Accounting for Managerial Decisions

By: Nirmal Kumar Gupta

This reference book can be useful for

BBA, MBA, B.Com, BMS, M.Com, BCA, MCA

and many more courses for Various Universities

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Accounting: An Overview

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We notice that every individual is engaged in some kind of financial transactions. An employee, a doctor, a teacher, a shopkeeper, an advocate, a hospital, a bank, a club and a company–all are busy in performing financial transactions. Recording of the various financial transactions helps various persons and institutions to work efficiently. For example, a housewife keeps a record of her receipts and payments. She can plan her future income and expenses. Recording of receipts and payments acts as an aid to human memory because there is a limit to human memory. But accounting, as an organised activity, is generally associated with business concerns. A business is engaged in a large number of transactions. A systematic record of transactions is indispensable for every business. Accounting came into practice as an aid to human memory by maintaining a systematic record of business transactions. It was subsequently realised that accounting is capable of providing the kind of information for decision-making by managers and other interested persons. This aspect of accounting has become so important that accounting is regarded as an information system or language of business.

NEED FOR ACCOUNTING

Accounting developed as a result of the needs of the business to keep systematic records of business transactions and keep relationship with the outsiders. Accounting is needed to communicate the results of business operations to various interested parties. Accounting information is useful both for the management and the outside agencies. The management needs it for the purpose of planning, controlling and decision-making. The outsiders require it for assessing the financial solvency of the business and the tax authorities uses for determining the amount of tax liability. Infact accounting is necessary not only for business organisation, but also for non-business organisations like schools, colleges, hospitals and clubs etc.

DEFINITION OF ACCOUNTING

Accounting has been defined in different ways by different authors, experts and authorities. There is no unanimity among them because the concept of accounting has to be changed with the passage of time. On the basis of functions, accounting may be defined as the art of recording, classifying and summarising business transactions of a financial character and interpreting and communicating the results to the users to enable them to make decisions.

The following are some of the important definitions of accounting:

According to the Committee on Terminology of American Institute of Certified Public Accountants (AICPA), "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 atleast, of a financial character, and interpreting the results thereof ."

Eric L. Kohlen (A Dictionary for Accountants) defines Accounting as "the procedure of analysing, classifying and recording transactions in accordance with a pre-conceived plan for the benefit of

(a) providing a means by which an enterprise can be conducted in orderly fashion, and

(b) establishing a basis for reporting the financial condition of enterprise and the results of its operations."

The former definition denotes that accounting is concerned with the recording of transactions which are measurable in monetary terms in such a way that analysis and interpretation of business activities is possible. According to the latter definition accounting is concerned with the recording of business transactions for better management of the concern and also reporting the true financial position of the concern.

The American Accounting Association (AAA) defines accounting as "the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of information."

Smith and Ashburne define accounting as "the science of recording and classifying business transactions and events, primarily of a financial character, and the art of making significant summaries, analysis and interpretations of those transactions and events and communicating the results to persons who must make decisions or form judgements." Thus this definition emphasises financial reporting and decision-making aspects of accounting.

From the above definitions it is clear that accounting is a science of recording transactions of economic nature in a systematic manner and also an art of analysing and interpreting the same.

Attributes of Accounting

Following are the attributes of accounting:

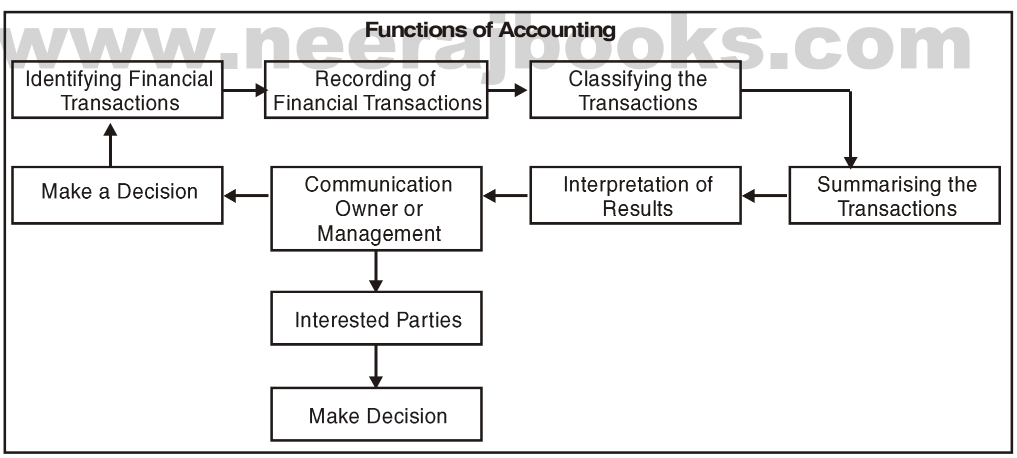
(a) The input of accounting comprises the business transactions which can be measured in terms of money.

(b) Accounting is the process of recording, classifying and summarising the business transactions.

(c) Accounting consists of interpreting the results.

(d) Accounting conveys economic information to various groups interested in them.

Functions of Accounting: Functions of accounting may be shown as under:



OBJECTIVES OF ACCOUNTING

Following are the objectives of accounting:

1. To keep systematic records: The primary objective of accounting is to maintain a systematic record of business transactions. There is a limit to human memory and, therefore, a systematic record of all transactions is essential for every business.

2. To calculate income: Another objective of accounting is to ascertain profit or loss earned by the business during an accounting year. This is done by preparing Profit and Loss Account or Income Statement.

3. To ascertain financial position: Every businessman desires to know about his financial position i.e. where he stands, what he owns and what he owes. This is served by the Balance Sheet. Balance Sheet is a statement of assets, liabilities and capital on a particular date.

4. To communicate the information: The last but not the least objective of the accounting is to communicate the various informations and facts to various interested groups viz. owners, creditors, employees, investors, taxation authorities etc. Accounting facilitates rational decision-making by providing relevant data.

Parties Interested in Accounting Information

Following are the groups of people interested in accounting information:

(1) Owners: Owners are the persons who provide funds to the business and share the risks. Owners need accounting information to know the profitability and financial soundness of the business to make proper decisions.

(2) Management: Management is answerable to the owners. The responsibility of the management is to operate the business efficiently. Management needs accounting information for decision-making.

(3) Employees: Employees need accounting information to claim increase in wages, bonus and other benefits.

(4) Investors: Investors are the persons who want to invest their money in the business. They need accounting information to know the safety of their investments and future prospects of the business.

(5) Creditors: Creditors are the persons who have advanced some money or goods to the business. They need accounting information to know the capacity of the business to pay their claims in time.

(6) Government: Government needs accounting information to collect the various taxes like sales tax, income tax, excise duty etc.

(7) Research Scholars: Research scholars need accounting information to study the financial operations of a particular firm or company.

(8) Consumers: Consumers need accounting information to create public opinion against those business firms who exploit the consumers.

ACCOUNTING AS PART OF THE INFORMATION SYSTEM

Accounting is an integral part of the information system. As a part of information system accounting is the process of communicating the economic events of the organisation to interested users of the information. According to Myvon I. Gordon Shillinglaw, "Accounting has come to be recognised as a tool for mastering the various economic problems which a business organisation may have to face. It systematically writes the economic history of the organisation. It provides information that can be drawn upon by those responsible for decisions affecting the organisation's future." Accounting is an effective means of communication of financial information to various groups. Financial statements have been designed to suit the information needs of various groups.

Uses of Accounting Information

Following are three general uses of accounting information:

(1) Managerial Decision-making: Decision-making is the primary work of management. Accounting information helps the management to arrive at right conclusions. Accounting provides necessary information for decisions regarding price of the product, make or buy, to expand its operations etc.

(2) Managerial Planning, Control and Performance Evaluation: Managerial planning requires direction of standards. Accounting information help the management in establishing the standard. Accounting also provides actual results to compare with standards to measure the variations in the actual performance. Accounting provides information necessary for performance evaluation of a department, product or unit.

(3) External Financial Reporting: Accounting supplies necessary information to those who are interested in the affairs of the company. There are a number of laws which make it compulsory for an enterprise to prepare financial statements in such a manner that various interested groups get "true and fair" view of the affairs of the enterprise.

BRANCHES OF ACCOUNTING

In order of satisfy information needs of different people, different branches of accounting have developed. Each and every branch of accounting is generally confined to its own area of operation. Following are the branches of accounting:

(i) Financial Accounting

(ii) Cost Accounting

(iii) Management Accounting

***(i)* Financial Accounting:** Financial Accounting is the original form of accounting. Kohler in *Dictionary for Accounting* has defined financial accounting as the accounting for revenues, expenses, assets and liabilities that is commonly carried on in the general office of a business. Financial accounting is mainly concerned with recording, classifying and summarising financial transactions with a view to prepare financial statements. The main task of financial accounting is to prepare Income Statement i.e. Profit and Loss Account and the Statement of Financial Position i.e., Balance Sheet. These financial statements not only provide overall operational results of the business but also furnish valuable information to the outsiders such as shareholders, creditors, tax authorities etc. The main objective of financial accounting is to ascertain profit earned during a year and financial position at the end of the year.

Functions of Financial Accounting

Following are the functions of Financial Accounting:

(1) Recording of Information: Accounting is an art of recording financial facts of a concern. It is not possible to remember each and every transaction of the business. Accounting is necessary to supplement human memory. The information is recorded in Journal and other subsidiary books. The subsidiary books to be used may be Purchase Book, Sales Book, Return Outward Book, Journal Proper, Cash Book etc. These books are used to record various transactions in such a way that the information is properly classified and analysed so that management may take use of that information.

(2) Managerial Decision-making: Financial accounting involves preparation of financial statements e.g. Profit and Loss Account and Balance Sheet. Financial statements provide a lot of information to management for decision-making. Management evaluates the performance of the various departments and products with the help of financial accounting.

(3) Interpreting Financial Information: Information provided by financial accounting is modified in such a way that it is easily interpreted by the various groups of persons for drawing conclusions. The outsiders such as creditors, investors, bankers, shareholders are able to form an opinion about the profitability and overall financial position of the business.

(4) Communicating Results: Financial Accounting is not only concerned with the recording of facts and figures but it is also connected with the communication of results. The profitability and financial position of the business are communicated through Profit and Loss Account and Balance Sheet. The persons interested in knowing the results of the business can make their own conclusions from financial statements. The information is supplied at regular intervals.

Limitations of Financial Accounting

Following are the important limitations of financial accounting:

1. Quantitative Information: Financial accounting records only that information which can be quantitatively measured i.e. which can be measured in terms of money. Events, which cannot be measured in terms of money, will not find a place in the accounts even though it is important for the business. For example, policies of the government have a direct effect on the working of the business but financial accounts will not record its impact because it cannot be measured in terms of money.

2. Historical in Nature: Financial accounting is historical in the nature in the sense that accounting data are summarised only at the end of accounting period. Financial statements throw light on what has happened during a particular period. The impact of future uncertainties i.e. what will happen has no place in financial accounting. It does not suggest what should be done to increase the efficiency of the enterprise.

3. Recording of Actual Costs: Only actual cost figures relating to purchase of materials, property or other assets is recorded in the account books. The prices of goods and assets change from time to time. Accountants ignore the changes in the values of assets may be absolutely different from the recorded values. Recorded values do not provide correct information about the assets.

4. Conflict between Accounting Principles: There is a conflict between different accounting principles. For example, principles of prudence (conservatism) require that stock should be valued on the basis of cost or market price whichever is less. This principle is in conflict with principle of consistency which requires that either cost or market price basis should be consistently followed.

5. Personal Judgement: Financial statements are influenced by the personal judgement of the accountant.