

CHAPTER 1

BASICS OF ACCOUNTING - AN INTRODUCTION

Meaning of Accounting

Accounting can be defined as the art of recording, classifying, summarizing and interpreting all the transactions and events in terms of money for a specified time period.

Let's us understand in details what this meaning is trying to say:

Recording- The accounting process starts with recording of all the transactions and events happened in a particular financial year. Here the term transaction refers to all the planned business activities. For example purchase and sale of goods, payment of salaries, etc. whereas events refer to unplanned activities such as fire in the office, lockdown due to COVID 19. This recording is done in the book of original entry known as Journal which we will discuss in detail in the upcoming chapter of JOURNAL.

Financial Year refers to a period of 12 months for which accounting is done. In India, the financial year is 1st April to 31st March every year.

Classifying- Under classification the transactions those were recorded in the journal, are posted to the relevant account in LEDGER. All the accounts put together make a Ledger. Ledger is a book in which various accounts (Assets Account, Liability Accounts, Capital Accounts, Revenue Accounts and Expenses Accounts) are opened and transactions are posted from the Journal book.

A ledger is also called the Principal book of account or book of final entry, since all transactions recorded in books as Original Entry (Journal) are transferred (posted) in the Ledger. We will discuss the more about Ledger in the upcoming chapter of LEDGER.

- Here **Account** refers to a record of transactions in form of Debit and Credit under a particular head that shows the summary of transactions incurred during a relevant period of accounting with that particular head or account.

Let's consider an example that if our business is dealing with a supplier named Ram Traders and there were more than 50 transactions with Ram Traders that can be of Purchase of Goods, Purchase return, Payment to Ram traders etc and the business wants to know about all these transactions including amount payable to Ram traders on a particular date then Accounting provides this information in form of Account which we will create in Ledger and we can collect all these required information from Ram Traders Account.

Summarizing- Under summarizing step we prepare Trial Balance. A TRIAL BALANCE is a statement, showing the list of Accounts prepared in the LEDGER with their respective balances. Trial balance is prepared to ensure arithmetical correctness of posting. We will discuss more about Trial balance in the upcoming chapter of Trial balance.

Interpreting- This step of Accounting cycle shows the final Result of Business at the end of the financial year i.e. in this we interpret the performance of business in terms of Profit/Loss incurred during a financial year and also the financial position of the business. For this financial statements of the business are prepared at the end of financial year. Financial statement includes:

- (i) Trading and Profit and Loss Account; and
- (ii) Balance Sheet.

We will discuss more about it in the relevant chapter of financial statements.

Need of Accounting

Consider this example:

You are running your own Gym and you are expert in body building and physical fitness. You have all the ideas to run your business more profitably but you are lacking with funds to purchase some more advanced equipments for your business.

You need ₹100000 to buy new equipments. Now you decide to go to the bank and ask for a loan.

You ask the bank for ₹100000 loan. But the problem is you do not have any **financial information** about your business.

The loan officer asks how much profit you made this year. You don't know so you guess. You say it was maybe ₹300000.

Loan officer asks you how much your assets are worth but you have no idea.

Loan officer asks how much debt (liability) you have. You're not sure.

Loan officer asks what your cash flow is each month. You don't even know what that means.

Because you have no financial information, loan officer says no to you for the loan.

Now let's say you go and find an accountant, who prepares some financial records for you. You return to the bank with confidence that you have your books of accounts ready with your financial statements and the required information which were previously asked by the loan officer.

Now you can tell the loan officer exactly how much money you make, how much you spend, what you spend it on, how much you owe, how much you have in the bank, and how much your assets are worth.

Because loan officer now has **information**, he can decide to loan you the money as per your financial reports. This is because he knows how much money you make each month and can be confident you will be able to repay the loan.

Similarly you defaulted in payment of income tax and income tax department send you a notice for representation or scrutiny of your income evidence than your books of accounts will help you to satisfy the tax authorities.

Before starting the Process of Accounting Cycle (Journal, Ledger, Trial Balance and Financial Statements) we must understand the following relevant aspects of the Accounting:

- Branches of Accounting
- Book-keeping

- Important Accounting Terms
- Important Accounting Concepts/ Principals/ Assumptions
- Bases of Accounting

Branches of Accounting-

The need and importance of accounting gave rise to special branches of accounting. Every branch has its own objectives. These are briefly explained below:

- **Financial accounting**
- **Cost Accounting**
- **Management Accounting**

BOOK KEEPING: Book keeping is a part of accounting being a process of recording financial transactions and events in the books of account. Thus, the book keeping involves:

- **Identifying financial transactions and events,**
- **Measuring them in terms of money,**
- **Recording the identified financial transactions and events in the books of account, and**
- **Classifying recorded transactions and events, i.e. posting them into Ledger accounts.**

ACCOUNTANCY: It refers to a systematic knowledge of accounting concerned with the principles and techniques which are applied in accountancy. It tells us how to prepare the books of accounts, how to summaries the accounting information and how to communicate it to interested parties. In short it can be said as the entire body of theory and practice of accounting. Only the person having specialized knowledge and skills can perform the task of accountancy.