CBSE

CLASS-11th

THE CENTRAL BOARD OF SECONDARY EDUCATION

Accountancy - I

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Accountancy - I

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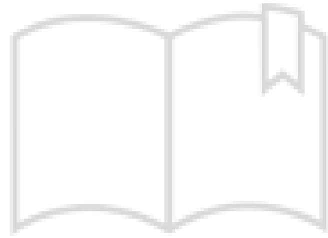
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Ch-1 Introduction to Accounting

Contents

- Meaning and need of Accounting
- Accounting as a source of information
- Internal and external users of Accounting information
- Objectives of Accounting
- Role of Accounting
- Basic terms used in Accounting

Meaning and need of Accounting

Accounting is the process of identifying, measuring, recording and communicating economic information or events of an organisation to permit informed judgements and decisions by interested users of information.

- **Economic information or events-** An economic event is known as a happening of consequence to a business organisation which consists of transactions and which are measurable in monetary terms. Accounting identifies a bunch of transactions relating to an economic event. If an event involves transactions between an outsider and an organisation, these are known as **external events.**

An **internal event** is an economic event that occurs entirely between the internal wings of an enterprise.

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1. **Identifying:** It means determining which transactions to record i.e. to identify events which are to be recorded.
2. **Measurement**: It means quantification of business transactions into financial terms by using monetary units.
3. **Recording**: It means summarising transactions in monetary terms and in a chronological order.
4. **Communicating**: The information identified, measured and recorded is communicated to the management and other users. These reports provide information that are useful to a variety of users who have an interest in assessing the

financial performance and the position of an enterprise, planning and controlling business activities and making necessary decisions from time to time.

- **Organisation:** Organisation refers to a business enterprise, whether for profit or not-for-profit motive.

Interested users: Many users need financial information in order to make important decisions. These users can be divided into two broad categories: internal users and external users.

1. Internal users: All users who work for the organisation and mainly need the information for decision making.
2. External users: It includes- present and potential Investors (shareholders), Creditors (Banks and other Financial Institutions, Debenture-holders and other Lenders), Tax Authorities, Regulatory Agencies (Department of Company Affairs, Registrar of Companies, Securities Exchange Board of India, Labour Unions, Trade Associations, Stock Exchange and Customers, etc.

Accounting as a source of information

To be useful, the accounting information should ensure to:

- provide information for making economic decisions;
- serve the users who rely on financial statements as their principal source of information;
- provide information useful for predicting and evaluating the amount, timing and uncertainty of potential cash-flows;
- provide information for judging management's ability to utilise resources effectively in meeting goals
- provide factual and interpretative information by disclosing underlying assumptions on matters subject to interpretation, evaluation, prediction, or estimation
- provide information on activities affecting the society.

1. **Financial Accounting** assists in keeping a systematic record of financial transactions and the preparation and presentation of financial reports in order to arrive at a measure of organisational success and financial soundness. It relates to the **past period**, serves the stewardship function and is monetary in nature.
2. **Cost Accounting** assists in analysing the expenditure for ascertaining the cost of various products manufactured or services rendered by the firm and fixation of prices thereof. It also helps in controlling the costs and providing necessary costing information to management for decision-making.
3. **Management Accounting** deals with the provision of necessary accounting information to people within the organisation to enable them in decision-making, planning and controlling business operations. It generates other information (quantitative and qualitative, financial and non-financial) which relates to the future and is relevant for decision-making in the organisation.

Some qualitative characteristics of accounting information are-

1. Reliability
2. Relevance
3. Understand ability
4. Comparability

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<u>**Objectives of Accounting**</u>

- **Maintenance of records of transactions**- Accounting is used for the maintenance of a systematic record of all financial transactions in book of accounts.
- **Calculation of Profit and Loss**- Another objective of accounting is to ascertain the profit earned or loss sustained by a business during an accounting period which can be easily worked out with help of **record of incomes and expenses** relating to the business by preparing a **profit or loss account** for the period.
- **Depiction of Financial Position-** Accounting also aims at ascertaining the financial position of the business concern in the form of its **assets and liabilities (Balance sheet)** at the end of every accounting period.
- **Providing Accounting information to its users-** The accounting information generated by the accounting process is communicated in the form of reports, statements, graphs and charts to the users who need it in different decision situations.

Role of accounting

- As a language – it is perceived as the language of business which is used to communicate information
- As a historical record- it is viewed as chronological record of financial transactions of an organisation at actual amounts involved
- As current economic reality- it is viewed as the means of determining the true income of an entity namely the change of wealth over time
- As an information system – it is viewed as a process that links an information source (the accountant) to a set of receivers (external users) by means of a channel of communication
- As a commodity- specialised information is viewed as a service which is in demand in society, with accountants being willing to and capable of providing it.

Basic Accounting terms

1. **Entity-** Entity means a reality that has a definite individual existence. Business entity means a specifically identifiable business enterprise.
2. **Transaction-** An event involving some value between two or more entities. It can be a purchase of goods, receipt of money, payment to a creditor, incurring expenses, etc. It can be a cash transaction or a credit transaction.
3. **Assets** are economic resources of an enterprise that can be usefully expressed in monetary terms. Assets are items of value used by the business in its operations.
4. **Liabilities-** Liabilities are obligations or debts that an enterprise has to pay at some time in the future. They represent creditors' claims on the firm's assets.
5. **Capital-** Amount invested by the owner in the firm is known as capital. It may be brought in the form of cash or assets by the owner for the business entity capital is an obligation and a claim on the assets of the business. It is, therefore, shown as capital on the liabilities side of the balance sheet.
6. **Sales-** Sales are total revenues from goods or services sold or provided to customers. Sales may be cash sales or credit sales.
7. **Revenue-** These are the amounts of the business earned by selling its products or providing services to customers, called sales revenue. Other items of revenue common to many businesses are: commission, interest, dividends, royalty, rent received, etc. Revenue is also called income.

8. **Expenses-** Costs incurred by a business in the process of earning revenue are known as expenses. Generally, expenses are measured by the cost of assets consumed or services used during an accounting period. The usual items of expenses are: depreciation, rent, wages, salaries, interest, cost of heater, light and water, telephone, etc.

9. **Expenditure-** Spending money or incurring a liability for some benefit, service or property received is called expenditure. Purchase of goods, purchase of machinery, purchase of furniture, etc. are examples of expenditure**. If the benefit of expenditure is exhausted within a year, it is treated as an expense** (also called revenue expenditure). On the other hand, the **benefit of an expenditure lasts for more than a year, it is treated as an asset** (also called capital expenditure) such as purchase of machinery, furniture, etc.

10. **Profit-** The excess of revenues of a period over its related expenses during an accounting year is profit. Profit increases the investment of the owners.

11. **Gain-** A profit that arises from events or transactions which are incidental to business such as sale of fixed assets, winning a court case, appreciation in the value of an asset.

12. **Loss-** The excess of expenses of a period over its related revenues its termed as loss. It decreases in owner's equity. It also refers to money or money's worth lost (or cost incurred) without receiving any benefit in return, e.g., cash or goods lost by theft or a fire accident, etc. It also includes loss on sale of fixed assets.

13. **Discount-** Discount is the deduction in the price of the goods sold. It is offered in two ways. Offering deduction of agreed percentage of list price at the time selling goods is one way of giving discount. Such a discount is called **'trade discount'**. It is generally offered by manufacturers to wholesalers and by wholesalers to retailers. After selling the goods on credit basis the debtors may be given certain deductions in amount due in case they pay the amount within the stipulated period or earlier. This deduction is given at the time of payment on the amount payable. Hence, it is called cash **discount.** Cash discount acts as an incentive that encourages prompt payment by the debtors.

14. **Vouchers-** The documentary evidence in support of a transaction is known as voucher. For example, if we buy goods for cash, we get a cash memo.

15. **Goods-** It refers to the products in which the business unit is dealing, i.e. in terms of which it is buying and selling or producing and selling. The items that are purchased for use in the business are not called goods.

16. **Drawings-** Withdrawal of money and/or goods by the owner from the business for personal use is known as drawings. Drawings reduce the investment of the owners.

17. **Purchases-** Purchases are the total amount of goods procured by a business on credit and on cash, for use or sale.

18. **Stock-** Stock (inventory) is a measure of something on hand-goods, spares and other items in a business. It is called Stock in hand.

19. **Debtors-** Debtors are persons and/or other entities who owe to an enterprise an amount for buying goods and services on credit. The total amount standing against such persons and/or entities on the closing date, is shown in the **balance sheet as sundry debtors on the asset side.**

20. **Creditors-** Creditors are persons and/or other entities who have to be paid by an enterprise an amount for providing the enterprise goods and services on credit. The total amount standing to the favour of such persons and/or entities on the closing date, is shown **in the Balance Sheet as sundry creditors on the liabilities side.**

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POINTS TO REMEMBER

- Accounting is the process of identifying, measuring, recording and communicating relevant accounting information with its users.
- There are two types of users of this information – internal and external. Internal users are the employees and management of the organisation. External users includers outsiders like investors, government, public, debtors, creditors etc.
- Objectives of accounting includes- Maintain record of transactions, calculate profit or loss (P&L account), depict financial position (Balance sheet) and communicate information with its users.
- Three main types of accounting- Cost accounting, Management Accounting and Financial Accounting.
- Financial accounting works with past data whereas management accounting focuses on the future.
- Cost accounting is used to calculate costs of the organisation and to fix prices of the good accordingly.

- Expenditure that lasts up to one year is an expense or revenue expenditure whereas expenditure that last more than one year is called capital expenditure.
- Profit is excess of revenue over expenses and gain is incidental profit from non-operating activities of the organisation.
- Two types of discount- cash and trade discount. Trade discount is offered on goods at the time of sale whereas cash discount is offered on credit sales to promote early payment of the amount owed.

Questions

Q1. What are the 3 advantages of accounting? (1 mark)

Answer:

- Helpful in business
- Helpful in decision making
- Helpful in controlling

Q2. What is the traditional function of accounting? (1 mark)

Answer: Recording of financial transactions.

Q3. Enumerate informational needs of management. (1 mark)

Answer:

1. Assists in decision making and business planning
2. Preparing reports related to funds, costs and profits to ascertain the soundness of the business

Q4. Differentiate between Profit and Gain. (1 mark)

- **Gain–** Gain is incidental to the business. They arise from irregular activities or non-recurring transactions; for example, profit on sale of fixed assets, appreciation in value of asset, profit on sale of investment, etc.
- **Profit–** This refers to the excess of revenue over the expense. It is normally categorised into gross profit or net profit. Net profit is added to the capital of the owner, which increases the owner's capital. For example, goods sold above its cost.

Q5. 'Accounting information should be comparable'. Do you agree with this statement? Give reason. (1 mark)

Answer:

Comparable accounting information helps in inter-firm comparisons. This helps in assessing viability and advantages of various policies adopted by different firms. It also

helps in intra-firm comparisons that help in determining the changes and also to ascertain the results of various policies and plans adopted in different time periods.

Q6. Giving examples, explain each of the following accounting terms: (1 mark each)

- Fixed assets
- Revenue
- Expenses
- Short-term liability
- Capital

Answer:

- **Fixed assets–** These are held for long term and increase the profit earning capacity of the business, over various accounting periods. These assets are **not** meant for sale; for example, land, building, machinery, etc.
- **Revenue–** It refers to the amount received from day to day activities of business, *viz.* Amount received from sales of goods and services to customers; rent received, commission received, dividend, royalty, interest received, etc. Are items of revenue that are added to the capital.
- **Capital–** It refers to the amount invested by the owner of a firm. It may be in the form of cash or assets. It is an obligation of the business towards the owner of the firm, since business is treated separate or distinct from the owner.

Capital = Assets − Liabilities.

- **Expenses–** Expenses are those costs that are incurred to maintain the profitability of business, like rent, wages, depreciation, interest, salaries, etc. These help in the production, business operations and generating revenues.
- **Short term liabilities–** Those liabilities that are incurred with an intention to be paid or are payable within a year; for example, bank overdraft creditors, bills payable, outstanding wages, short-term loans, etc.

Q7. Describe the informational needs of external users. (3-4 marks)

Answer:

1. **Banks and other financial institutions–** Banks provide finance in form of loans and advances to various businesses. Thus, they need information regarding liquidity, creditworthiness, solvency and profitability to advance loans.

2. **Creditors–** These are those individuals and organisations to whom a business owes money on account of credit purchases of goods and receiving services; hence, the creditors require information about credit worthiness of the business.

3. **Investors and potential investors–** They invest or plan to invest in the business. Hence, in order to assess the viability and prospectus of their investment, creditors need information about profitability and solvency of the business.

4. **Tax authorities–** They need information about sales, revenues, profit and taxable income in order to determine the levy of various types of tax on the business.

5. **Government–** It needs information to determine national income, GDP, industrial growth, etc. The accounting information assists the government in the formulation of various policies measures and to address various economic problems like employment, poverty etc.

6. **Researcher -- Various** research institutes like NGOs and other independent research institutions like CRISIL, stock exchanges, etc. Undertake various research projects and the accounting information facilitates their research work.

7. **Consumer–** Every business tries to build up reputation in the eyes of consumers, which can be created by the supply of products of better quality and post-sale services at reasonable and affordable prices. Business that has transparent financial records, assists the customers to know the correct cost of production and accordingly assess the degree of reasonability of the price charged by the business for its products and thus helps in repo building of the business.

8. **Public–** Public is keenly interested to know the proportion of the profit that the business spends on various public welfare schemes; for example, charitable hospitals,

funding schools, etc. This information is also revealed by the profit and loss account and balance sheet of the business.

Q8. Explain the qualitative characteristics of accounting information. (3-4 marks)

Answer:

1. **Reliability–** It means that the user can rely on the accounting information. All accounting information is verifiable and can be verified from the source document (voucher), *viz.* Cash memos, bills, etc. Hence, the available information should be free from any errors and unbiased.

2. **Relevance–** It means that essential and appropriate information should be easily and timely available and any irrelevant information should be avoided. The users of accounting information need relevant information for decision making, planning and predicting the future conditions.

3. **Understand ability–** Accounting information should be presented in such a way that every user is able to interpret the information without any difficulty in a meaningful and appropriate manner.

4. **Comparability–** It is the most important quality of accounting information. Comparability means accounting information of a current year can be comparable with that of the previous years. Comparability enables intra-firm and inter-firm comparison. This assists in assessing the outcomes of various policies and programmes adopted in different time horizons by the same or different businesses. Further, it helps to ascertain the growth and progress of the business over time and in comparison to other businesses.

Q9. What do you mean by an asset and what are different types of assets? (4-5 marks)

Answer:

Any valuable thing that has monetary value, which is owned by a business, is its asset. In other words, assets are the monetary values of the properties or the legal rights that are owned by the business organisations.

- **Fixed Assets–** These are assets that are held for the long term and increase the profit earning capacity and productive capacity of the business. These assets are **not** meant for sale, for example, land, building machinery, etc.
- **Current Assets–** Assets that can be easily converted into cash or cash equivalents are termed as current assets. These are required to run day to day business activities; for example, cash, debtors, stock, etc.
- **Tangible Assets–** Assets that have physical existence, i.e., which can be seen and touched, are tangible assets; for example, car, furniture, building, etc.
- **Intangible Assets–** Assets that **cannot** be seen or touched, i.e. those assets that do **not** have physical existence, are intangible assets; for example, goodwill, patents, trade mark, etc.
- **Liquid Assets–** Assets that are kept either in cash or cash equivalents are regarded as liquid assets. These can be converted into cash in a very short period of time; for example, cash, bank, bills receivable, etc.
- **Fictitious Assets–** These are the heavy revenue expenditure; the benefit of whose can be derived in more than one year. They represent loss or expense that are written off over a period of time, for example, if advertisement expenditure is Rs 1,00,000 for 5 years, then each year Rs 2,00,000 will be written off.

Chapter 2: Theory Base of Accounting

Contents-

- Need for theory base accounting
- Generally accepted Accounting Principles
- Systems of Accounting
- Basis of Accounting
- Concept of Accounting standards
- Objectives of accounting standards

❖ **Need for theory base of accounting**

1. The theory base of accounting consists of principles, concepts, rules and guidelines developed over a period of time **to bring uniformity and consistency** to the process of accounting **and enhance its utility to different users** of accounting information.
2. Apart from these, the **Institute of Chartered Accountants of India, (ICAI),** which is **the regulatory body for standardisation of accounting policies** in the country has issued Accounting Standards which are expected to be uniformly adhered to, in order to bring consistency in the accounting practices.

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❖ **Generally Accepted Accounting Principles**

1. Generally Accepted Accounting Principles (GAAP) refers to the rules or guidelines adopted for recording and reporting of business transactions, in order to bring uniformity in the preparation and the presentation of financial statements. These are constantly influenced by changes in the legal, social and economic environment as well as the needs of the users. Hence, they have evolved over a long period of time.

2. These Principles are referred to as ‘Basic Accounting Concepts’ in this chapter and are listed below:
    - Business entity
    - Money measurement
    - Going concern
    - Accounting Period
    - Cost
    - Dual aspect

- Revenue Recognition
- Matching
- Full disclosure
- Consistency
- Conservatism (Prudence)
- Materiality
- Objectivity

- **Business entity concept**: This concept assumes that the **organisation/business has a separate entity from its owners.** Therefore, in accounting, the business and its owners are treated as two separate entities. So, if the owner brings in some amount as capital into the business, it is treated as a liability of the business towards the owner because the business, having a separate identity, owes that amount to the owner.
  Important points to remember:
  1. Accounting records are made from the point of view of the business, not the owner.
  2. Personal assets and liabilities of the owner are not considered while recording the assets and liabilities of the business.
  3. Similarly, personal transactions of the owner are not recorded in the books of accounts of the business unless it involves inflow or outflow of business funds.

- **Money Measurement Concept**: This concept **states that only those transactions which can be expressed in terms of money are to be recorded in the books of accounts.** Therefore, non-monetary transactions or events like hiring a manager, creativity of an employee, capabilities of its human resources are not recorded in the books.
  Moreover, assets and liabilities should be expressed in monetary terms and NOT in terms of physical units. For example, if an organisation owns 30 PCs valued 15 lakhs, the monetary value of the PCs (15 lakhs) is recorded in the books.

- **Going concern concept**: This concept assumes that **a business firm would continue to carry out its operations indefinitely i.e. for a long period of time and would not be liquidated in the foreseeable future.** On the basis of this assumption, only part of an asset owned or purchased which has been consumed or used in that given time period

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is charged for that period from the revenue of the same period. (As it provides a more realistic picture of the revenue earned during that time period.)

- **Accounting Period: Accounting period refers to the span of time at the end of which financial statements of an enterprise are prepared.** The financial statements are prepared at a regular interval, normally after a period of one year, so that timely information is made available to the users. This interval of time is called accounting period.

- **Cost concept**: **According to this concept, all assets recorded in the books should be recorded at their purchase price which should include cost of acquisition, transportation, instalment and all costs incurred to make the asset ready for use.** The concept of cost is historical in nature as it is something, which has been paid on the date of acquisition and does not change year after year.
  Limitation of this concept: It does not show the true worth of the business and may lead to hidden profits.

- **Dual aspect concept:** This concept is the ***basic principle of account ting.*** **It states that every concept has dual or two-fold effect and therefore, should be recorded at two places.** Hence, at least two accounts will be involved in one transaction. It can be expressed in by this accounting equation:
  Assets= Liabilities + Capital
  For example, suppose one of the owners brings in Rs. 50,000 as capital, it would result in an increase in the Cash/Bank balance of the organisation (which is an asset) and equal increase in the capital of the organisation.
  Another example: Suppose the organisation wants to pay Rs. 30,000 to its creditors, it would result in decrease in the Creditors (Liabilities) and equal decrease in the cash/bank balance of the organisation (asset).

- **Revenue Recognition concept**: The concept of revenue recognition **requires that the revenue for a business transaction should be included in the accounting records only when it is realised.** Revenue is assumed to be realised when a legal right to receive it arises, i.e. the point of time when goods have been sold or service has been rendered.