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# UNIT 2 NATURE AND SCOPE OF ACCOUNTING

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## 2.0 OBJECTIVES

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After studying this unit, you should be able to :

- explain the need for accounting
- identify the objectives of accounting
- define accounting
- outline the scope of accounting
- distinguish between book-keeping, accounting and accountancy
- identify the parties interested in accounting information
- describe the important branches of accounting
- describe the advantages of accounting

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## 2.1 INTRODUCTION

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In the previous unit we discussed the nature of business, identified various types of business activities and explained different forms of business organisation. In the process we identified the need for accounting. In this unit we intend to elaborate on the need for accounting and then discuss the nature, scope and importance of accounting.

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## 2.2 NEED FOR ACCOUNTING

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In the previous unit we have identified the need for accounting. Let us elaborate on this. Suppose you are given ten rupees to purchase vegetables and asked to account for the amount. You have purchased the vegetables—1 kg of tomatoes for Rs. 4, 1 kg of potatoes for Rs. 3, and 1 kg of brinjals for Rs. 2. The total amount spent is Rs. 9 and the balance of amount with you is Re 1. Thus, you have rendered the account for Rs. 10. This is one time affair. Therefore, you could remember what you have spent.

Suppose, you are given Rs. 2,000 and asked to manage the home for a month and render the account for the money at the end of the month. You will be purchasing groceries, milk,

vegetables, paying for electricity, school/college fees, etc. You will be spending almost everyday. In that case, is it possible to remember all the payments you are making everyday and render account at the end of the month? No, it is not possible to remember, especially when the number of payments is more. Not only that, it is not even advisable to depend on memory. Therefore, it is better to write down (or record) whatever payments you have made. Further, it is advisable to obtain receipts or bills for the payments you have made, so that you can render the account, beyond doubt.

The above example is a simple one, where you have one receipt of money i.e., Rs. 2,000 and a number of payments. But the case of business is different. In business you may have to purchase and sell hundreds and thousands of times over a period of time. You will have a number of receipts and a number of payments (known as transactions). Will it be possible for you to remember hundreds and thousands of transactions which have taken place in your business, that too over a period of time, say a year? It is not humanly possible to remember all transactions which have taken place in business over a period of time. Even if you remember all the transactions, you will find it impossible to calculate the net effect of all such transactions i.e., profit. It, therefore, becomes necessary to record all the transactions that have taken place in business.

Further, it is not possible for the businessman to sit at the cash counter throughout the day. Sometimes his family members may be asked to sit at the cash counter. As the size of the business grows, it becomes necessary to employ people to assist the businessman. In such cases, theft of goods or cash is possible or all the sale proceeds may not be put into the cash box. Hence, it becomes necessary to maintain accounting records for the purpose of control, especially when outsiders are employed. It can, thus, be seen that there is need for proper accounting records even in case of a sole proprietorship concern. It is all the more important in the case of other forms of business organisation.

In case of a partnership firm, all the partners may or may not be actively participating in the day-to-day management of the business. It is, therefore, necessary to record all the transactions in order to satisfy all the partners. In case of a company, it is not possible for the owners (shareholders) who are too large in number to take part in the day-to-day management of the company. Generally, the management of the company is entrusted to paid managers. Hence, the need for recording all transactions.

Information about the business is required for both internal and external use. For example, the management needs a lot of information (for their internal use) for planning, controlling and evaluating the operations of the business. Information is also needed by some outsiders, banks, creditors, etc. For example, it is required for filing sales tax, income tax, and other tax returns with appropriate tax authorities. When a firm approaches the bank for loan or the creditors for supply of goods on credit, the bank or creditors like to know the firm's financial position (whether it is financially sound or not) and its profit earning capacity. The question is how to obtain all such information. A systematic accounting record is the only answer.

Accounting is necessary in not only business organisations, but also 'non-business' organisations like schools, colleges, hospitals, libraries, etc.

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## 2.3 OBJECTIVES OF ACCOUNTING

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From the above discussion, the objectives of accounting can be stated as follows:

- i) **To keep systematic records:** Accounting is done to keep a systematic record of financial transactions, like purchase of goods, sale of goods, cash receipts and cash payments. Systematic record of various assets and liabilities of the business is also to be maintained.
- ii) **To ascertain the net effect of the business operations i.e., profit or loss of business:** We know that the primary objective of business is to make profit and the businessman is very much interested in knowing the same. A proper record of income and expenses facilitates the preparation of the profit and loss account (income statement). The profit and loss account reveals the profit earned or loss incurred by the business firm during a particular period.
- iii) **To ascertain the financial position of the business:** The businessman is not only interested in knowing the operating result, but also interested in knowing the financial position of his business i.e., where it stands. In other words, he wants to know what the business owes to others and what it owns, and what happened to his capital—whether the capital has

increased or decreased or remained constant. A systematic record of various assets and liabilities facilitates the preparation of a statement known as 'balance sheet' (position statement) which answers these questions.

iv) **To provide accounting information to interested parties:** Apart from the owners, there are various other parties who are interested in knowing about the business firm, such as the management, the bank, the creditors, the tax authorities, etc. For this purpose, the accounting system has to supply the required information.

**Check Your Progress—A**

1 Give five points in support of the need for accounting.

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2 State the main objects of accounting

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3 What is profit?

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4 What do you understand by 'Financial Position'?

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**2.4 DEFINITION AND SCOPE OF ACCOUNTING**

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Accounting has been defined in different ways by different authorities on the subject. Accounting is a comprehensive discipline and it is difficult to explain satisfactorily through any single definition. However, two definitions are given below. This should help you to understand the nature and scope of accounting.

The American Accounting Association defines Accounting as *the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information. This definition stresses three aspects viz., identifying, measuring and communicating economic information*

In the words of the Committee on Terminology appointed by the American Institute of Certified Public Accountants, *Accounting is the art of recording, classifying and summarising 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. This is a popular definition of accounting and it outlines the nature and scope of accounting activity.*

A business is generally started with the proprietor's funds i.e., capital. The proprietor may also acquire additional funds from outsiders like banks and creditors. These funds are utilised to acquire the assets needed for business and also to carry out other business activities. In the process many transactions and events take place. The accountant has to identify all such transactions and events, measure them in terms of money, and record them in appropriate books of account. Then, he has to classify them under separate heads of accounts, summarise periodically in the form of Profit and Loss Account and Balance Sheet; and analyse, interpret and communicate the results thereof to the interested parties. Accounting can thus be broadly defined as follows:

Accounting is the process of identifying, measuring, recording, classifying, summarising, analysing, interpreting, and communicating the financial transactions and events in monetary terms.

The above definitions clearly bring out the scope of accounting. This can now be outlined as follows :

- 1 Accounting is concerned with financial transactions and events which bring about a change in the resources (or wealth) position of the business firm. Such transactions have to be **identified** first, as and when they occur. It is not difficult because, there will be proof in the form of a bill or receipt (called vouchers). With the help of these bills and receipts identification of a transaction is easy. For example, when you purchase something you get a bill, when you make payment you get a receipt.
- 2 These transactions are to be **measured** or expressed in terms of money, if not done already. Generally, this problem will not arise, because the statement of proof expresses the transaction in terms of money. For example, if ten books are purchased at the rate of Rs. 20 each, then the bill is prepared for Rs. 200. But, if an event cannot be expressed in monetary terms, it will not come under the scope of accounting.
- 3 The transactions which are identified and measured are to be **recorded** in a book called journal or in one of its sub-divisions.
- 4 The recorded transactions are to be **classified** with a view to group transactions of similar nature at one place. The work of classification is done in a separate book called ledger. In the ledger, a separate account is opened for each item so that all transactions relating to it can be brought to one place. For example, all payments of salaries are brought to salaries account.
- 5 The recording and classification of many transactions will result in a mass of financial data. It is, therefore, necessary to **summarise** such data periodically (at least once a year), in a significant and meaningful form. The summarisation is done in the form of profit and loss account which reveals the profit made or loss incurred, and the balance sheet which reveals the financial position.
- 6 The summary results will have to be **analysed, interpreted** (critically explained) and **communicated** to interested parties. Accounting information is generally communicated in the form of a 'report'. Big organisations generally present printed reports, called published accounts.

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## 2.5 BOOK-KEEPING, ACCOUNTING AND ACCOUNTANCY

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Very often you will come across terms like book-keeping, accounting, and accountancy in the literature on accounting. We propose to explain them in the following paragraphs.

You know Accounting involves a series of activities, as listed out in the scope of accounting. These activities are : (1) identifying, (2) measuring, (3) recording, (4) classifying, (5) summarising, (6) analysing, (7) interpreting, and (8) communicating, the financial transactions and events.

Book-keeping is a narrow term, which means record keeping or maintaining books of account. It only covers the first four activities (1 to 4 above) of accounting.

The term 'Accountancy' refers to a systematised knowledge of accounting and is regarded as an academic subject like economics, statistics, chemistry, etc. It explains 'why to do' and 'how

to do' of various aspects of accounting. In other words, while Accounting refers to the actual process of preparing and presenting the accounts, Accountancy tells us why and how to prepare the books of account and how to summarise the accounting information and communicate it to the interested parties. Thus Accountancy is a science, a body of systematised knowledge, whereas Accounting is the art of putting such knowledge into practice.

In general usage, however, Accountancy and Accounting are used as synonyms (meaning the same thing). But, of late, the term accounting is becoming more and more popular.

**Check Your Progress—B**

1 Define accounting.

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2 What do you mean by book-keeping?

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3 What is accountancy?

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4 Accounting involves a series of activities. List them.

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## 2.6 PARTIES INTERESTED IN ACCOUNTING INFORMATION

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You have learnt that many groups of people are interested in accounting information which may help them:

- i) to understand the present position of the enterprise
- ii) to compare its present performance with that of its past years
- iii) to compare its present performance with that of similar enterprises.

Now, let us see who such parties are and how accounting information is useful to various parties.

**Owners:** Owners contribute capital and assume the risk of business. Naturally, they are interested to know the amount of profit earned by the business and so also its financial position. If, however, the management of the business is entrusted to paid managers, the owners also use the accounting information to evaluate the performance of the managers.

**Managers:** Accounting information, supplemented by other information, is of immense use to managers. It helps them to plan, control and evaluate the operations of the business. They also need such information for various decision-making.

**Lenders:** The funds are provided by the owners initially, but if the business requires more funds, they are provided by banks and other lenders of money. Before they lend money, they would like to know the solvency (i.e., capacity to repay debts) of the enterprise, so as to satisfy themselves that their money will be safe and that they can expect repayment on time.

**Creditors:** Those who supply goods and services on credit are called creditors. Like lenders, they too want to know about solvency of the enterprise, so as to decide whether credit can be granted or not.

**Prospective investors:** A person who wants to become a partner in a partnership concern or a person who wants to become a shareholder of a company, would like to know how safe and rewarding the proposed investment would be.

**Tax authorities:** Tax authorities of the Government are interested in the financial statements so as to assess the tax liability of the enterprise.

**Employees:** The employees of the enterprise are also interested in knowing the state of affairs of the organisation in which they are working, so as to know how safe their interests are in that organisation.

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## 2.7 BRANCHES OF ACCOUNTING

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Accounting, as we know it today, has evolved over many centuries in response to the changing economic, social and political conditions. The development of modern accounting was influenced by a number of factors such as industrial revolution, growth of large enterprises like companies, introduction of compulsory audit of companies, legal regulations, establishment of professional organisations like the Institute of Chartered Accountants of India, the Institute of Cost and Works Accountants of India, American Institute of Certified Public Accountants, etc. Economic development and technological improvements have resulted in an increase in the scale of business operations and the advent of company form of organisation. This has made management function more and more complex. These factors have increased the importance of accounting and have given rise to special branches of accounting. The important branches of accounting are briefly explained below.

**Financial Accounting:** The purpose of this branch of accounting is to keep a record of financial transactions and events so that:

- a) the net result of the operations of the business (profit or loss) during an accounting period can be ascertained;
- b) the financial position (assets, liabilities and capital position) of the business as at the end of the period can be ascertained; and
- c) relevant financial information can be provided to management and other interested parties.

**Cost Accounting:** The purpose of cost accounting is to analyse the expenditure so as to ascertain the cost of each product, operation, service, etc. The price of an article is nothing but the cost plus a certain amount of profit. Unless cost is known, price cannot be fixed rationally. Cost accounting helps not only in ascertaining the costs but also assists the management in controlling the costs.

**Management Accounting:** The purpose of management accounting is to assist the management in taking rational policy decisions and to evaluate the impact of its decisions and actions. Examples of such decisions are: pricing decisions, capital expenditure decisions, etc. This branch of accounting is primarily concerned with presenting information that may be needed by management in such decision-making.

In this course, we are concerned with financial accounting only.

### Check Your Progress—C

- 1 Mr. Agarwala started Agarwala Electricals shop with a capital of Rs. 1,00,000. As this amount is insufficient, he has borrowed Rs. 50,000 from Syndicate Bank. As he is not keeping good health, he appointed Mr. Ram Naresh to look after the business on a salary of Rs. 1,000 per month. Pavan Electrical Works supplies electrical goods to Agarwala Electricals on credit. Mr. Mirchand, Mr. Sabir and Mr. Wilson are the other persons

working in Agarwala Electricals, as salesmen. Mr. Agarwala wants to expand the business. But he is not in a position to invest more money. Mr. Shyamlal wants to join as a partner. From this, identify the names of the following parties and write them in the blank space provided.

- |                          | Name  |
|--------------------------|-------|
| i) Business firm         | ..... |
| ii) Owner                | ..... |
| iii) Manager             | ..... |
| iv) Lender               | ..... |
| v) Creditor              | ..... |
| vi) Prospective Investor | ..... |
| vii) Employees           | ..... |
- 2 Complete the following sentences:
- i) Accounting is the process of identifying, measuring and ..... economic information to permit informed judgements.
  - ii) Accounting designed to serve parties external to the operating responsibilities of the business is termed as.....
  - iii) Accounting designed for operational needs of business is termed as .....
  - iv) ..... Accounting is more or less compulsory for every business.

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## 2.8 ADVANTAGES OF ACCOUNTING

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The following are the advantages of a properly maintained accounting system.

- 1 **Replaces memory:** Since all the financial events are recorded in the books, there is no need to rely on memory. The books of account will serve as historical records. Any information required at any time can be had from these records.
- 2 **Provides control over assets:** Accounting provides information regarding balance of cash in hand and at bank, the stock of goods on hand, the amount receivable from various parties, the amount invested in various other assets, etc. Information about these matters help owner(s) and management to make use of the assets in the best possible way.
- 3 **Facilitates the preparation of financial statements:** With the help of information contained in the accounting records, financial statements viz., Profit and Loss Account and Balance Sheet can be easily prepared. These statements enable the businessman to know the net result of the business during an accounting period and its financial position.
- 4 **Meets the information requirements:** Various interested parties such as owners, management, lenders, creditors, etc. get the necessary information at frequent intervals which help them in their decision-making.
- 5 **Facilitates a comparative study:** The financial statements prepared will enable the enterprise to compare its present position with that of its past, and with that of similar organisations. This helps them to draw useful conclusions and improve its performance.
- 6 **Assists the management in many ways:** It is possible to identify reasons for the profit earned or loss suffered. The identification of reasons helps in taking necessary steps to increase profits further, or to avoid losses. Accounting information will also help in planning and controlling the activities of the business.
- 7 **Difficult to conceal fraud or theft:** It is difficult to conceal fraud, theft, etc., as there is an automatic check in the form of periodic balancing of books of account. Further, in big organisations the record keeping work is divided among many persons, so that chances of committing fraud are minimised.

**8 Tax matters:** The Government levies various taxes such as customs duty, excise duty, sales tax, and income tax. Properly maintained accounting records will help in the settlement of tax matters with the tax authorities.

**9 Ascertaining value of business:** In the event of sale of a business firm, the accounting records will help in ascertaining the value of business.

By now, you must have got an overview of accounting. We can now move into details. As a first step, we intend to explain, in the next unit, some terms commonly used in accounting and the basic accounting concepts.

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## 2.9 LET US SUM UP

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1 Business has a series of transactions. It is not possible to remember all the transactions which have taken place over a period of time, and calculate the net effect of all such transactions i.e., profit or loss. Hence, the need for accounting.

2 Information about the business enterprise is required for both internal and external use. To get the required information, a systematic record is necessary.

3 The objectives of accounting are: to keep systematic records; to ascertain the profit or loss and also the financial position; and to provide accounting information to interested parties for rational decision-making.

4 Accounting is the process of identifying, measuring, recording, classifying, summarising, analysing, interpreting and communicating the financial transactions and events.

5 The series of activities mentioned above, explain the nature and outline the scope of accounting.

6 Book-keeping is a part of accounting. It is the record keeping function of accounting and is limited upto the classifying stage.

7 Accountancy is the systematic knowledge while accounting is the practice of the knowledge i.e., the actual maintenance of books of account and provide accounting information.

8 Many groups of people like owners, management, lenders, creditors, investors, tax authorities, employees, etc., are interested in the accounting information of the enterprise.

9 Changes in economic environment and the increasing complexity of management function have given rise to specialised fields of accounting such as financial accounting, cost accounting and management accounting.

10 There are many advantages of a properly maintained accounting system.

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## 2.10 KEY WORDS

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**Accountancy:** The science of measurement of wealth. It is the systematic knowledge of accounting.

**Accounting:** Process of identifying, measuring, recording, classifying, summarising and communicating business transactions and events in terms of money.

**Book-keeping:** Systematic recording of business transactions in the books of account.

**Cost Accounting:** A branch of accounting concerned with measurement and control of costs.

**Financial Accounting:** It is primarily concerned with record keeping directed towards preparation of financial statements and other accounting reports.

**Financial Position:** Position of assets and liabilities of a business at a given point of time.

**Financial Statements :** Summary of accounting information such as Profit and Loss Account and Balance Sheet.



**Management:** It is used in two senses:

- i) to mean the process of management or managing the business, for example, the day-to-day management is entrusted to paid managers; and
- ii) to mean the persons who are incharge of carrying out the business activity i.e., managers, for example, management wants this information. Report has to be submitted to the management.

**Management Accounting:** It is concerned with the supply of information which is useful to the management in planning, controlling and decision-making.

**Profit:** Excess of income over expenses.

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## 2.11 SOME USEFUL BOOKS

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Bierman, Harold & Drebin, Allan R. *Financial Accounting: An Introduction* (Philadelphia: W.B. Saunders Company, 1978).

Briston, R.J. *Introduction to Accountancy & Finance* (London: The Macmillan Press Ltd., 1981).

Maheshwari, S.N. *Principles and Practice of Book-Keeping* (New Delhi: Arya Book Depot, 1986).

Matulich, S. & Heitger, L.E. *Financial Accounting* (New York: McGraw Hill Book Company, 1980).

Patil, V.A. & Korlahalli, J.S. *Principles and Practice of Book-Keeping* (New Delhi: R. Chand & Co., 1985).

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## 2.12 ANSWERS TO CHECK YOUR PROGRESS

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- C 1
- i) Agarwala Electricals Shop
  - ii) Mr. Agarwala
  - iii) Mr. Ram Naresh
  - iv) Syndicate Bank
  - v) Pavan Electrical Works
  - vi) Mr. Syamlal
  - vii) Mr. Mirchand, Mr. Sabir and Mr. Wilson.
- 2
- i) Communicating
  - ii) Financial Accounting
  - iii) Management Accounting
  - iv) Financial

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## 2.13 TERMINAL QUESTIONS

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- 1 Outline the need for accounting and briefly describe the objects of accounting.
- 2 Define accounting and explain its scope.
- 3 Name the different parties interested in accounting information, and explain why do they want it.

**Note :** These questions will help you to understand the unit better. Try to write answers for them. But, do not submit your answers to the University for assessment. These are for your own practice only.

