Accountancy and Financial Management

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This reference book can be useful for

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INTRODUCTION

Accounting is often called the language of business. The basic function of any language is to serve as a means of communication. In this context, the purpose of accounting is to communicate, or report the results of business operations and its various aspects. Though accounting has been defined in various ways. According to one commonly accepted definition, "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 financial character interpreting the results thereof. Another definition which is less restrictive interprets accounting as the process of identifying measuring and communicating economic information to permit informed judgments and decisions by the users of information.

Accounting is an important service activity in business and is concerned with the collecting, recording evaluating and communicating the results of past events. The history of accounting development reflects its changing role in response to the changing business and social needs. Accounting can be perceived as an information system which has its inputs, processing methods and outputs. The usefulness of accounting lies in its capacity to provide information to various shareholders in business so that they could arrive at the correct decisions.

THE ORGANIZATION FOR ACCOUNTING AND FINANCE

The typical organization chart for accounting and finance is presented in *fig. 1.1.* You will note that the person at the helm of affairs is the Director (Finance) who is an member of the Board of Directors. Reporting to him may be one or more General Managers. If there is only one General Manager, she/he may be designated as General Manager (Finance) or General Manager (Finance and Accounts), or Controller or Finance Controller. In a large company, four or five (as in *fig 1.1*) the Deputy General Managers in charge of different areas like systems and data processing, accounts, finance, internal auditing may report to him/her. Following the American pattern, a tendency has recently been observed among large companies, especially in the private sector to designate General Manager (Finance) as President (Finance, or Finance and Accounts) and a Deputy General Manager or Vice-President. Each of these Deputy General Managers is assisted by a number of senior managers who look after different components of similar activities, *e.g.*, financial accounting, tax planning and administration, management auditing, etc. Management audit is a comprehensive review of the various sub-systems of the organization such as objectives and goals, structure, technical system, personnel policies (including succession planning), control and coordination policies and procedures, adequacy and effectiveness of communication systems, etc. This type of audit is usually done by a team of people comprising the internal resource persons drawn from various function areas and an external management consultant.

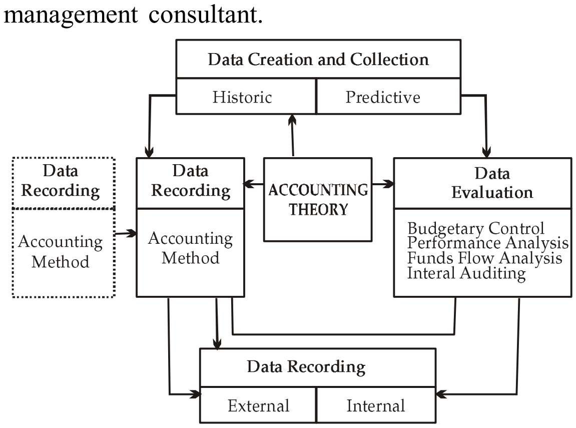

Fig. 1.1. Scope of Accounting

TEXTUAL QUESTIONS

Q. 1. Explain in brief the different branches of accounting.

Ans. On the basis of objects of accounting, the entire job of accounting is divided into three branches:

(i) **Financial Accounting:** Financial Accounting involves preparation of financial reports, which provide summaries of a firm's financial condition. The main task of financial accounting is to prepare Balance Sheet and income statement etc.

(ii) **Cost Accounting:** The main purpose of cost accounting is to ascertain the cost of production of goods and cost of running different departments to enable the management to fix the selling price.

(iii) **Management Accounting:** The main purpose of management accounting is to provide all the relevant informations that may be required by the management to take decisions in respect of various aspects of running the business enterprise. It is a tool in the hands of management for the purpose of making policy-decisions.

Q. 2. What groups of people would be interested in accounting informations ?

Ans. Accounting provides informations which are useful for persons inside the organisation and for persons or groups outside the organisation:

(a) **External Groups:** External users' groups or persons are outside the organisation. Following can be the various external users of accounting information:

(i) **Investors:** Those who are interested in investing money in an organisation are interested in knowing the financial health of the organisation to know how safe the investment already made is and how safe their proposed investment will be. For this, they need accounting information which will help them in evaluating the past performance and future proposal of the organisation.

(ii) **Creditors:** Creditors are those persons who have already advanced some money or money's worth to the business. They constantly watch the progress and day-to-day working of the business and hence, they are always interested in the accounting information.

(iii) **Government:** Government has to collect sales tax, income tax, excise duty and other taxes from the business and therefore government is interested in the accounting information. Today government is also interested in keeping a watch on big business, regarding the manner in which they make huge profits without regard to the interests of the community. For this, it is necessary that proper accounts are made available to the Government.

(iv) **Consumers:** Consumers need accounting information for establishing good accounting control so that cost of production may be reduced with the resultant reduction of the prices of goods they buy. Consumers can create public opinion against the business organisation who exploit the consumers. For this various informations from the financial statements are highlighted and circulated.

(v) **Research Scholars:** Accounting information is of immense value to the research scholar who wants to make a study into the financial operations of a particular firm. The research scholars needs detailed information relating to purchase, sales, expenses, cost of materials used, current assets, fixed assets, current liabilities, shareholder's funds etc, which are available in the accounting records maintained by the firm.

(b) **Internal Groups:** Internal groups are those persons who are within the organisation. Such groups are following:

(i) **Owners:** Owners provide funds for the operations of a business and share the risks of the business. Naturally they are interested in the safety of thier capital and also for a reasonable return thereon. Owners need accounting information to know these points. Financial statements highlight the past performance and assists in assessing future prospects of the concern.

(ii) **Management:** The management of the business are more concerned with the accounting information because they are answerable to the owners. Management's responsibility is to efficiently operate the business and maximise the return on capital. Accounting information helps a manager in appraising the performance of the subordinates. Actual performance of the employees can be expected to achieve and remedial action can be taken if the actual performance is not upto the mark. Thus, accounting information provides "the eyes and ears of management".

(iii) **Employees:** Employees are also interested in the good running of the business. Increase in wages, bonus, profit sharing, avenues of promotion etc. greatly rest upon the progress and profitability of the firm. Annual accounting reports highlight these basic data and hence are of great significance to the employees.

Q. 3. What are the main characteristics of financial accounting? Enumerate its major limitations.

Ans. Financial accounting is the traditional form of accouting which is mainly concerned with the recording of business transactions and the periodic preparations of various reports and statements from such records. The process of financial accounting includes the preparation of regular financial statements showing the results of business operations for a specific period like profit and loss account and balance sheet etc. It is designed for outsiders. It focuses primarily on providing information to investors and prospective investors etc. It is also called "Maintenance Accounting" since the efficient book-keeping maintains historical and statutory records accurately and promptly.

Financial accounting has two characteristics:

***(i)* Usefulness:** Financial accounting is concerned with the recording of transactions and periodic preparations of various statements from such records.

The reports provide useful informations to parties external to the organisation.

***(ii)* Symbolism:** Symbolism means that the financial statements are symbols of activities of the enterprises at a point in time and over a span of year. The ledger accounts, source documents etc. are also symbols expressing functions or activities performed.

Objectives of Financial Accounting:

(i) To provide information useful for making economic decisions.

(ii) To serve primarily those groups who rely on financial statements as their principal source of information about an enterprise's economic activites.

(iii) To provide users with information for predicting, comparing and evaluating enterprise earning power.

(iv) To provide information for meeting various legal requirements as income tax returns, returns for sales tax etc.

Advantages of Financial Accounting: The following are the main advantages of financial accounting :

***(i)* Helps in the payment of Income-tax and Sales Tax:** Many types of taxes *viz.* income tax and sales tax are imposed upon the business-men now-a-days. To make payment of these taxes, it is necessary that accounts are maintained according to the principles of accounting.

***(ii)* Helps in remembering:** A businessman cannot remember all the transactions, howsoever sharp his memory may be. Therefore, every transaction should be recorded in black and white, so that there may not be any misappropriation.

***(iii)* Proof in the court of law:** If the accounts of the business are kept properly according to the principles of accounting, they can be presented in the court of law for giving necessary documentary evidence.

For example, the businessman has to present his accounts in the court if he wants himself to be declared insolvent.

***(iv)* Helps in the sale of business:** If the businessman wants to sell his running business, he can realise its reasonable price if he had maintained proper accounts according to the principles of accounting. Otherwise it will not be possible to assess the correct value of business.

***(v)* Helps in the realisation of debts:** Financial accounting proves useful in realising debts from other persons. The businessman can produce his account books in the court of law as a proof of debt.

***(vi)* Helps in ascertaining the profit or loss of the business and its financial position:** The main objective of financial accounting is to ascertain profit or loss of the business and to show the financial position of the business. Such information is useful to many groups of persons interested in the business. Employees also claim bonus, etc. on the basis of the profit earned by business. Various other groups also may get desired information from the financial accounts.

***(vii)* Assists in managing the business:** Accounting helps the management in taking prompt decisions to run the business efficiently. After the study of the books of account management takes decisions about the selling price of his product, purchase policy, inventory policy, advertisement policy etc.

***(viii)* Facilitates comparative study:** Financial reports and statements facilitate inter-firm comparisons and inter-period comparisons. By this a businessman can detect the weak points of the business, interpret their causes and take corrective measures.

Limitations of Financial Accounting: Undoubtedly, financial, accounting is an important tool and instrument in the realisation of various objectives and advantages stated above. But it suffers from a number of limitations which are as follows:

(i) Financial accounting records only those transactions which can be measured in terms of money. Some non-monetary events and transactions such as conflict between production and marketing manager, efficiency of management price, policy etc, may be very important for a business but not recorded in the business books.

(ii) Financial accounts are of historical nature. They record the net effect of events which take place in the business. Such recording of past facts does not

help the management in planning for future and decision-making, which is a significant aspect for modern business.

(iii) In financial accounts assets and properties are shown at their cost less depreciation. Hence, they fail to show what a business is worth *i.e.* its real value in the books after their acquisition.

(iv) Financial accounting presents the picture for a limited period or at a moment of time with the result that limited period measurement is seldom more than an approximation. The effect of prize level changes is not brought into the books with the result that comparison of the various years becomes difficult.

(v) Financial accounting lacks precision and data are based on conventional procedures, concepts, convention and personal judgement. Hence, the financial statements will not reflect the true position of the business.

(vi) Financial accounts do not provide for evaluation of business policies and plans. They do not throw light on the implementation of programmes and policies of the management.

Q. 4. Briefly describe the different systems of accounting.

Ans. Following are the main systems of recording business transactions :

***(a)* Cash system:** Under this system actual cash receipts and payments are recorded. Credit transactions are not recorded at all until the cash is actually received or paid. Such a system is generally in adopted by non-trading concerns *i.e.,* a club, a charitable institution, a school etc. and professional men like a lawyer, a doctor, a chartered accountant etc. They prepare receipts and payments account which shows payments made and receipts received during the specified period.

***(b)* Mercantile or Accrual system:** Under this system all transactions relating to the period are recorded in the books of account irrespective of actual receipts of cash and actual payments. Such a system is based upon the concept of accrual.

***(c)* Mixed system:** Under this system, both cash system and mercantile system are followed. Some records are kept under cash system whereas others are kept under mercantile system.

Q. 5. Explain in brief the following terms:

(i) Entry	*(ii) Books of Accounts*
(iii) Goods	*(iv) Revenue*
(v) Income	*(vi) Expenses*
(vii) Capital Expenses	*(viii) Assets*
(ix) Liabilities	*(x) Accounting Cycle*
(xi) Equity	*(xii) Losses*
(xiii) Drawings	*(xiv) Insolvent.*

Ans. *(i)* Entry: The recording of business transactions in the books of account is called an entry.

***(ii)* Books of Account:** Books of Account include set of books in which entries of business transactions are made. It may be in the form of loose sheets or bound registers. Books of account are journal and ledger.

***(iii)* Goods:** Goods are those things which are purchased for resale or for producing the finished products which are meant to be sold. Goods include articles in which the business deals *i.e.* articles which are bought for resale for profit. For cloth dealer cloth is goods.

***(iv)* Revenue:** Revenue means the amount which as a result of business operations, increase the assets and capital of the business. Revenue is an inflow of assets which results in an increase in the owner's equity sales earnings from interest, dividends, rents etc.

***(v)* Income:** Income is a part of revenue that increases the capital. Income is money or money's equivalent earned or accrued during an accounting period increasing total of previously existing net assets and arising from sales and rentals of any type of goods or services. For example, goods costing Rs. 1,000 are sold for Rs. 1500 in cash the receipt of Rs. 1500 is the revenue but the net increase in assets Rs. 500 is the income. Besides sales, receipts or amounts receivable for services rendered (rent, commission, salary, interest, dividends, etc.) are also incomes.

***(vi)* Expenses:** Expense is the money spent in conducting business activities. It is the expenditure in return for which some benefit *i.e.,* service is received. For example, expense of salary, clerk's service, carriage expense for transporter's service; expense of rent for landlord's giving benefit of accommodation. Expenses include business operations that decrease the amount of capital.

***(vii)* Capital Expenses:** Expenses incurred for acquiring fixed assets are known as capital expenses. The capital expenses result either in reduction of cash or in creation of liabilities. But unlike revenue expenses, they do not reduce capital. However, any loss on these assets will decrease the capitals of the business. For example, a machine is purchased for Rs. 1,000. It is a capital expense. After one year the value of machine reduces to Rs. 900. The difference of Rs. 100 is the depreciation and will reduce the capital.

***(viii)* Assets:** Assets are properties of the business that help to earn revenue and which are measured in