1.10 LIMITATIONS OF ACCOUNTING

The accounting information is used by various parties who form judgments about the profitability and the financial soundness of a business on the basis of such information. It is, therefore, necessary to know about the limitations of accounting. These are as follows:

1. They do not record transactions and events which are not of a financial character. Hence. They do not reveal a complete picture because facts like quality of human resources, licences possessed, locational advantage, business contacts, etc. do not find any place in books of account.
2. The data is historical in nature. The accountants adopt historical cost as the basis in valuing and reporting all assets and liabilities. They do not reflect current values, it is quite possible that items like land and buildings may have much more value than what is stated in the balance sheet.
3. Facts recorded in financial statements are greatly influenced by accounting conventions and personal judgements. Hence, they do not reveal the true picture. In many cases, estimates may be used to determine the value of various items. For example, debtors are estimated in terms of collectability, inventories are based on marketability, and fixed assets are based on useful working life. All these estimates are materially affected by personal judgements.
4. Data provided in the financial statements is insufficient for proper analysis and decision making. It only provides information about the overall profitability of the business. No information is given about the cost and profitability of different activities.

1.11 BASES OF ACCOUNTING

There are two bases of accounting: (i) cash basis, and (ii) accrual basis. These are explained below:

1.11.1 Cash Basis of Accounting

In this system, the accounting entries are made on the basis of cash received or cash paid. In other words, transactions are recorded only when cash is received or paid. The incomes earned but not yet received (accrued income) or the expenses incurred but not yet paid (expenses outstanding) are completely ignored while preparing the final accounts. For example, rent for the month of December, 2017 is paid in January, 2018. This is taken into the Profit and Loss Account of 2018 even though the benefit of that payment (accommodation) is enjoyed in 2017 itself.

1.11.2 Accrual Basis of Accounting

This system of accounting attempts to record the financial effects of transactions in the period in which they occur and not in the period in which the amount is received or paid to the enterprise.

Accrual accounting is also called 'Mercantile System of Accounting'. It recognises that buying, selling and all other operations of an enterprise during a period may not coincide with the period during which the related cash receipts and cash payments take place. In other words, all revenues earned in a year may or may not have been received in cash in that year. Similarly, all expenses incurred in a year may or may not have been paid in the same year. Accrual accounting attempts to relate the revenues and expenses to year in which they are actually earned or incurred. For example, rent for the month of December, 2017 is paid in January, 2018. As per the accrual principle, it would be taken to the Profit and Loss Account of the year 2017 and not 2018. This is more logical because the benefit of payment is enjoyed in the year 2017 and not in 2018.

The main difference between accrual accounting and cash basis of accounting is the recognition of revenues, gains, expenses and losses. The objective of accrual accounting is to account for the effects of transactions and events to the extent that their financial effects are recognisable and measurable in the periods in which they occur. The adjustments made in the final accounts in respect of prepaid expenses (prepaid insurance, salaries paid in advance, etc.), income received in advance (rent received in advance, interest received in advance, etc.), income earned but not yet received (interest receivable, commission receivable, etc.) are based on accrual accounting.

Sometimes, a business adopts a combination of both the above systems. In that case it is called 'Mixed or Hybrid System'. For example, the business may consider income in cash receipt basis and expenses on accrual basis. This is considered most conservative. In practice, most enterprise adapt the accrual basis of accounting.

1.12 QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION

Business owners can use accounting information to conduct a financial analysis of business operations. Accounting information often has quantitative and qualitative characteristics. Quantitative characteristics refer to the calculation of financial transactions. Qualitative characteristics include the business owner's perceived importance of financial information. Business owners often require financial information when making business decisions. Incorrect or inappropriate information can hamper decision-making or cause business owners to make incorrect assessments about their companies. Some of the qualitative characteristics of accounting information are as follows:

(i) Understandable

Accounting information must be understandable. This is an important qualitative characteristic for small business owners. Many small business owners do not have a strong accounting background. Financial information that is too technical or cannot be understood by a layperson can be ineffective for business owners. Small business owners often use professional accountants to complete various accounting functions. Business owners should choose an accountant who can prepare information in an easily understandable manner.

(ii) **Usefulness**

Business owners need accounting information that is applicable to the business decision at hand. They can request financial statements, accounting schedules, reconciliations or cost-benefit analysis. For example, cost allocation reports may not provide sufficient information for business owners who must make a decision on hiring employees. Cost allocation usually refers to applying business costs to goods or services produced by the company, which has very little to do with human resources. Business owners should carefully request and review accounting information to ensure that it provides the most useful information for the decision-making process.

(iii) **Relevance**

Accounting information should relate to a specific time period or contain information regarding individual business functions. Business owners often conduct a trend analysis when reviewing financial information. The trend analysis compares historical financial information to the company's current accounting period information. Irrelevant historical information can severely distort the trend analysis process. For example, reviewing the production process for budgets requires relevant information on the cost of materials for budgets. Cost information on the materials to produce COGS would be irrelevant.

(iv) **Reliability**

Accounting information must be reliable, so that business owners can be reasonably assured that accounting information presents an accurate picture of the company's financial health. Business owners often use accounting information to secure external financing for their business. Information that is not reliable or accurate may cause lenders and investors to question the business's management ability. Business owners may also struggle to secure external financing with poor accounting information.

(v) **Comparable**

Comparability allows business owners to review their company's accounting information against that of a competitor. Business owners use comparison to gauge how well their companies operate under certain market conditions. Owners often use the leading company of an industry for the comparison process. These companies usually have the most efficient and effective business operations. Non-comparable accounting information can make this a difficult process. For example, business owners should consider preparing financial statements according to standard accounting principles. The statements can then be compared to other company's financial standard prepared in a similar manner.

(vi) **Consistent**

Consistency refers to how business owners and accountants record financial information in a company's general ledger. Business owners need to ensure that financial transactions are handled the same way. Inventory purchases should be recorded the same way as yesterday, today and tomorrow. This helps companies create accurate historical records and limit the amount of financial accounts or journal entries included in their general ledgers.

1.13 FUNCTIONS OF ACCOUNTING

Functions of Accounting involves the creation of financial records of business transactions, flows of finance, the process of creating wealth in an organization, and the financial position of a business at a particular moment in time. The progress and reputation of any business big or small is build up on sound financial footing. There are number of parties who are interested in accounting information relating to a business. Financial Accounting communicates financial information of the business concern to various parties. Financial accounting provides information regarding the status of a business and results of its operation. Here are the functions of accounting:

(i) Recording

This is the basic function of accounting. It is essentially concerned with not only ensuring that all business transactions of financial character are in fact recorded but also that they are recorded in an orderly manner. Recording is done in the book "Journal".

(ii) Classifying

Classification is concerned with the systematic analysis of the recorded data, with a view to group transactions or entries of one nature at one place. The work of classification is done in the book termed as "Ledger".

(iii) Summarizing

This involves presenting the classified data in a manner which is understandable and useful to the internal as well as external end-users of accounting statements. This process leads to the preparation of the following statements: (1) Trial Balance, (2) Income statement (3) Balance Sheet.

(iv) Analysis and Interprets

This is the final function of accounting. The recorded financial data is analyzed and interpreted in a manner that the end-users can make a meaningful judgment about the financial condition and profitability of the business operations. The data is also used for preparing the future plan and framing of policies for executing such plans.

(v) Communicate

The accounting information after being meaningfully analyzed and interpreted has to be communicated in a proper form and manner to the proper person. This is done through preparation and distribution of accounting reports, which include besides the usual income statement and the balance sheet, additional information in the form of accounting ratios, graphs, diagrams, funds flow statements etc.

1.14 LET US SUM UP

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 takes place.

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.

1.15 KEY WORDS

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.

Accounting Year : A period of 12 months at the end of which the financial results of the enterprise are generally ascertained.

Accrual Basis of Accounting: A basis of accounting which takes into account all incomes, gains, expenses and losses in the year in which they are earned or incurred, and not when they are received or paid.

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

Balance Sheet: A statement prepared for ascertaining the financial position of the business as at the end of the accounting period.

Cash Basis of Accounting: A basis of accounting in which accounts are prepared on the basis of cash received or cash paid. No accruals -are considered.

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.

Final Accounts : Financial statements prepared at the end of the accounting period for ascertaining the profit or loss and the financial position of the business. They include Profit and Loss Account and the 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.

Profit and Loss Account: A statement showing all incomes and expenses for the accounting period. It is prepared for ascertaining the operational result of the enterprise.

1.16 SOME USEFUL BOOKS

Bièrman, Harold & Drebin, *Allan R., Financial Accounting: An Introduction* (Philadelphia: W.B. Saunders Company, 1998).

Briston, R.J., *Introduction to Accountancy & Finance* (London: The Macmillan Press Ltd., 1991).

Maheshwari, S.N., *Principles and Practice of Book-Keeping* (New Delhi: Arya Book Depot, 2018).

Matulich, S. & Heitger, *L.E., Financial Accounting* (New York: McGraw Hill Book Company, 1990).

Patil, V.A. & Korlahalli, Principles and Practice of Book-Keeping (New Delhi: R. Chand & Co., 2018).

1.17 ANSWERS TO CHECK YOUR PROGRESS

C 1. i) Agarwala Electricals Shop

ii) Mr. Agarwala

iii) Mr. Ram Naresh

iv) Syndicate Bank

v) Pawan Electrical Works

vi) Mr. Shyamlal

vii) Mr. Mirchand, Mr. Sabir and Mr. Wilson.

2. i) Communicating

ii) Financial Accounting

iii) Management Accounting

iv) Financial

1.18 TERMINAL QUESTIONS

1. Outline the need for accounting and briefly describe the objectives 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.
4. What are the qualitative characteristics of accounting information? Briefly Explain.
5. Describe the advantages and limitations of accounting.
6. Briefly discuss the functions of accounting.
7. Define accounting. Explain the need for accounting.
8. Write short notes on the following:
   a) Book-keeping
   b) Accountancy
   c) Accounting
9. Distinguish between cash basis and accrual basis of accounting with examples.

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.