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Accounts and Audit

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CHAPTER 1 – INTRODUCTION TO ACCOUNTING

Introduction

According to American institute of certified public accountants, "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."

Attributes of Accounting

- **Identifying:** Recognizing financial transactions and events that affect the business.
- **Recording:** Systematically entering all transactions in books of accounts.
- **Classifying:** Grouping similar transactions under proper heads (e.g., salary, rent).
- **Summarizing:** Preparing financial statements like Trial Balance, Profit & Loss, and Balance Sheet.
- **Interpreting:** Analyzing financial results to understand business performance.
- **Communicating:** Sharing financial information with users like management, investors, and regulators.
- **Monetary Measurement:** Recording only those transactions that can be expressed in money.

Objectives of Accounting

Objective	Explanation (in simple language)
To maintain systematic records	Accounting helps record all business transactions in a proper and organized manner according to accounting rules, reducing errors and frauds.
To determine profit or loss	It helps find out how much profit or loss the business has made during a specific accounting period through the preparation of the Profit & Loss Account.
To determine financial position	By preparing a Balance Sheet, accounting shows the financial position of a business — its assets, liabilities, and capital.
To provide useful information to stakeholders	Accounting provides relevant financial data to owners, investors, creditors, banks, employees, and government authorities for analysis and decision-making.
To assist management in planning and decision-making	It gives valuable financial information to management for effective budgeting, forecasting, and business decisions.

Advantage and Limitation of Accounting

Advantages of Accounting	Limitations of Accounting
• Helps in Decision-Making: Provides useful financial information to management for making sound business and economic decisions. • Comparison of Performance: Enables owners to compare results of different years and identify factors responsible for profit or loss. • Determines Financial Position: Shows the financial health of a business through the Balance Sheet, reflecting assets, liabilities, and capital. • Systematic Record-Keeping: Maintains a complete and organized record of transactions as per standard rules, accepted legally as evidence. • Tax Assessment: Assists in the accurate calculation of taxes like income tax, GST, and excise duties. • Pricing Decisions: Helps in determining appropriate selling prices and cost control based on accounting data.	• Historical Nature: Reflects past data and does not show the current market value or real worth of a business. • Ignores Qualitative Factors: Focuses only on monetary information and ignores non-financial aspects like employee efficiency or customer satisfaction. • Possibility of Manipulation: Accounts can be influenced by window dressing to show a more favorable financial position. • Subjective Judgments: Affected by personal opinions—for example, estimation of depreciation or doubtful debts may vary among accountants. • Conceptual Restrictions: Based on accounting conventions that may not reflect real conditions—for instance, assets are shown at cost price, not market value.

Book Keeping the Basics of Accounting

Book keeping is the record-making phase of accounting which is concerned with the recording of financial transaction and events relating to business in a significant and orderly manner. Book keeping should not be confused with accounting.

Book Keeping	Accounting
- It is the recording phase of an accounting system. - It is a primary stage and basis for accounting. - It is routine in nature and does not require any special skill or knowledge - It is done by junior staff called book-keepers. - It does not give the complete picture of the financial conditions of the business unit.	- It is the summarizing phase of an accounting system. - It is a secondary stage which begins where the book keeping process ends. - It is analytical in nature and required special skill or knowledge. - It is done by senior staff called accountants. - It gives the complete picture of the financial conditions of the business unit.

Types of accounting information

1. Information on Profit or Loss:

- Shown through the Income Statement (Profit & Loss Account).
- It reveals the net result of business operations — whether the firm made a profit or loss during a specific period.

2. Information on Financial Position:

- Presented in the Balance Sheet.
- It shows what the business owns (assets) and what it owes (liabilities and capital) on a particular date.

3. Schedules and Notes to Accounts:

- These provide detailed explanations and breakdowns of figures shown in the Income Statement and Balance Sheet.
- They help in understanding the composition of financial items and ensuring transparency.

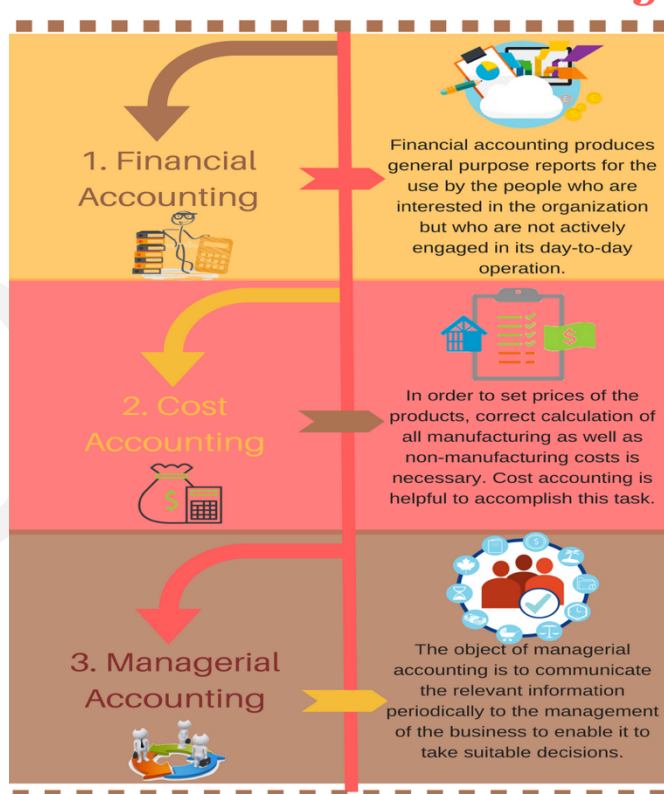
Qualitative characteristics of accounting information

- Reliability:** Means the information must be based on facts and be verified through source document by anyone. It must be free from bias and errors.
- Relevance:** To be relevant, information must be available in time and must influence the decisions of users by helping them to form prediction about the outcomes.
- Understandability:** The information should be presented in such a manner that users can understand it well.
- Comparability:** The information should be disclosed in such a manner that it can be compared with previous year's figures of business itself and other firm's data.

Interested user/parties of accounting information and their needs

User	Classification	Information the User want
Internal	Owner	Return of their investment, financial health of their company/business.
	Management	To evaluate the performance to take various decisions.

Branches Of Accounting



External	Investor and Potential Investor	Safety and growth of their investments, future of the business.
	Creditors	Assessing the financial capability, ability of the business to pay its debts.
	Lenders	Repaying capacity, credit worthiness.
	Tax Authorities	Assessment of due taxes, true and fair disclosure of accounting information.
	Employees	Profitability to claim higher wages and bonus, whether their dues (PF,ESI,etc.) deposited regularly.
	Others	Customers, researchers etc., may seek different information for different reasons.

Basic accounting terms

Term	Simplified Definition
Business Transaction	Any financial activity that affects a business's position and can be measured in money (e.g., purchase of goods).
Account	Record of all transactions related to one item (like cash, rent, etc.); has two sides — Debit (left) and Credit (right) .
Capital	Money or assets invested by the owner into the business.
Drawings	Money or goods taken by the owner from the business for personal use.
Assets	Valuable resources owned by the business. Types: • Current Assets: Convert to cash within a year (stock, debtors) • Non-current Assets: Used long-term (land, machinery) - Tangible: Physical (building) - Intangible: Non-physical (goodwill, patent).
Liabilities	Debts or obligations payable in future. Types: • Current Liabilities: Payable within a year (creditors). • Non-current Liabilities: Payable after a year (loans, debentures).
Receipts	Money received by the business. Types: • Revenue Receipts: From normal business (sales). • Capital Receipts: From non-routine activities (sale of asset).
Expenses	Cost incurred to earn revenue (rent, salaries, interest).
Expenditure	Spending money or incurring liability to buy assets/services. Types: • Revenue Expenditure: Benefits $\leq$ 1 year (rent). • Capital Expenditure: Benefits $>$ 1 year (machinery). • Deferred Revenue Expenditure: Benefit spread over years (advertising).
Profit	Excess of revenue over expenses. ($Profit = Revenue - Expenses$)
Gain	Non-recurring profit (e.g., sale of old asset).
Loss	Excess of expenses over revenue. ($Loss = Expenses - Revenue$)
Goods	Items bought for resale or production, not for own use.
Purchase	Buying goods for resale or manufacturing. (<i>Can be cash or credit</i>)
Purchase Return	Goods returned to suppliers.
Sales	Revenue from goods sold or services provided. (<i>Can be cash or credit</i>)
Sales Return	Goods returned by customers.
Debtors	People who owe money to the business (credit sales) → Asset .
Creditors	People to whom the business owes money (credit purchases) → Liability .
Bills Receivable	Amounts due from others through a bill of exchange (for seller).
Bills Payable	Amount owed to others through a bill of exchange (for buyer).
Discount	Rebate given by seller to buyer. Types:

	• Trade Discount: For bulk buying; not recorded. • Cash Discount: For early payment; recorded in books.
Income	Overall increase in wealth; includes profit.
Stock	Goods remaining unsold at a given date.
Cost	Total expenditure to produce or procure goods for sale.
Voucher	Documentary proof of a transaction (invoice, cash memo, receipt).
GST (Goods and Services Tax)	Indirect tax levied on the supply of goods and services in India.

