

Introduction to Accounting & Finance

Unit

1

Introduction to Accounting

Introduction

Accounting is required to account for the economic resources in all business and non-business activities, in business organizations like manufacturing or trading entities and in non-business organizations like schools, colleges, hospitals, libraries etc. Language serves as a means of communication; therefore, accounting is the language of business.

Definition of Accounting

According to the American Institute of Certified Public Accountants (AICPA), accounting is “the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events, which are, in part at least, of a financial character and interpreting the results thereof”.

Objectives of Accounting

Accounting fulfils different objectives depending on the specific requirements of businesses. However, some basic accounting objectives are as follows:

i) To keep systematic record: A business is involved in various business transactions on a daily basis and accounting keeps track of these transactions by recording them in books of accounts.

ii) To ascertain the results of the operation: Accounting ascertains any profit earned or loss incurred by a business during a particular period through Trading Profit and Loss account or an Income and Expenditure account. These accounts match the revenue earned by the business with the expenditure during the same period to calculate the profit or loss.

iii) To ascertain the financial position of the business: A business's financial statements reflect its financial position with regard to cash, assets, liabilities, capital etc. They help the business owner to determine the health of his enterprise.

iv) To portray the liquidity position: A business obtains and spends cash for numerous purposes such as lending, repayment of loans, capital transactions, paying cash dividends to shareholders and distribution of resources among owners. This information, along with other factors that determine an entity's liquidity and solvency, is portrayed in financial reports.

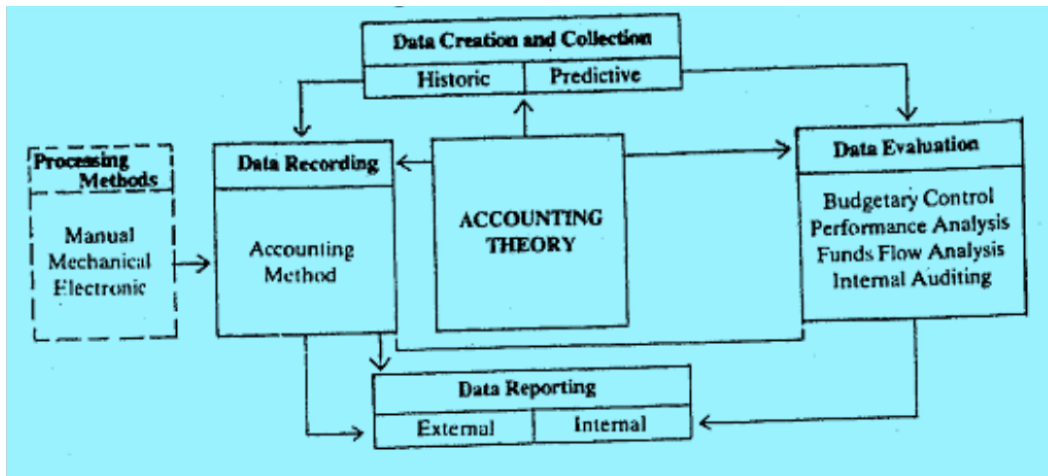
v) To protect business properties: Accounting keeps an updated record of the business's assets and liabilities to prevent false claims against the entity's properties.

vi) To facilitate rational decision – making: Financial statements and records help a business owner in analysing different aspects of his business and in decision-making.

vii) To satisfy the requirements of law: Laws such as the Companies Act, Societies Act, Sales Tax Act, Income Tax Act etc. that govern business operations require companies, public trusts and other business entities to maintain up to date accounts.

Scope of Accounting

The figure below is the diagrammatic representation of the scope of accounting.



Data creation and collection provides the basis for financial statements and accounting records. Historic data refers to the transactions that have already occurred. Earlier, accounting relied more heavily on historic data rather than predicting for the future.

Once data is collected, it is **recorded** in the books of original entry, also called journals and ledgers, in accordance with Generally Accepted Accounting Principles. These principles provide a framework and standards according to which data has to be recorded. The recording and processing of data can be manual, mechanical or electronic.

Data evaluation controls the business activities through budgets and standard costs, evaluating the performance of the business, analysing financial statements, analysing cash flows and choosing alternative courses of action for decision-making process. Evaluation of data is one of the most important business activities.

The analytical and interpretative aspect of accounting has a wide range of internal and external uses, from producing snap answers to elaborate reports based on extensive research. It also includes capital project analysis, budgetary projections, financial forecasts and research based analysis for reorganization, takeovers and mergers.

Audit is the verification of financial transactions as recorded in the books of accounts and the authentication of financial statements. Professional accountants and auditors are hired for auditing the financial accounts of businesses to keep track of financial flows and point out any lapses or fraud.

Data reporting can be internal or external. Internal data reporting is the communication of financial statements, analysis and evaluation to the management for decision-making. External data reporting communicates the business's financial position and its earnings to

outside parties such as the government, shareholders, regulatory bodies, other businesses etc.

The primary purpose of **accounting theory** is to match the costs (efforts) and revenues (accomplishments) of a business within a particular period. However, modern day accounting has moved beyond the sole purpose of record keeping and emphasizes on evaluation and forecasting of financial information.

Functions of Accounting

a) Record Keeping Function: Journalising, posting, and preparation of final statements are the primary tasks in accounting, which fulfil the function of recording, classification and summary of financial transactions. This function is used for reporting financial statements and helps us to know accurate financial position of entities. Hence, accounting, while giving us a clear picture of the past performance, assists in making decisions and devising strategies for future.

b) Managerial Function: Making decisions and performing managerial tasks without the help of accounting can often lead to critical mistakes. To perform managerial function efficiently, some predetermined standards and performance parameters are setup, against which the daily operations are measured. Accounting facilitates in making the analysis and studying the comparison of actual operations and the performance standards.

c) Legal Requirement function: Registered firms are legally obligated to carry out auditing. Auditing cannot take place without accounting. Therefore, in order to meet legal requirements accounting is mandatory. Accounting is a foundation, which can help to generate returns, documents, statements etc.

d) Language of Business: If there is a language of business, it is accounting. It communicates results of companies and firms to all those who are interested whether they are owners, employees, investors or creditors. Accounting can paint a true and accurate picture of a business and can highlight and foresee results.

Advantages of Accounting

Following are the advantages of accounting for any business or a firm:

- a) It assists in keeping and managing record of transactions of a business or a firm.
- b) It not only provides useful information about all the financial operations of a business but also highlights net gains or any loss made at the end of a financial year, and thus draws an accurate picture of the business.
- c) It helps in making important economic decisions by analysing the past performance.
- d) It assists in undertaking a comparative study of profits, losses, sales, revenues and expenses in different years.
- e) It analyses and tells us if an enterprise or a business is utilising its resources in the most effective possible manner.

- f) It interprets information on financial health of a business and facilitates in predicting and forecasting its financial future.
- g) It assists the businesses in meeting legal requirements, which include filing of sales-tax returns and income tax. Good accounting and accurate maintenance of all financial transactions helps a lot in assessment of taxes.

Limitations of Accounting

Accounting facilitates in making assessments of the values of businesses in terms of profits, losses, assets and liabilities. It gives the information that helps to decide future course of actions. Accounting provides us with logical conclusions, however, the facts derived from accounting at times can be biased, inclined or influenced by one factor or the other and hence false. Accounting has the following limitations:

1. **Record keeping:** Accounting helps in maintaining records of financial transactions only. Any actions, dealings or events that have a non-financial nature do not fall in accounting. Sometimes these may include information that directly or indirectly influence the financial health of the business. Managements skills, variation in consumer preferences or any other changes in the Human Resources may not be recorded in accounting but are, nonetheless, very important factors in running a business.
2. **Accuracy of information generated by accounting system:** Financial health of a business, including revenues, losses, assets and liabilities, are analysed by Accounting. During the analysis accountants rely on both real and assumed estimates. The methods of determining depreciation and valuating stocks may differ from business to business as each has their own standard practices and provisions.
3. **Value of assets:** The true market value of the assets is not normally reflected in balance sheets. The assets shown on the balance sheet have their costs adjusted according to the conventional rules of accounting. Furthermore, many assets enlisted in a balance sheet do not have any real market value at all. These assets may include patents, goodwill, preliminary expenses etc. When these assets are shown on the balance sheet, the final results may appear dubious.
4. **Window dressing:** Many firms adopt actions described as window dressing practices in order to increase profits in the short term. These actions may include postponing the maintenance of plant and machinery, which will decrease costs and increases profitability in the short term but such a strategy can lead to a complete disruption in production and operations when the machinery breaks down.
5. **Changing price levels:** Accounting measures of performance and evaluation of financial position may not be accurate due to changing prices and changes in the value of assets. Additional information based on the current replacement value of assets is required to get a closer estimate.

Evolution of Modern Accounting

Accounting has evolved over the period of time to adjust to changing socio-economic factors and stay relevant. Four distinguishable phases in the evolution of accounting are listed below:

Stewardship Accounting

The basis of financial reporting which involves recording day to day business transactions in journals, also called book-keeping, has its roots in earlier times when wealthy people hired stewards to maintain accounts and manage their properties. Accounts were submitted by the stewards to their owners periodically. Modern day practice of “double entry book keeping” was introduced by Italian merchants during the 15th century and was adopted by other European countries during the 19th century. Therefore, stewardship accounting originated from the need of business owners to keep a record of their transactions, their properties, the debts they owed and the money they lent etc.

Financial Accounting

Financial accounting began as businesses expanded and Joint Stock Companies (companies which enable the public to buy shares in the business in exchange for a particular percentage of the company's earnings) emerged. It was during this time that the need to invest savings into profitable ventures was recognized and investors started seeking information to help them with their investment decisions. Financial accounting gave investors a list of alternatives to their investment decisions, which helped them minimise the risk of investment.

Financial accounting is based on income statement and balance sheet. A company's income statement records the profit or loss made during the year while its balance sheet indicates the company's assets and liabilities. Income statement and balance sheet are required for financial evaluation and projection. As per law, it is mandatory for companies to maintain financial statements and disclose information. Generally, companies are unwilling to disclose more than necessary information, which has led to some governments extending the disclosure (of information) requirements.

Cost Accounting

Industrial Revolution in England threatened the ability of accounting to act as a tool for management in making efficient decisions. There was an inclination during that period to move towards a more scientific approach to management. Therefore, cost accounting was developed to give industrial management the techniques to minimise costs and attain efficiency. Cost accounting incorporates the application of costing principles and methods to ascertain costs so that management is able to control them and assess the profitability of their decisions. Cost accounting became an important aspect of running an efficient enterprise.

Management Accounting

Management accounting took managerial decision-making beyond the 20th century practice of relying on information from financial statements. Management Accounting prepares and presents accounting information, which is meant to help the management in policy formulation and decision-making. It enables management to control various routine and non-routine operations that affect the business enterprise. Management accounting gives

managers the techniques to get information and achieve the goals that they are accountable for. Therefore, accounting has broadened its horizon from simply recording and analysing financial statements to providing information that affects future decisions. While financial accounting produces reports that conform to a standard, generally accepted framework, management accounting produces internal reports, which do not have to be according to such guidelines.

Social Responsibility Accounting

Social scientists, social workers and the society in general are laying emphasis on the social and environmental outcome of industrialization. Businesses are no longer concerned only with increasing profitability. They have to take into account the fact that they will be held responsible for the social impact of their decisions. Social responsibility accounting goes beyond evaluating economic outcomes from business decisions to focus on the social effects as well. In the last two decades, the harmful effects of industrialisation on the environment and on society have been highlighted therefore businesses cannot be concerned only with maximising profits by analysing their financial statements and balance sheets. Social responsibility accounting helps management in taking steps that are not only economically profitable but socially responsible as well.

Human Resource Accounting

Human Resource Accounting (HRA) identifies and measures data regarding the company's human resource and communicates it to interested parties. Hermansson made the first attempt to include human capital figures in the balance sheet in 1964. With the emergence of "Knowledge Economy" in the 1990s there has been a greater emphasis on recognising human capital in addition to physical capital. Human resource accounting acknowledges the contribution of a business entity's employees and its intellectual assets in increasing profitability. Therefore, HRA accounts for investing in people, replacement costs of human assets, and the economic value of human resource for the business. Methods of HRA include assigning costs and economic value to human capital although it is very hard to express information on an organization's human resource in numbers and figures. HRA is an effective managerial tool that provides managers with information regarding their employees and helps them make decisions regarding investment in manpower.

Inflation Accounting

Accounting records original costs of assets in financial statements, which means that increases in prices over time are not taken into account, which sometimes results in inaccuracies. Inflation accounting deals with adjustment of the value of current and fixed assets to the changes in prices. Ignoring the effect of rising prices causes overstatement of profits and inflation accounting provides different methods to remove this distortion.

Main Branches of Accounting

There are three main branches of accounting based on the kind of information they provide:

- a) Financial accounting
- b) Cost accounting
- c) Management accounting

Financial Accounting (FA)

Financial Accounting is the preparation of two kinds of final accounts/ financial statements:

- a) Income Statement, which deals with the business's operations, profit or loss in the previous year. Income statement is also known as Profit & Loss Account (P&L A/c).
- b) Balance Sheet (B/S), which records the company's financial position regarding assets and liabilities in the previous year.

Cost Accounting (CA)

Cost accounting presents the unit cost of different levels of production, also known as cost centres. It includes:

- a) Cost determination
- b) Cost analysis, which studies the effect of cost and volume of production on profit.
- c) Cost control, which compares the actual cost of production with standard or predetermined cost.

The above-mentioned information is obtained through the following cost accounting methods:

- a) Cost sheet for cost determination.
- b) Cost-Volume-Profit (CVP) analysis and Break-Even (BE) analysis to determine the effect of cost and volume on profit.
- c) Variance analysis for enabling the management to take corrective action where required and controlling costs.

Note:

- The data required for CA and FA is derived from the book keeping system.
- In an organization, book keeping is considered a part of financial accounting.

Management Accounting (MA)

Management accounting helps managers in planning and controlling the organization's financial activities and in taking important financial decisions. MA is a part of financial accounting and cost accounting as it uses the statements generated by both systems to make decisions. For example, the cost-volume-profit analysis and variance analysis help management in keeping track of the organization's cost of production. These analyses give managers an idea of how their assets, liabilities, fixed costs and variable costs are affecting their profits. Similarly, fund flow statement produced by financial accounting enables the management to assess the flow of funds in the organization during the financial year. Therefore, management accounting is made possible with the help of information acquired through FA and CA.

However, management accounting is able to generate exclusive information as well, which is not a part of financial, or cost accounting. For example:

- a) Projected statements like projected income statement to estimate the company's target profit in the future, projected balance sheet to estimate the company's future financial position with respect to its assets and liabilities and future cash flow statements to project the company's cash position in the coming year.
- b) Providing a budgetary control system
- c) Providing short-term decision making techniques like marginal costing.

Difference between FA, MA and CA System

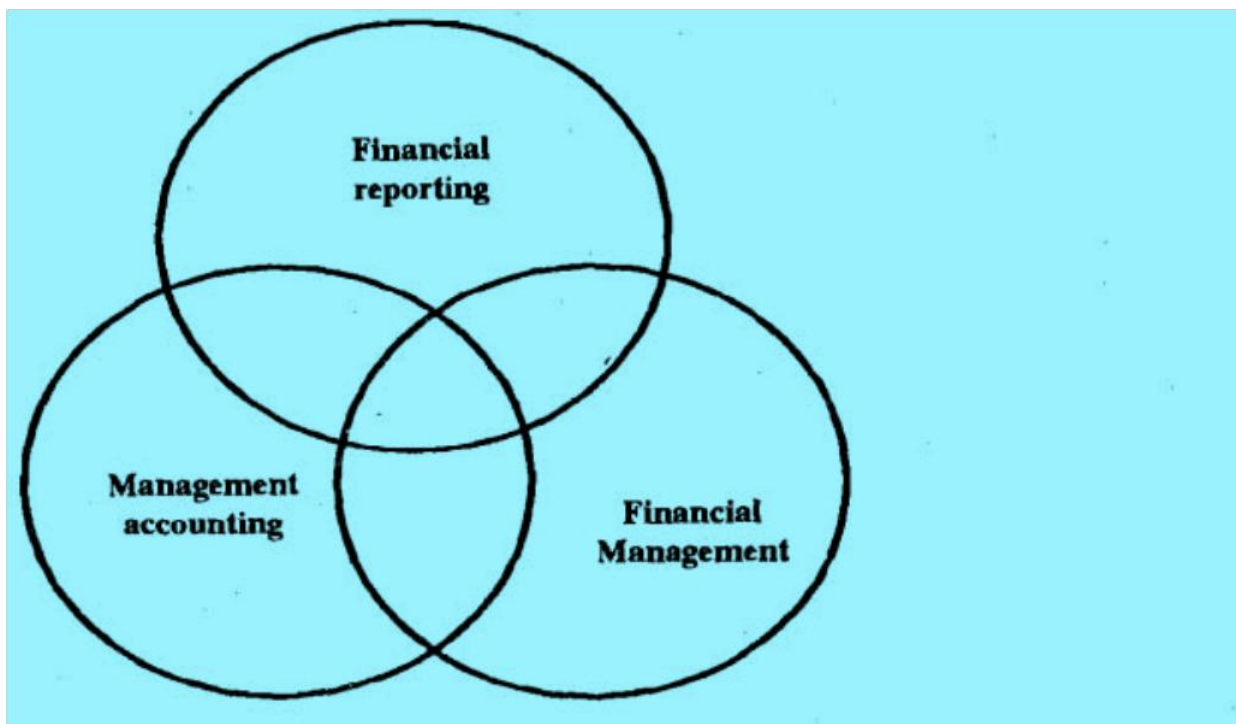
Financial Accounting (FA)	Management Accounting (MA)	Cost Accounting (CA)
1. Financial accounting involves financial statements and recording financial transactions like income statement and balance sheet.	1. Management accounting involves accounting of a business or a firm that is carried out for the purpose of facilitation in decision making by the management	1. Cost accounting involves costing, cost analysis and cost control.
2. Financial accounting follows certain guidelines, accounting standards and principles.	2. Management accounting is not restricted by guidelines. Managers prepare reports according to their requirements.	2. Cost accounting has certain rules and guidelines as well. There are standard costing and cost control techniques.
3. Financial accounting derives raw data from book keeping system.	3. Management accounting uses data from financial and cost accounting as input.	3. Cost accounting derives input data from vouchers, journals of entry etc.

4. Public accounting is responsible for auditing financial statements.

4. Auditing is not required for management accounting although the senior executive can review it.

4. Cost accountants are responsible for auditing cost accounting information.

Note: MA system is common to FA and CA systems.



Information Flow Chart

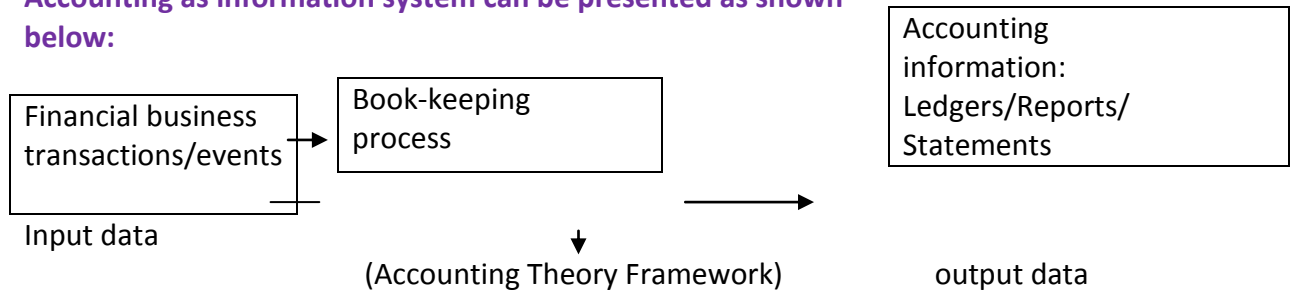
- Processing of book-keeping system includes identifying, recording, classifying and summarizing the financial transactions of an organization.
- Financial accounting system is the preparation of financial statements like income statement and balance sheet.
- Cost accounting consists of classification, allocation, recording, summarizing and reporting current and future estimated costs. It includes preparation of cost sheets reporting the unit cost at different stages of production. The basic components of cost accounting are:
 - (i) Cost determination
 - (ii) Cost analysis
 - (iii) Cost control
- Management accounting consists of:
 - (a) Interpretation and analysis of financial statements produced by financial accounting.
 - (b) Cost sheet analysis on the basis of financial statements.
 - (c) Variance analysis and its interpretation.
 - (d) Developing techniques for cost control.
 - (e) Preparation of budgets.
 - (f) Preparation of short-term decision making techniques.

Modern View of Accounting

Modern accounting theory views the process of accounting as a system for generating information. It starts with business transactions of financial nature that are considered as raw data. This data is identified, classified, recorded and then summarized according to standard accounting framework as a part of the book keeping process. Financial statements are generated as an output of processing raw information for internal and external parties that are relevant to the business organization. These statements and reports help in the decision making process as well as in planning and controlling business activities.

Therefore, the role of accounting as an information generating system is also called Accounting Information System (AIS).

Accounting as information system can be presented as shown below:



Bookkeeping is common in all theories of accounting as it is an essential part of accounting. It is important to know the users of information generated by accounting.

Users of Accounting

Accounting constitutes various inter connected activities from collecting and recording information to analysing, evaluating and finally communicating it to interested parties. Information is meaningless unless it fulfils a specific purpose.

Accounting operates as an information system as it has all the features of a system including inputs (raw data), processes (human resource and equipment) and outputs (financial statements and reports). Important observations can be made if accounting is considered as an information system. Firstly, needs of the ultimate users of accounting information are identified. If the needs are correctly identified, the next step is to specify the nature of output or information that is required. Secondly, the nature of output determines the nature of input or raw data that is required. Therefore, data that gives the required information is selected.

There are various internal and external stakeholders in a business organization such as its managers, shareholders, employees, customers, creditors, competitors etc. General public has a social interest in the business's activities as well. Pressure groups that lobby for cleaner environment or customer rights are also considered as interested parties in the operations of the business. On a larger scale, the government is a stakeholder as well because it keeps track of whether an organization is fulfilling its legal requirements, its contribution to the country's economy and social welfare etc.

Listed below are the information requirements of some of the users of accounting information.

Shareholders and Investors: Shareholders have shares in the company's wealth therefore they are interested in keeping track of its profitability and prospects of growth. Similarly, investors who invest their wealth in the business organization want to be sure that their investment is safe. Earlier, one of the primary functions of accounting was to provide information to the company's shareholders and investors.

Creditors: Creditors, also known as lenders, can be both short term or long term. Short-term creditors are also called trade creditors since they supply raw materials, goods and services. They usually lend money for a year or less. Long-term creditors are those who give loans for

longer periods of times (usually more than a year) usually in the form of secured loans. Creditors are concerned with information about the company's ability to pay its loans back in the short and long term. In other words, they are interested in company's credit worthiness, liquidity, profitability etc. Before lending money to the company the creditors rely on the financial statements to know if the company will be able to pay back its debts in the foreseeable future.

Employees: The business organization has moved beyond just maximising profits for shareholders to ensuring the welfare of its employees. The economic and social role of managers has undergone a shift as management theories have progressed. There is a realisation that a satisfied and highly motivated workforce is the most efficient and productive as well. Industrial democracy where there is greater participation of employees in managerial decision-making and more emphasis on employee feedback has taken the place of a more autocratic managerial style which focussed on maximising output. Therefore, employees are considered important users of the company's financial information, as their input is required for matters such as settlement of wages, bonuses, output benchmarks and profit sharing.

Government: One of the hallmarks of a mixed economy is that the government intervenes in the market system to make sure that business organizations are contributing to the general welfare of the society and the economy. For this purpose, some rules and regulations are put in place for private sector companies to follow. The government requires enterprises to disclose information about their output, profits, taxes, investments, costs etc. in order to control and monitor business information. This makes the government an important user of information that they can easily obtain from the company's financial statements.

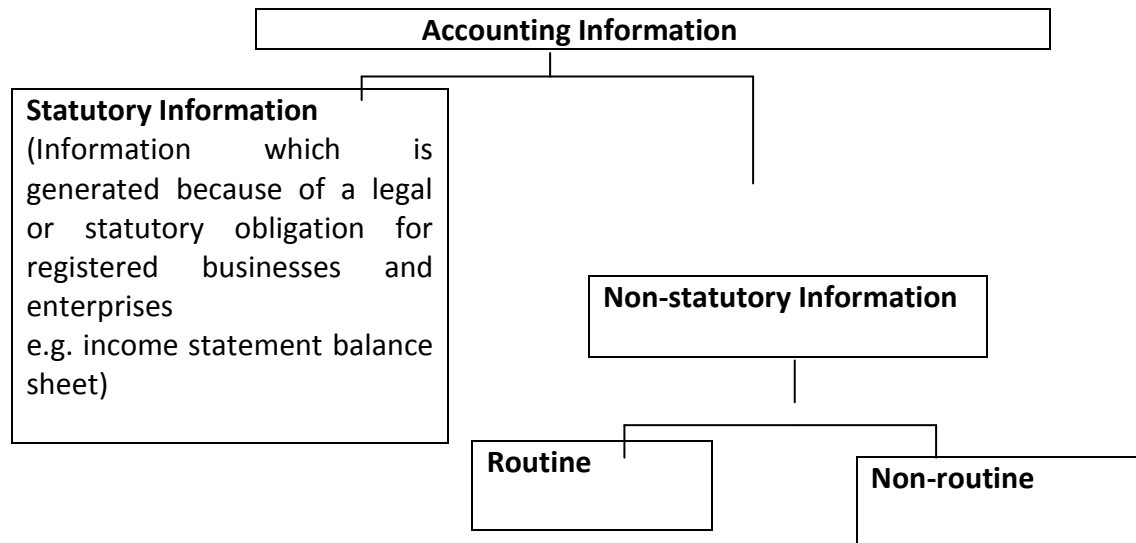
Management: Managers need information in both profit making and not for profit organizations. A manager in any organization needs to plan, organize, control and make decisions regarding important aspects of business operations. Accounting information helps managers in the general managerial process and it caters to their specific information requirements. The field management accounting is based on managers analysing financial statements and reports to carry out their responsibilities effectively and efficiently. An informed manager is better able to foresee and manage crises in addition to taking better decisions.

Consumers and others: Consumers' groups and other organisations, which look after welfare of consumers and public, use information generated by accounting for several reasons. Through this accounting information these organisations can analyse and keep a check on the performance and efficiency of businesses. The information also gives an insight into social responsibility of businesses. By looking at the accounting information including profits and outputs generated by businesses, the consumers' organisations can also keep a track of the growth of businesses and find out whether they are in line with the defined national goals.

It can be concluded that different entities have different information needs. Accounting fulfils these needs and generates information that can be utilized by varying groups. The information facilitates the groups to make well-informed decisions and meet their goals.

Accounting Information

Accounting generates different information that can be grouped under two categories:



- The information generated after regular intervals is Routine Information. For instance Annual budget, performance reports, Cash Flow Statements, Cost Sheets etc.
- The information generated when it is needed for a specific purpose or to address a particular issue is known as non-routine information. For instance Zero-based Budgeting, Marginal Cost Sheet etc.

Accounting tells us about:

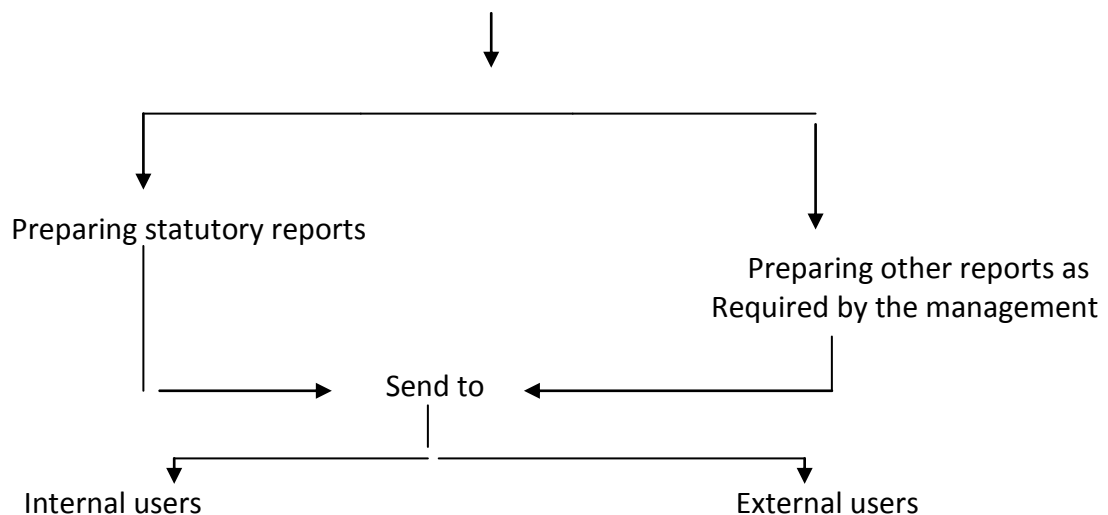
- a) The outcome of an enterprise or a business i.e. revenues/losses through income statement.
- b) The financial health i.e. Details of assets and liabilities through balance sheet.
- c) The position of Fund and Cash through fund flow statement/cash flow statement.
- d) The efficiency of resource utilization through ratio analysis.
- e) The record and information of cost through cost sheet.

Steps in Accounting Process

The following steps are involved in the accounting process:

1. Identifying financial business transactions/events
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2. Measuring transactions/events
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3. Recording transactions/events, also known as journal entry

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4. Classifying transactions/events, also called ledger entries.
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 5. Summarizing transactions/events in the form of trial balance, income statements and balance sheets.
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 6. Analyzing and interpreting transactions/events.
↓
 7. Reporting and communicating transactions/ events.

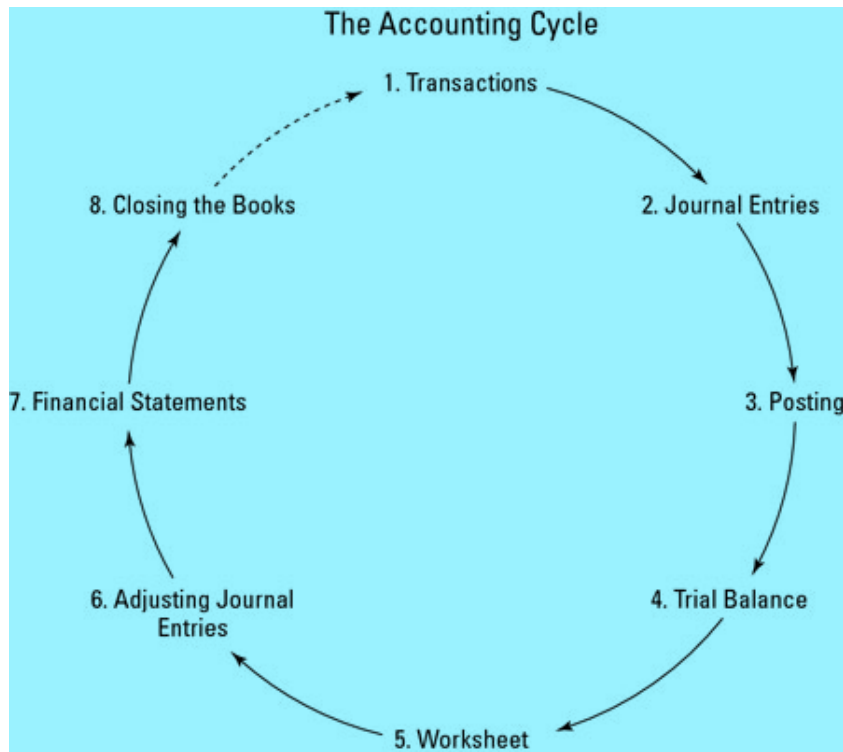


Accounting cycle

The Eight Steps of the Accounting Cycle

The circular accounting workflow, also known as the accounting cycle consists of eight steps. Bookkeepers are assigned with the task to complete the accounting cycle. The cycle starts with entering financial transactions, processing them and preparing financial statements, and finally closing the books of accounts. It is a circular procedure because after the books of accounts are closed at the end of a particular accounting period, it starts again by recording transactions for the new period.

The eight basic steps involved in the accounting cycle are listed below.



1. Transactions

Financial transactions include sale of an asset, acquiring new equipment, paying off loans, recovering debt, capital from the company's owners, paying out dividends to owners and any other activity that involves an exchange of the company's asset. The accounting cycle starts from these transactions.

2. Journal entries

After transactions have occurred, they are entered in a chronological order in the journals. These journals are called books of original entry and they contain a record of business transactions along with the date on which the transaction occurred, the kind and amount of the transaction.

3. Posting

The General ledger contains a summary of all business accounts. Transactions recorded in journals are then posted to accounts that they belong to in the general ledger.

4. Trial balance

A trial balance is prepared at the end of an accounting period, which can be a month, a quarter or a year depending on the business's practice.

5. Worksheet

It often happens that the entries in trial balance do not balance i.e. inflows do not equal outflows, and certain corrections and adjustments have to be made. These adjustments are recorded in worksheets.

Depreciation of an asset, one-time payments like insurance, advance payments etc. are some examples of the adjustments that are shown in worksheets. An adjusted trial balance is made to ensure that all accounts are in balance.

6. Adjusting journal entries

After the errors in trial balance are recognized and corrections are made, the adjusted trial balance is prepared. Adjusting entries are not made until all corrections are made and trial balance is prepared.

7. Financial statements

Profit and loss account and balance sheet are prepared using the correct and adjusted accounts.

8. Closing the books

Revenue and expense accounts are closed at the end of an accounting cycle and a new cycle begins with zero carry forward balances in accounts.