

**Accounting For Managers**

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**TABLE OF CONTENTS:**

**CHAPTER-I**

Book-Keeping and Accounting – Financial Accounting – Concepts and Conventions – Double Entry System – Preparation of Journal, Ledger and Trial Balance – Preparation of Final Accounts – Trading, Profit and Loss Account and Balance Sheet With Adjustment Entries, Simple Problems Only - Capital and Revenue Expenditure and Receipts.

**CHAPTER-II**

Depreciation – Causes – Methods of Calculating Depreciation – Straight Line Method, Diminishing Balance Method and Annuity Method - Ratio Analysis – Uses and Limitations – Classification of Ratios – Liquidity, Profitability, Financial and Turnover Ratios – Simple Problems Only.

**CHAPTER-III**

Funds Flow Analysis – Funds From Operation, Sources and Uses of Funds, Preparation of Schedule of Changes In Working Capital and Funds Flow Statements – Uses And Limitations - Cash Flow Analysis – Cash From Operation – Preparation of Cash Flow Statement – Uses and Limitations – Distinction Between Funds Flow and Cash Flow – Only Simple Problems

#### **CHAPTER-IV**

Marginal Costing - Marginal Cost and Marginal Costing - Importance - Break-Even Analysis - Cost Volume Profit Relationship - Application of Marginal Costing Techniques, Fixing Selling Price, Make or Buy, Accepting a Foreign Order, Deciding Sales Mix.

#### **CHAPTER-V**

Cost Accounting - Elements of Cost - Types of Costs - Preparation of Cost Sheet - Standard Costing - Variance Analysis - Material Variances - Labour Variances - Simple Problems Related to Material And Labour Variances Only.

## CHAPTER – I: Basics of Accounting

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### Lesson – 1.1 Accounting – An Introduction

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#### 1.1.1 Introduction

Accounting is aptly called the language of business. This designation is applied to accounting because it is the method of communicating business information. The basic function of any language is to serve as a means of communication. Accounting duly serves this function. The task of learning accounting is essentially the same as the task of learning a new language. But the acceleration of change in business organization has contributed to increase the complexities in this language. Like other languages, it is undergoing continuous change in an attempt to discover better means of communications. To enable the accounting language to convey the same meaning to all stakeholders, it should be made standard. To make it a standard language certain accounting principles, concepts and standards have been developed over a period of time. This lesson dwells upon the different dimensions of accounting, accounting concepts, accounting principles and the accounting standards.

#### 1.1.2

Know the Evolution of Accounting  
Understand the Definition of Accounting  
Comprehend the Scope and Function of Accounting  
Ascertain the Users of Accounting Information  
Know the Specialized Accounting Fields  
Understand the Accounting Concepts and Conventions  
Realize the Need for Accounting Standards

#### 1.1.3 CONTENTS:

1. Evolution of accounting
2. Book keeping and accounting

3. Definition of accounting
4. Scope and functions of accounting
5. Groups interested in accounting information
6. The profession of accounting
7. Specialized accounting fields
8. Nature and meaning of accounting principles
9. Accounting concepts
10. Accounting conventions
11. Summary
12. Key words
13. Self assessment questions

### **1.1.3.1 Evolution Of Accounting**

Accounting is as old as money itself. It has evolved, as have medicine, law and most other fields of human activity in response to the social and economic needs of society. People in all civilizations have maintained various types of records of business activities. The oldest known are clay tablet records of the payment of wages in babylonia around 600 b.c. accounting was practiced in india twenty-four centuries ago as is clear from kautilya's book 'arthshastra' which clearly indicates the existence and need of proper accounting and audit.

For the most part, early accounting dealt only with limited aspects of the financial operations of private or governmental enterprises. Complete accounting system for an enterprise which came to be called as "double entry system" was developed in italy in the 15th century. The first known description of the system was published there in 1494 by a franciscan monk by the name luca Pacioli.

The expanded business operations initiated by the industrial revolution required increasingly large amounts of money which in turn resulted in the development of the corporation form of organizations. As corporations became larger, an increasing number of individuals and institutions looked to accountants to provide economic information about these enterprises. For e.g. Prospective investors and creditors sought information about a corporation's financial status. Government agencies required financial information for purposes of taxation and regulation. Thus accounting began to expand its function of meeting the needs of

relatively few owners to a public role of meeting the needs of a variety of interested parties.

### **1.1.3.2 Book Keeping And Accounting**

Book-keeping is that branch of knowledge which tells us how to keep a record of business transactions. It is considered as an art of recording systematically the various types of transactions that occur in a business concern in the books of accounts. According to spicer and pegler, “book-keeping is the art of recording all money transactions, so that the financial position of an undertaking and its relationship to both its proprietors and to outside persons can be readily ascertained”. Accounting is a term which refers to a systematic study of the principles and methods of keeping accounts. Accountancy and book-keeping are related terms; the former relates to the theoretical study and the latter refers to the practical work.

### **1.1.3.3 Definition Of Accounting**

Before attempting to define accounting, it may be made clear that there is no unanimity among accountants as to its precise definition. Anyhow let us examine three popular definitions on the subject:

Accounting has been defined by the american accounting association committee as:

***“the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information”***. This may be considered as a good definition because of its focus on accounting as an aid to decision making.

The American Institute of Certified and Public Accountants Committee on terminology defined accounting as:(AICPAC 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 a financial character and interpreting the results thereof”***. of all definitions available, this is the most acceptable one because it encompasses all the functions which the modern accounting system performs.

Another popular definition on accounting was given by American Accounting Principles Board in 1970, which defined it as:

***“accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is useful in making economic decision, in making reasoned choices among alternative courses of action”.***

This is a very relevant definition in a present context of business units facing the situation of selecting the best among the various alternatives available. The special feature of this definition is that it has designated accounting as a service activity.

#### **1.1.3.4 Scope And Functions Of Accounting**

Individuals engaged in such areas of business as finance, production, marketing, personnel and general management need not be expert accountants but their effectiveness is no doubt increased if they have a good understanding of accounting principles. Everyone engaged in business activity, from the bottom level employee to the chief executive and owner, comes into contact with accounting. The higher the level of authority and responsibility, the greater is the need for an understanding of accounting concepts and terminology.

A study conducted in United States revealed that the most common background of chief executive officers in United States corporations was finance and accounting. Interviews with several corporate executives drew the following comments:

***“..... my training in accounting and auditing practice has been extremely valuable to me throughout”. “a knowledge of accounting carried with it understanding of the establishment and maintenance of sound financial controls- is an area which is absolutely essential to a chief executive officer”.***

Though accounting is generally associated with business, it is not only business people who make use of accounting but also many individuals in non-business areas that make use of accounting data and need to understand accounting principles and terminology. For e.g. An engineer responsible for selecting the most desirable solution to a technical

manufacturing problem may consider cost accounting data to be the decisive factor. Lawyers want accounting data in tax cases and damages from breach of contract. Governmental agencies rely on an accounting data in evaluating the efficiency of government operations and for approving the feasibility of proposed taxation and spending programs. Accounting thus plays an important role in modern society and broadly speaking all citizens are affected by accounting in some way or the other.

Accounting which is so important to all, discharges the following vital functions:

### **1.Keeping Systematic Records:**

This is the fundamental function of accounting. The transactions of the business are properly recorded, classified and summarized into final financial statements – income statement and the balance sheet.

### **2.Protecting The Business Properties:**

The second function of accounting is to protect the properties of the business by maintaining proper record of various assets and thus enabling the management to exercise proper control over them.

### **3.Communicating The Results:**

As accounting has been designated as the language of business, its third function is to communicate financial information in respect of net profits, assets, liabilities, etc., to the interested parties.

### **4.Meeting Legal Requirements:**

The fourth and last function of accounting is to devise such a system as will meet the legal requirements. The provisions of various laws such as the companies act, income tax act, etc., require the submission of various statements like income tax returns, annual accounts and so on. Accounting system aims at fulfilling this requirement of law.

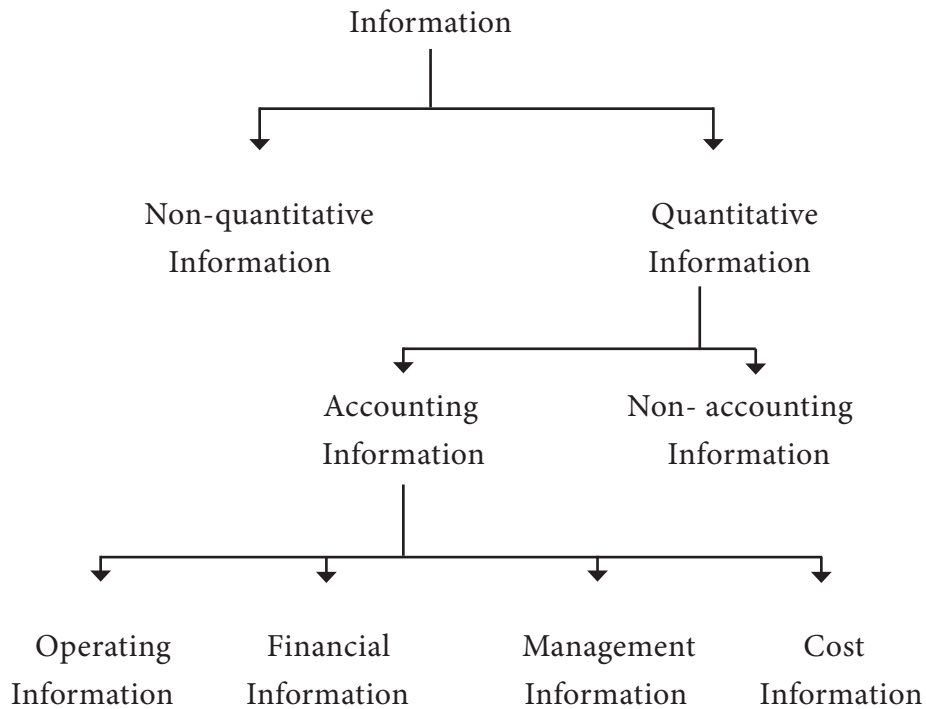
It may be noted that the functions stated above are those of financial accounting alone. The other branches of accounting, about which we are going to see later in this lesson, have their special functions with the common objective of assisting the management in its task of planning, control and coordination of business activities. Of all the branches of accounting, management accounting is the most important from the management point of view.

As accounting is the language of business, the primary aim of accounting, like any other language, is to serve as a means of communication. Most of the world's work is done through organizations – groups of people who work together to accomplish one or more objectives. In doing its work, an organization uses resources – men, material, money and machine and various services. To work effectively, the people in an organization need information about these sources and the results achieved through using them. People outside the organization need similar information to make judgments about the organization. Accounting is the system that provides such information.

Any system has three features, viz., input, processes and output. Accounting as a social science can be viewed as an information system, since it has all the three features i.e., inputs (raw data), processes (men and equipment) and outputs (reports and information). Accounting information is composed principally of financial data about business transactions. The mere records of transactions are of little use in making “informed judgments and decisions”. The recorded data must be sorted and summarized before significant analysis can be prepared. Some of the reports to the enterprise manager and to others who need economic information may be made frequently; other reports are issued only at longer intervals. The usefulness of reports is often enhanced by various types of percentage and trend analyses. The **“basic raw materials”** of accounting are composed of business transactions data. Its “primary end products” are composed of various summaries, analyses and reports. The information needs of a business enterprise can be outlined and illustrated with the help of the following chart:



### Chart Showing Types Of Information



The chart clearly presents the different types of information that might be useful to all sorts of individuals interested in the business enterprise. As seen from the chart, accounting supplies the quantitative information. The special feature of accounting as a kind of a quantitative information and as distinguished from other types of quantitative information is that it usually is expressed in monetary terms.

In this connection it is worthwhile to recall the definitions of accounting as given by the American Institute of Certified and Public Accountants and by the American Accounting Principles Board.

The types of accounting information may be classified into four categories: (1) operating information, (2) financial accounting information (3) management accounting information and (4) cost accounting information.

### **Operating Information:**

By operating information, we mean the information which is required to conduct the day-to-day activities. Examples of operating information are: amount of wages paid and payable to employees, information about the stock of finished goods available for sale and each one's cost and selling price, information about amounts owed to and owing by the business enterprise, information about stock of raw materials, spare parts and accessories and so on. By far, the largest quantity of accounting information provides the raw data (input) for financial accounting, management accounting and cost accounting.

### **Financial Accounting:**

Financial accounting information is intended both for owners and managers and also for the use of individuals and agencies external to the business. This accounting is concerned with the recording of transactions for a business enterprise and the periodic preparation of various reports from such records. The records may be for general purpose or for a special purpose. A detailed account of the function of financial accounting has been given earlier in this lesson.

### **Management Accounting:**

Management accounting employs both historical and estimated data in assisting management in daily operations and in planning for future operations. It deals with specific problems that confront enterprise managers at various organizational levels. The management accountant is frequently concerned with identifying alternative courses of action and then helping to select the best one. For e.g. The accountant may help the finance manager in preparing plans for future financing or may help the sales manager in determining the selling price to be fixed on a new product by providing suitable data. Generally management accounting information is used in three important management functions: (1) control (2) co-ordination and (3) planning. Marginal costing is an important technique of management accounting which provides multi dimensional information that facilitates decision making.

### **Cost Accounting:**

The industrial revolution in England posed a challenge to the development of accounting as a tool of industrial management. This necessitated the development of costing techniques as guides to management action. Cost accounting emphasizes the determination and the control of costs. It is concerned primarily with the cost of manufacturing processes. In addition, one of the principal functions of cost accounting is to assemble and interpret cost data, both actual and prospective, for the use of management in controlling current operations and in planning for the future.

All of the activities described above are related to accounting and in all of them the focus is on providing accounting information to enable decisions to be made. More about cost accounting can be gained in unit v.

#### **1.1.3.5**

### **Groups Interested In Accounting Information:**

**OR**

### **USERS OF ACCOUNTING INFORMATION:**

There are several groups of people who are interested in the accounting information relating to the business enterprise. Following are some of them:

#### **Shareholders:**

Shareholders as owners are interested in knowing the profitability of the business transactions and the distribution of capital in the form of assets and liabilities. In fact, accounting developed several centuries ago to supply information to those who had invested their funds in business enterprise.

#### **Management:**

With the advent of joint stock company form of organization the gap between ownership and management widened. In most cases the

**Potential Investors:**

An individual who is planning to make an investment in a business would like to know about its profitability and financial position. An analysis of the financial statements would help him in this respect.

**Creditors:**

As creditors have extended credit to the company, they are much worried about the repaying capacity of the company. For this purpose they require its financial statements, an analysis of which will tell about the solvency position of the company.

**Government:**

Any popular government has to keep a watch on big businesses regarding the manner in which they build business empires without regard to the interests of the community. Restricting monopolies is something that is common even in capitalist countries. For this, it is necessary that proper accounts are made available to the government. Also, accounting data are required for collection of sale-tax, income-tax, excise duty etc.

**Employees:**

Like creditors, employees are interested in the financial statements in view of various profit sharing and bonus schemes. Their interest may further increase when they hold shares of the companies in which they are employed.

**Researchers:**

Researchers are interested in interpreting the financial statements of the concern for a given objective.

**Citizens:**

Any citizen may be interested in the accounting records of business enterprises including public utilities and government companies as a voter and tax payer.

### **1.1.3.6 The Profession Of Accounting**

Accountancy can very well be viewed as a profession with stature comparable to that of law or medicine or engineering. The rapid development of accounting theory and techniques especially after the late thirties of 20th century has been accompanied by an expansion of the career opportunities in accounting and an increasing number of professionally trained accountants. Among the factors contributing to this growth has been the increase in number, size and complexity of business enterprises, the imposition of new and increasingly complex taxes and other governmental restrictions on business operations.

Coming to the nature of accounting function, it is no doubt a service function. The chief of accounting department holds a staff position which is quite in contra - distinction to the roles played by production or marketing executives who hold line authority. The role of the accountant is advisory in character. Although accounting is a staff function performed by professionals within an organization, the ultimate responsibility for the generation of accounting information, whether financial or managerial, rests with management. That is why one of the top officers of many businesses is the financial controller. The controller is the person responsible for satisfying other managers' demands for management accounting information and for complying with the regulatory demands of financial reporting. With these ends in view, the controller employs accounting professionals in both management and financial accounting. These accounting professionals employed in a particular business firm are said to be engaged in private accounting. Besides these, there are also accountants who render accounting services on a fee basis through staff accountants employed by them. These accountants are said to be engaged in public accounting.

### **1.1.3.7 Specialised Accounting Fields**

As in many other areas of human activity, a number of specialized fields in accounting also have evolved besides financial accounting. Management accounting and cost accounting are the result of rapid technological advances and accelerated economic growth. The most important among them are explained below:

**Tax Accounting:**

Tax accounting covers the preparation of tax returns and the consideration of the tax implications of proposed business transactions or alternative courses of action. Accountants specializing in this branch of accounting are familiar with the tax laws affecting their employer or clients and are up to date on administrative regulations and court decisions on tax cases.

**International Accounting:**

This accounting is concerned with the special problems associated with the international trade of multinational business organizations. Accountants specializing in this area must be familiar with the influences that custom, law and taxation of various countries bring to bear on international operations and accounting principles.

**Social Responsibility Accounting:**

This branch is the newest field of accounting and is the most difficult to describe concisely. It owes its birth to increasing social awareness which has been particularly noticeable over the last three decades or so. Social responsibility accounting is so called because it not only measures the economic effects of business decisions but also their social effects, which have previously been considered to be immeasurable. Social responsibilities of business can no longer remain as a passive chapter in the text books of commerce but are increasingly coming under greater scrutiny. Social workers and people's welfare organizations are drawing the attention of all concerned towards the social effects of business decisions. The management is being held responsible not only for the efficient conduct of business as reflected by increased profitability but also for what it contributes to social well-being and progress.

**Inflation Accounting:**

Inflation has now become a world-wide phenomenon. The consequences of inflation are dire in case of developing and underdeveloped countries. At this juncture when financial statements or reports are based on historical costs, they would fail to reflect the effect of changes in

purchasing power or the financial position and profitability of the firm. Thus, the utility of the accounting records, not taking care of price level changes is seriously lost. This imposes a demand on the accountants for adjusting financial accounting for inflation to know the real financial position and profitability of a concern. Thus emerged a future branch of accounting called inflation accounting or accounting for price level changes. It is a system of accounting which regularly records all items in financial statements at their current values.

### **Human Resources Accounting:**

Human resources accounting is yet another new field of accounting which seeks to report and emphasize the importance of human resources in a company's earning process and total assets. It is based on the general agreement that the only real long lasting asset which an organization possesses is the quality and caliber of the people working in it. This system of accounting is concerned with, ***“the process of identifying and measuring data about human resources and communicating this information to interested parties”***.

#### **1.1.3.8 Nature And Meaning Of Accounting Principles**

What is an accounting principle or concept or convention or standard? Do they mean the same thing? Or does each one has its own meaning? These are all questions for which there is no definite answer because there is ample confusion and controversy as to the meaning and nature of accounting principles. We do not want to enter into this controversial discussion because the reader may fall a prey to the controversies and confusions and lose the spirit of the subject.

The rules and conventions of accounting are commonly referred to as principles. The American Institute of Certified Public Accountants has defined the accounting principle as, ***“a general law or rule adopted or professed as a guide to action; a settled ground or basis of conduct or practice”***. It may be noted that the definition describes the accounting principle as a general law or rule that is to be used as a guide to action. The Canadian Institute of Chartered Accountants has defined accounting principles as, ***“the body of doctrines commonly associated with the theory and procedure of accounting, serving as explanation of current practices”***.

*and as a guide for the selection of conventions or procedures where alternatives exist*". This definition also makes it clear that accounting principles serve as a guide to action.

The peculiar nature of accounting principles is that they are manmade. Unlike the principles of physics, chemistry etc. They were not deducted from basic axiom. Instead they have evolved. This has been clearly brought out by the Canadian Institute of Chartered Accountants in the second part of their definition on accounting principles: *"rules governing the foundation of accounting actions and the principles derived from them have arisen from common experiences, historical precedent, statements by individuals and professional bodies and regulation of governmental agencies"*. Since the accounting principles are man made they cannot be static and are bound to change in response to the changing needs of the society. It may be stated that accounting principles are changing but the change in them is permanent.

Accounting principles are judged on their general acceptability to the makers and users of financial statements and reports. They present a generally accepted and uniform view of the accounting profession in relation to good accounting practice and procedures. Hence the name generally accepted accounting principles.

Accounting principles, rules of conduct and action are described by various terms such as concepts, conventions, doctrines, tenets, assumptions, axioms, postulates, etc. But for our purpose we shall use all these terms synonymously except for a little difference between the two terms – concepts and conventions. The term "concept" is used to connote accounting postulates i.e. Necessary assumptions or conditions upon which accounting is based. The term convention is used to signify customs or traditions as a guide to the preparation of accounting statements.

### **1.1.3.9 Accounting Concepts**

The important accounting concepts are discussed hereunder:

#### **Business Entity Concept:**

It is generally accepted that the moment a business enterprise is



started it attains a separate entity as distinct from the persons who own it. In recording the transactions of a business, the important question is:

How do these transactions affect the business enterprise? The question as to how these transactions affect the proprietors is quite irrelevant. This concept is extremely useful in keeping business affairs strictly free from the effect of private affairs of the proprietors. In the absence of this concept the private affairs and business affairs are mingled together in such a way that the true profit or loss of the business enterprise cannot be ascertained nor its financial position. To quote an example, if a proprietor has taken rs.5000/- from the business for paying house tax for his residence, the amount should be deducted from the capital contributed by him. Instead if it is added to the other business expenses then the profit will be reduced by rs.5000/- and also his capital more by the same amount. This affects the results of the business and also its financial position. Not only this, since the profit is lowered, the consequential tax payment also will be less which is against the provisions of the income-tax act.

### **Going Concern Concept:**

This concept assumes that the business enterprise will continue to operate for a fairly long period in the future. The significance of this concept is that the accountant while valuing the assets of the enterprise does not take into account their current resale values as there is no immediate expectation of selling it. Moreover, depreciation on fixed assets is charged on the basis of their expected life rather than on their market values. When there is conclusive evidence that the business enterprise has a limited life, the accounting procedures should be appropriate to the expected terminal date of the enterprise. In such cases, the financial statements could clearly disclose the limited life of the enterprise and should be prepared from the 'quitting concern' point of view rather than from a 'going concern' point of view.

### **Money Measurement Concept:**

Accounting records only those transactions which can be expressed in monetary terms. This feature is well emphasized in the two definitions on accounting as given by the American Institute of Certified Public Accountants and the American Accounting Principles Board. The

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