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# A study on Components and Importance of an Accounting

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**1. Introduction**

Even if you're new to accounting, you may have noticed some use of accounting in your daily life. My mom for example is the chief accountant of our family. At the start of each month, she prepares a budget that lists all expected payments and income for the month. She then records all payments and receipts in her personal diary such as groceries, utilities, taxes and so on. Tracking home expenses against the monthly budget helps her avoid overspending and also gives her peace of mind knowing where the money was spent in case she forgets. She keeps all the invoices and bank statements in a shoe box. Once every year my Mom files her taxes and this is where all her hard work in maintaining the financial record pays off as she has all the required information on her finger tips (and a shoe box). Even though my mom doesn't know, she is performing basic functions of an accountant to manage the home finances.

Accounting is just a more formal and efficient version of such processes in the context of a business. Businesses use accounting to keep their financial information organized which helps them in making sense of their financial data and also keeps them compliant of financial regulations.

**2. What is accounting?**

Accounting is the process of recording and summarizing financial information in a useful way.

**3. Components of Accounting**

Accounting consists of 2 parts:

**1. Book-keeping**

**2. Analysis**

Book-keeping, which is also known as financial accounting, is the process of recording and summarizing financial information. Book-keeping involves the recording of transactions (e.g. sales, purchases, and expenses) which are then summarized and presented in the form of financial statements which show the overall health of the business.

- Book-keeping helps to organize the financial data which facilitates the effective management of the business by providing key information such as:
- How much they owe to suppliers, tax authorities, banks, employees and others?
- How much each customer owes the business?
- How much capital is invested by the owners in the business?
- How profitable is the business?

Bookkeeping is the backbone of an accounting system and forms the basis of analysis in management accounting.

- Management accounting, also known as managerial accounting, provides information to management for analysis, decision making, planning and control of the business. For example, information relating to investment decisions, budgeting and performance measurement.

## 4. Importance of Accounting

### *4.1 Record*

Organizations need to have a reliable and systematic way of recording financial information. Accounting is necessary to ensure that those running the business have a reliable record of financial transactions.

### *4.2 Legal*

Accounting helps organizations to determine their financial rights and obligations. Without proper accounting, it would be very difficult for a business to calculate, for example, the exact amount a supplier needs to be paid taking into account cost of purchase, discounts, sales tax, withholding tax, duties, refunds, etc.. Accounting is therefore necessary for a business to fulfill its legal obligations and asserting its own legal rights. Maintaining accounting records and preparing financial statements is also often a legal responsibility for businesses above a certain size.

### *4.3 Performance*

Accounting information is summarized to produce financial statements. Financial Statements provide an overview of the financial activities of a business during a period (e.g. cash flow, income and expenses during the year) as well as information about its financial position on a specific date (e.g. amount of cash and inventory at the end of the year). Financial Statements help owners in assessing the performance and position of their business which can guide their investment decisions (e.g. whether they should invest more in the business, diversify or dispose their investment).

### *4.4 Planning and Control*

Accounting helps organizations to plan their finances by developing budgets and forecasts. Variance analysis provides a mechanism for the monitoring of expenses incurred by organizations by comparison with the budgeted expenditure. This process helps organizations in planning their finances ahead and controlling any deviations from the budget.

### *4.5 Decisions*

Accounting provides a basis for managerial decisions. Examples of such decisions include:

- Investment Appraisal
- Make or Buy decisions
- Pricing Decisions
- Limiting factors analysis

### *4.6 Summary*

Accounting is a reliable process for recording, organizing and analyzing financial information which helps in the effective management of the business.

## 5. Objectives of Accounting

Accounting systems help organizations in achieving their objectives by providing a reliable framework that is able to consistently produce accurate financial information.
Key objectives of accounting are summarized below.

1. **Recording**

   The fundamental role of accounting is to maintain a systematic, complete, accurate and permanent record of all transactions of a business which could be retrieved and reviewed whenever necessary. A reliable financial record is the backbone of any accounting system without which all other objectives of accounting will be compromised.

2. **Planning**

   Organizations need to plan how they intend to allocate their limited resources (e.g. cash, labor, materials, machinery and equipment) towards competing needs in the future. An effective way of doing so is by using various forms of budgets.

Budgeting is a major component of managerial accounting. Budgets enable organizations to plan ahead by anticipating business needs and resources. Budgeting helps in the coordination of different segments of an organization.

**3. Decision**

Accounting helps managers in making a range of business decisions and developing policies to make the organizational processes more efficient. Examples of management decisions that are based on accounting information include:

- How much price should be charged for products and services to achieve maximum profit;
- Which products should be produced in case of shortage of resources such as cash, labor or material in order to maximize profit;
- Whether a business needs to acquire financing;
- Whether an business should invest in a business opportunity;
- Whether a business should discontinue a product that is under-performing;
- Whether a business should offer credit to a certain customer.

**4. Performance**

Accountancy helps in determining how well a business is performing by summarizing the financial information into quantifiable measures (e.g. sales revenue, profit, expenses, etc.).It is important for organizations to have a reliable source of measuring their key performance indicators so they could improve by comparing themselves against their past performance as well as against competitors.

**5. Position**

Financial statements show the financial position of a business. Financial position reflects the financial condition of a business at that time and shows for example:

- How much capital has been invested in the business
- How have the funds been utilized in the business
- The cumulative profit or loss of the business
- How much the business owes to others (i.e. liabilities)
- The amount of cash, inventory, machinery and other assets owned by the business

**6. Liquidity**

Mismanagement of cash is often the reason for failure in many businesses. Accounting helps businesses in determining how much cash and other liquid resources are at its disposal to pay for its financial commitments. This information is necessary for working capital management and helps organizations to reduce the risk of bankruptcy through the timely detection of financial bottlenecks.

**7. Financing**

Accounting information is necessary in securing finance. Whether an organization applies for a bank loan or an investment by shareholders, it will be required to provide historic financial record (e.g. profit or loss for past five years) as well as financial projections (e.g. forecast sales for the next 3 years). In many cases, such information will be required by the financiers to be verified by external accounting experts known as auditors.

**8. Control**

One of the key objectives of an accounting system is to place sufficient internal controls within an organization for the safeguarding of its valuable resources. Assets of a business (e.g. cash, buildings, inventory, etc.) are susceptible to losses arising from theft, fraud, error, obsolescence, damage and mismanagement. Accounting ensures that such risks are reduced to an acceptable level by placing various checks across the organization. For example, accounting policy of an organization may require payments above a certain threshold to be approved by a senior member of management to ensure the accuracy and minimize the risk of fraudulent payment.

**9. Accountability**

Accounting provides a basis for performance assessment of a business over a period of time which promotes accountability across several tiers of an organization. Shareholders can ultimately hold the directors responsible for the overall performance of their company on the basis of accounting information published in the financial statements.

**10. Legal**

Accounting is a legal requirement for most businesses. Law requires businesses to maintain an accurate financial record of their transactions and to report their financial results to shareholders, tax authorities and regulators. Accounting also helps organizations to determine their financial rights and obligations accurately by recording the correct amounts of payables, receivables, payments, and receipts.

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