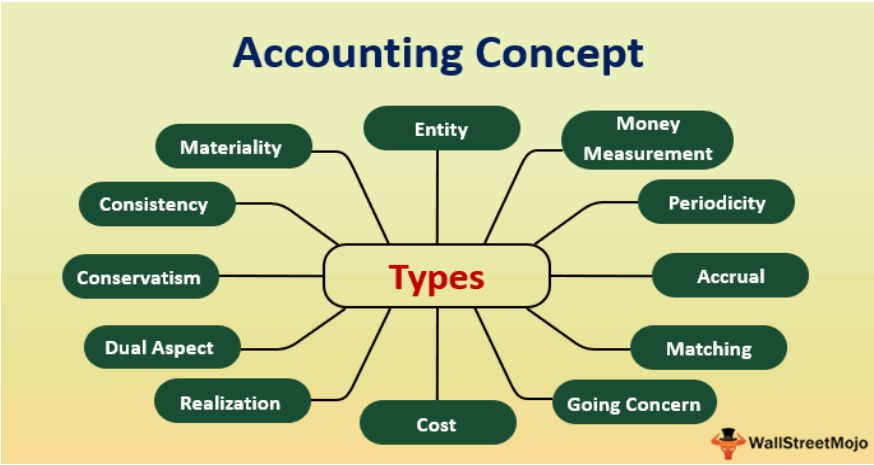
Accounting is a versatile system which serves a large number of purposes in the modern business world. Hence, the following terminologies need to be understood.

Transaction	An activity which involves transfer of money or money's worth (goods, services, ideas) from one person to another.
Cash transaction	It is a transaction which involves immediate cash receipt or immediate cash payment.
Credit transaction	It is a transaction in which cash is not received or paid immediately, but will be received or paid later.
Account	It is the basic unit for measurement in accounting. It is used for identifying a person, or an item in accounting. An account is opened individually for a person, asset, expense, income, etc. In ledger, an account is a summary of transactions under a head.
Capital	It is the amount invested by the owner or proprietor in an organisation.
Drawings	It is the amount of cash or value of goods, assets, etc., withdrawn from the business by the owner for the personal use of the owner.

Voucher	Any written or printed document in support of a business transaction is called a voucher. Examples: cash receipt, invoice, cash memo, bank pay-in- slip, etc.
Invoice	It is a statement prepared by a seller of goods to be sent to the buyer. It shows details of quantity, price, value, etc. of the goods and any discount given, finally showing the net amount payable by the buyer.
Purchases	Buying of goods with the intention of resale is called purchases.
Purchases returns or returns outward	When goods bought are returned to the suppliers, it is known as purchases returns or returns outward.
Sales	When goods meant for resale are sold, it is called sales.
Sales returns or returns inward	When goods sold are returned by the customers, it is called as sales returns or returns inward.
Stock	Unsold goods lying in a business on a particular date are known as stock.
income	It is the amount receivable or realised from sale of goods and earnings from interest, dividend, commission, etc.
Expense	It is the amount incurred in order to produce and sell the goods and services.
Solvency	Solvency is the capability of a person or an enterprise to pay the debts.
Insolvency	Insolvency is the incapability of a person or an enterprise to pay the debts
Asset	Any physical thing or right owned that has a monetary value is called asset
Liability	It refers to the financial obligation of the business.
Debtor	A person who receives a benefit without giving money or money's worth immediately, but liable to pay in future or in due course of time.
Creditor	A person who gives a benefit without receiving money or money's worth immediately but to claim in future.
Depreciation	It refers to the gradual reduction in the value of fixed assets due to usage and passage of time.
Bad debt	It is a loss to the business arising out of failure of a debtor to pay the dues. It is irrecoverable debt.

ACCOUNTING CONCEPT AND CONVENTIONS:

Accounting principles are the basic norms and assumptions developed and established as the basis for accounting system. These principles are adopted by the accountants universally. These accounting principles provide uniformity and consistency in the accounting methods and process. Such accounting principles are known as Generally Accepted Accounting Principles (GAAP).



(i) Business Entity Concept:

This concept implies that a business unit is separate and distinct from the owner or owners, that is, the persons who supply capital to it.

Based on this concept, accounts are prepared from the point of view of the business and not from the owner's point of view. Hence, the business is liable to the owner for the capital contributed by him/her.

(ii) Money Measurement Concept:

This concept implies that only those transactions, which can be expressed in terms of money, are recorded in the accounts. Since, money serves as the medium of exchange transactions expressed in money are recorded and the ruling currency of a country is the measuring unit for accounting.

(iii) Going concern Concept:

It is the basic assumption that business is a going concern and will continue its operations for a foreseeable future. Going concern concept influences accounting practices in relation to valuation of assets and liabilities, depreciation of the fixed assets, treatment of outstanding and prepaid expenses and accrued and unearned revenues.

(iv) Cost Concept:

An asset is recorded in the books on the basis of the historical cost, that is, the acquisition cost. Cost of acquisition will be the base for all further accounting. It does not mean that the asset will always be shown at cost. It is recorded at cost at the time of its purchase, but is systematically reduced in its book value by charging depreciation.

(v) **Dual Aspect Concept**:

According to this concept, every transaction or event has two aspects, i.e., dual effect.

For example, when Arun starts a business with cash ` 5,00,000, on the one hand, the business gets cash of ` 5,00,000 and on the other hand, a liability arises, that is, the business has to pay Arun a sum of ` 5,00,000.

(vi) Periodicity Concept:

This concept deals with preparing accounts for a particular period. As the proprietors, investors, creditors, employees and the government are interested in knowing the performance of the business unit periodically, it becomes necessary to select a particular period, normally one year for measuring performance. Hence, financial statements are prepared after every accounting period and not at the end of its life.

(vii) Matching Concept :

According to this concept, revenues during an accounting period are matched with expenses incurred during that period to earn the revenue during that period. This concept is based on accrual concept and periodicity concept. Periodicity concept fixes the time frame for measuring performance and determining financial status.

(viii) Accrual Concept:

According to accrual concept, the effects of the transactions are recognised on mercantile basis, i.e., when they occur and not when cash is paid or received. Revenue is recognised when it is earned and expenses are recognised when they are incurred. All expenses and revenues related to the accounting period are to be considered irrespective of the fact that whether revenues are received in cash or not and whether expenses are paid in cash or not.

(ix) Convention of Consistency:

The consistency convention implies that the accounting policies must be followed consistently from one accounting period to another. The results of different years will be comparable only when same accounting policies are followed from year to year. For example, if a firm follows the straight line method of charging depreciation since its purchase or construction, the method should be followed without any change. However, it does not mean that changes are not possible.

(x) Convention of full Disclosure:

It implies that the accounts must be prepared honestly and all material information should be disclosed in the accounting statement. This is important because the management is different from the owners in most of the organisations.

(xi) Convention of Materiality:

According to this convention, financial statements should disclose all material items which might influence the decisions of the users of financial statements. Hence, any item which is not significant and is not relevant to the users need not be disclosed in the financial statements.

(xii) Convention of Conservatism or Prudence:

It is a policy of caution or playing safe. While recording the business transactions one has to anticipate no income but provide for all possible losses.

ACCOUNTING EQUATION:

The relationship of assets with that of liabilities to outsiders and to owners in the equation form is known as accounting equation.

Under the double entry system of book keeping, every transaction has two fold effect, which causes the changes in assets and liabilities or capital in such a way that an accounting equation is completed and equated.

Capital + Liabilities = Assets

Capital can also be called as owner's equity and liabilities as outsider's equity.

Accounting equation is a mathematical expression which shows that the total of assets is equal to the total of liabilities and capital. This is based on the dual aspect concept of accounting. This means that total claims of outsiders and the proprietor against a business enterprise will always be equal to the total assets of the business enterprise.

As the revenues and expenses will affect capital, the expanded equation may be given as under:

Assets = Liabilities + Capital + Revenues – Expenses

Therefore, under this approach, accounts are classified into five categories: (i) Asset account, (ii) Liability account, (iii) Capital account, (iv) Revenue account and (v) Expense account as follows:

Asset account: Any physical thing or right owned that has a monetary value is called asset. The assets are grouped and shown separately; for example, Land and Buildings account, Plant and Machinery account.

Liability account: Financial obligations of the enterprise towards outsiders are shown under separate heads as liabilities; for example, creditors account, expenses outstanding account.

Capital account: Financial obligations of a business enterprise towards its owners are grouped under this category; for example, capital contributed by owner.

Revenue account: Accounts relating to revenues of an enterprise are grouped under this category, for example; revenues from sale of goods, rent received.

Expense account: Expenses incurred and losses suffered for earning revenue are grouped under this category; for example, purchase of goods, salaries paid.

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4. Dalston L Cecil and Jenitra L Merwin, Financial Accounting, 3rd ed., 2017, Learntech Press, Trichy.
5. Fundamentals of Accounting, 2017, The Institute of Chartered Accountants of India, New Delhi.

QUESTIONS

Two marks questions:

1. What is accounting?
2. Defining accounting.
3. What is money measurement concept?
4. What is cost concept?
5. What is personal account?
6. What is real account?
7. What is nominal account?
8. Give meaning of Debit.
9. Give meaning of Credit.

Five Marks Questions:

1. What are the advantages of accounting?
2. What are the objectives of accounting?
3. Discuss the Evaluation of accounting.
4. Discuss the meaning of Debit and Credit.

Ten marks questions:

1. Explain in detail principles of accounting.
2. Discuss the double accounting system.
3. Explain accounting terminology in detail.
4. What is accounting equation? And explain in detail.
5. Explain the types of accounting.
6. What are the importances of Accounting?