Chapter 1 Theoretical Framework

❖ Introduction to Accounting

❖ Theory Base of Accounting

CBSE Syllabus 2020-21

Introduction to Accounting

- Accounting- concept, objectives, advantages and limitations, types of accounting information; users of accounting information and their needs. Qualitative Characteristics of Accounting Information. Role of Accounting in Business.
- Basic Accounting Terms- Business Transaction, Capital, Drawings. Liabilities (Non Current and Current). Assets (Non Current, Current); Fixed assets (Tangible and Intangible), Expenditure (Capital and Revenue), Expense, Income, Profit, Gain, Loss, Purchase, Sales, Goods, Stock, Debtor, Creditor, Voucher, Discount (Trade discount and Cash Discount)

Theory Base of Accounting

- Fundamental accounting assumptions: GAAP – Concept
- Business Entity, Money Measurement, Going Concern, Accounting Period, Cost Concept, Dual Aspect, Revenue Recognition, Matching, Full Disclosure, Consistency, Conservatism, Materiality and Objectivity
- Systems of Accounting. Basis of Accounting: cash basis and accrual basis
- Accounting Standards: Applicability in IndAS
- Goods and Services Tax (GST): Characteristics and Objectives

Learning Outcomes

After going through this chapter, the students will be able to:

- describe the meaning, significance, objectives, advantages and limitations of accounting in the modem economic environment with varied types of business and non-business economic entities.
- identify / recognise the individual(s) and entities that use accounting information for serving their needs of decision making.
- explain the various terms used in accounting and differentiate between different related terms like current and non-current, capital and revenue.
- give examples of terms like business transaction, liabilities, assets, expenditure and purchases.
- explain that sales/purchases include both cash and credit sales/purchases relating to the accounting year.
- differentiate among income, profits and gains.
- state the meaning of fundamental accounting assumptions and their relevance in accounting.
- describe the meaning of accounting assumptions and the situation in which an assumption is applied during the accounting process.
- explain the meaning and objectives of accounting standards.
- appreciate that various accounting standards developed nationally and globally are in practice for bringing parity in the accounting treatment of different items.
- acknowledge the fact that recording of accounting transactions follows double entry system.
- explain the bases of recording accounting transaction and to appreciate that accrual basis is a better basis for depicting the correct financial position of an enterprise.
- Understand the need of IFRS
- Explain the meaning, objective and characteristic of GST.

Introduction to Accounting

Over the centuries, accounting has remained confined to the financial record-keeping functions of the accountant. But, today's rapidly changing business environment has forced the accountants to re-assess their roles and functions both within the organisation and the society.

The role of an accountant has now shifted from that of a mere recorder of transactions to that of the member providing relevant information to the decision-making team.

Accounting is concerned with the recording, classifying and summarising of financial transactions and events and interpreting the results thereof.

Accounting aims at providing information about the financial performance of a firm to its various users such as owners, managers employees, investors, creditors, suppliers of goods and services and tax authorities and help them in taking important decisions. The investors, *for example,* may be interested in knowing the extent of profit or loss earned by the firm during an accounting period and compare it with the performance of other similar enterprises. The suppliers of credit, say a banker, may be interested to know whether the firm is able to repay its debts with interest or not. All these people look forward to accounting for appropriate, useful and reliable information.

Broadly speaking, accounting today is much more than just book-keeping.

Book keeping is the record-making phase of accounting and is concerned with recording of financial transactions and events relating to business in a significant manner.

Book keeping should not be confused with accounting. The distinction between the two are as under:

Differences between 'Book Keeping' and 'Accounting'

Book Keeping	Accounting
It is the recording phase of an accounting system.	It is the summarizing phase of an accounting system.
It is a primary stage and basis for accounting.	It is a secondary stage which begins where the book keeping ends.
It is routine in nature and does not require any special skills or knowledge.	It is analytical in nature and require special skills or knowledge.
It is done by junior staff called book-keepers.	It is done by senior staff called accountants.
It does not give the complete picture of the financial position and net result of operations of the business enterprise.	It gives the complete picture of of the financial position and net result of operations of the business enterprise.

Extra Shots

Accountants are now capable of working in exciting new growth areas such as:

- **Forensic accounting** – It involves solving crimes such as computer hacking and the theft of large amounts of money on the internet.
- **E-commerce** – It involves designing web-based payment system.

This realisation came due to the fact that accounting is capable of providing the kind of information that managers and other interested persons need in order to make better decisions. This aspect of accounting gradually assumed so much importance that it has now been raised to the level of an information system. As an information system, Accounting collects data and communicates economic information about the organisation to a wide variety of users whose decisions and actions are related to its performance.

Concept of Accounting

Meaning of Accounting

In 1941, **The American Institute of Certified Public Accountants (AICPA)** had defined accounting as follows: *"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 financial character, and interpreting the results thereof."*

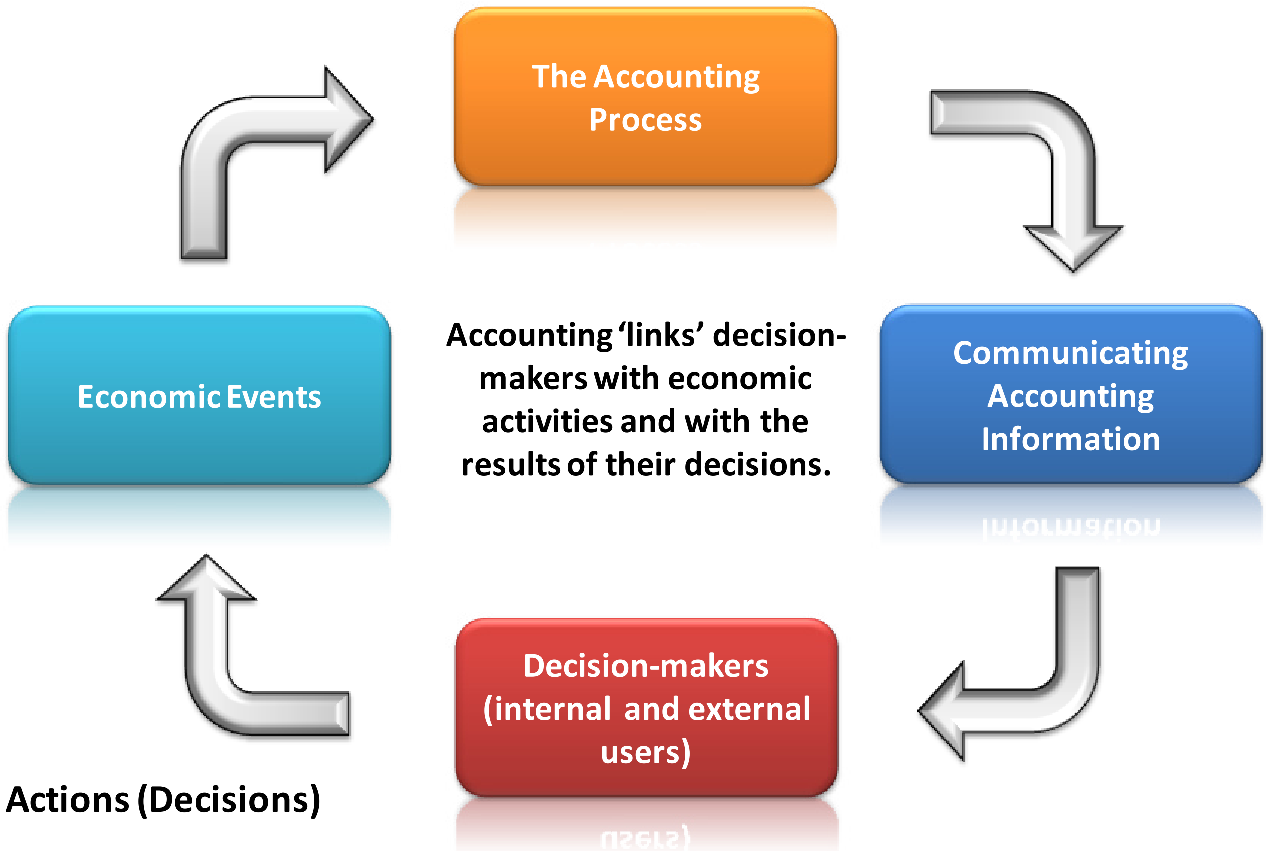
With greater economic development resulting in changing role of accounting, its scope, became broader. In 1966, the **American Accounting Association (AAA)** defined accounting as follows:
"Accounting is the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of information."

In 1970, the **Accounting Principles Board of AICPA** also emphasised that the function of accounting is to provide quantitative information, primarily financial in nature, about economic entities, that is intended to be useful in making economic decisions. Accounting can, therefore, be defined as follows:

Definition of Accounting

- "Accounting is the process of identifying, measuring, recording and communicating the required information relating the economic events of an organisation to the interested users of such information."

— The American Institute of Certified Public Accountants (AICPA)



Process of Accounting

Nature/Features of Accounting

In order to appreciate the exact nature of accounting, we must understand the following relevant aspects of the above definition:

- Economic Events
- Identification, Measurement, Recording and Communication
- Organisation
- Interested Users of Information

1. Economic Events

A business organisation involves economic events — both external and internal events.

External events: If an economic event involves transactions between an outsider and an organisation, these are known as external events.

Examples:

- Sale of goods to the customers
- Rendering services to the customers by ABC Limited
- Purchase of materials from suppliers
- Payment of monthly rent to the landlord

Internal events: An internal event is an economic event that occurs entirely between the internal wings of an enterprise.

Examples:

- Supply of raw material or components by the stores department to the manufacturing department
- Payment of wages and salaries to the employees

Key Term

Economic event: 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.

2. Identification, Measurement, Recording and Communication

- **Identification:** It means determining what transactions to record, i.e., to identity events which are to be recorded. It involves observing activities and selecting those events related to the organisation, which are of financial character, i.e. measurable in terms of money. *For example,* when an enterprise makes a sale or purchase, whether on cash or credit, or pays salary it is recorded in the books of accounts because these are measured in monetary terms.
- **Measurement:** It means quantification of business transactions in monetary terms (e.g. in rupees).

Top Tip

If an event cannot be quantified in monetary terms, it is not considered for recording in financial accounts. That is why important items like the appointment of a new managing director, signing of contracts, the value of human resources or changes in managerial policies are important but none of these are recorded in the books of accounts because these are not measured in monetary terms.

- **Recording:** Once the economic events are identified and measured in monetary terms, these are recorded in books of account in a chronological order.
- **Communication:** The economic events are identified, measured and recorded in order that the accounting information is communicated to management and other internal and external users who are interested in assessing the financial performance and the position of an enterprise, planning and controlling business activities and making necessary decisions from time to time.

The accounting information is regularly communicated through accounting reports, financial statements, graphs and charts. Accounting reports can be daily, weekly, monthly, or quarterly, depending upon the needs of the users.

3. Organisation

Depending upon the size of activities and level of business operation, an organisation can be a sole-proprietory concern, partnership firm, cooperative society, company, local authority, municipal corporation or any other association of persons.

Key Term

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

4. Interested Users of Accounting Information

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

Interested Users of Accounting Information

Internal Users

- Chief Executive Officer (CEO)
- Vice President
- Business Unit Managers
- Plant Managers
- Store Managers
- Line Supervisors

External Users

- Investors (shareholders)
- Customers
- Creditors, Debentureholders
- Tax Authorities
- Regulatory Agencies
- Labour Unions

Key Term

Creditors: Creditors are persons or/and other entities who have to be paid by the business enterprise.
Debenture: 'Debenture' is an instrument acknowledging a debt of the company. A company issues debentures (like shares) to raise long-term funds from the public. The company in return has to pay interest at a fixed rate to the debentureholders.

Top Tip

Accounting is a means to an end

Since the primary function of accounting is to provide useful information for decision-making, it is a means to an end, with the end being the 'decision' that is helped by the availability of accounting information.

Objective Type Questions 1.1

1. Information in financial reports is based on ____________. *(Fill up the blank with appropriate words)*
2. The Internet has assisted in decreasing the ____________ in issuing financial reports to users. *(Fill up the blank with appropriate words)*
3. The process of accounting starts with ____________ and ends with ____________. *(Fill up the blank with appropriate words)*
4. Accounting measures the business transactions in terms of ____________ units. *(Fill up the blank with appropriate words)*
5. Identified and measured economic events should be recording in ___________ order. *(Fill up the blank with appropriate words)*
6. The accounting process involves recording: *(Choose the correct alternative)*
   (a) Quantifiable economic event (b) Non quantifiable economic event
   (c) All of them (d) None of them
7. Identify the correct sequence of accounting process:*(Choose the correct alternative)*
   (a) Communicating → Recording → Identifying (b) Recording → Communicating → Identifying
   (c) Identifying → communicating → recording (d) Identifying → recording → communicating
8. Book keeping mainly concerns with which part of accounting process? *(Choose the correct alternative)*
   (a) Analysing (b) Preparing financial statements
   (c) Recording financial information (d) Auditing the books of accounts
9. For which step of accounting process the accountants of business entity prepare financial statements? *(Choose the correct alternative)*
   (a) Identification of economic event (b) Communication of financial information
   (c) Recording financial information (d) Making decisions about business
10. _________ is the first phase of accounting cycle.*(Choose the correct alternative)*
    (a) Identifying an economic event or transaction (b) Preparing journals
    (c) Posting entries to ledger accounts (d) Making decisions about business
11. The type of accounting involved in solving crimes such as computer hacking and the theft of large amounts of money on the internet is called _____________.*(Fill up the blank with appropriate words)*
12. As an information system, ______________ collects data and communicates economic information about the organisation to a wide variety of users whose decisions and actions are related to its performance. *(Fill up the blank with appropriate words)*
13. ______________ is known as a happening of consequence to a business organisation which consists of transactions and which are measurable in monetary terms. *(Fill up the blank with appropriate words)*
14. Payment of wages/salary to the employees is an example of ______________ of a business organisation.(internal economic event/external economic event) *(Fill up the blank with appropriate words)*
15. Which of the following is an example of an internal economic event of a business organisation? *(Choose the correct alternative)*
    (a) Purchase of materials from suppliers
    (b) Payment of monthly rent to the landlord
    (c) Supply of raw material or components by the stores department to the manufacturing department.
    (d) Sale of merchandise to the customers.
16. _______________ means determining what transactions to record. It involves observing activities and selecting those events that are of financial character and relate to the organisation. *(Choose the correct alternative)*
    (a) Identification (b) Measurement
    (c) Recording (d) Communication
17. Which of the following is recorded in the books of account? *(Choose the correct alternative)*
    (a) Value of human resource (b) Changes in managerial policies
    (c) Appointment of personnel (d) None of the above

18. ____________ means quantification (including estimates) of business transactions into financial terms. *(Choose the correct alternative)*
   (a) Identification (b) Measurement
   (c) Recording (d) Communication
19. The appointment of a new managing director, signing of contracts or changes in personnel are ___________ in the books of accounts because ___________. *(Fill up the blank with appropriate words)*
20. The accounting information is regularly communicated through ____________. *(Fill up the blank with appropriate words)*
21. Accounting reports can be daily, weekly, monthly, or quarterly. *(True/False)*
22. ____________ links decision makers with economic activities and with the results of their decisions. *(Fill up the blank with appropriate words)*
23. _____________ refers to a business enterprises whether for profit or not-for-profit motive. *(Fill up the blank with appropriate words)*
24. _____________ is regarded as the 'language of business because ______________. *(Fill up the blank with appropriate words)*
25. The primary function of accounting is _________________________ *(Complete the sentence)*
26. "Accounting is a means to an end." What does this statement mean?
27. "Accounting is a means to an end." The terms 'means' and 'end' here imply ____________ and __________ respectively.
28. Which of the following is an internal user of financial information? *(Choose the correct alternative)*
   (a) Shareholders (b) Line Supervisors
   (c) Creditors (d) Tax Authorities
29. Which of the following is an external user of accounting information? *(Choose the correct alternative)*
   (a) Chief Executive Officer (CEO) (b) Investors
   (c) Debenture holders (d) Both (b) and (c)
30. Which of the following is not an internal user of accounting information? *(Choose the correct alternative)*
   (a) Chief Financial Officer (b) Store Manager
   (c) Customers (d) Vice President
31. Which of the following is not an external user of accounting information? *(Choose the correct alternative)*
   (a) Tax Authorities (b) Plant Managers
   (c) Bank (d) Labour Unions
32. ______________ is the record-making phase of accounting and is concerned with recording the financial transactions and events relating to business in a significant manner. *(Fill up the blank with appropriate words)*

Basic Accounting Terms

Business Entity

Business entity means a specifically identifiable business enterprise engaged in trading/dealing or manufacturing of goods or services, such as Shree Radhey Publications Pvt. Ltd., ITC Ltd., Jain Jewellers, etc.

Key Term

Entity: Entity means a reality that has a definite individual existence.

Top Tip

An accounting system is always devised for a specific business entity (also called accounting entity).

Business Transaction

An economic event that affects the financial position of the business enterprise and can be measured in terms of money is called a business transaction.

- It involves some value between two or more entities.
- A business transaction can be a cash transaction or a credit transaction.

Examples:

- Purchase of goods
- Payment to a creditor
- Receipt of money by sale of goods
- Payment of salaries to employees.

Voucher

The documentary evidence in support of a business transaction is known as voucher, e.g. Cash Memo, Invoice, Receipt, etc.

- If we buy goods for cash, we get **Cash Memo**.
- If we buy on credit, we get an **Invoice**.
- When we make a payment we get a **Receipt**.

Goods (or Merchandise)

Goods refer to the products in which the business enterprise is dealing, i.e. in terms of which it is buying and selling.

For example, for a furniture dealer purchase of chairs and tables is termed as goods, while for other it is furniture. Similarly, for a stationery merchant, stationery is goods, whereas for others it is an item of expense.

Top Tip

The items that are purchased for use in the business operations and not for sale are not called goods. *For example*, for a pen manufacturing firm, machinery is not treated as goods as it is used in the business operations for producing pens.

Stock (or Inventory)

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

In case of a trading concern:

The amount of goods which are lying unsold as at the end of an accounting period is called **closing stock** (or closing inventory).

Similarly, **opening stock** (or opening inventory) is the amount of stock at the beginning of the accounting period.

In case of a manufacturing concern:

Closing stock consists of the following:

- Stock of raw materials,
- Stock of semi-finished goods (also called 'Work in Progress'), and
- Stock of finished goods.

Top Tip

- If closing stock is more than opening stock, it is called 'increase in stock' during an accounting period.
  Increase in stock = Closing stock – Opening stock
- If closing stock is less than opening stock, it is called 'decrease in stock' during an accounting period.
  Decrease in stock = Opening stock – Closing stock

Purchases

Purchases are total amount of goods procured by a business on credit and on cash, for resale or further processing into finished goods and then sold.

- *In a trading concern*, purchases are made of goods (or merchandise) for resale.
- *In a manufacturing concern*, raw materials are purchased, processed further into finished goods and then sold.

Top Tips

Purchase Return (Return Outward) and Net Purchases

- When purchase goods are returned to the suppliers, it is called 'purchase return' or 'return outward'.
- Net Purchases = Purchases – Purchase Return

  Since purchases may be cash purchases and credit purchases both, therefore:

  Net Purchases = Cash Purchases + Credit Purchases – Purchase Return (Return Outward)

Revenue (or Income)

Revenue (or Income) refers to the amount received by a business enterprise from selling its products or providing services to customers (called sales revenue) and other items of revenue like commission received, interest received, dividends received, royalities received, rent received, etc.

Key Terms

Dividend: It is that portion of a company's profit (after tax) which is distributed to the shareholders.
Royalty, e.g. amount received by the author of a book from the publisher for granting rights to publish and sell his/her book in the market.

Sales

Sales are total revenues/receipts from goods sold or services provided to customers.
Sales may be cash sales or credit sales. (Sales = Cash Sales + Credit Sales)

Top Tips

1. **Sales Return (or Return Inward)** means sold goods are returned by customers.
2. **Net Sales** = Sales – Sales Return (Return Inward)

Note: Sales may also be termed as **'Revenue from Operations'** *(in case of a company)*.
Thus, Revenue from Operations = Cash revenue from operations + Credit revenue from operations

Expenses

Costs incurred by a business in the process of earning revenue are known as expenses.
Examples:

- Depreciation
- Wages and Salaries of workers/employees
- Heating and Lighting expenses
- Rent (office rent or factory rent)
- Interest on borrowings
- Telephone expenses

Key Term

Depreciation: It means decline in the value of a machine, equipment or motor vehicle, etc. due to use, passage of time or obsolescence (i.e. being 'out-of-date' or outdated).

Profit

The excess of revenues of a business over its related expenses during an accounting year is called 'profit'.

Profit = Revenues – Expenses

For example, if the total revenue of a given accounting period is ₹6,00,000 and total expenses related to that period are ₹5,40,000, then the profit will be equal to ₹60,000 (i.e.₹6,00,000 – ₹5,40,000).

Top Tip

Profit increases the investment of the owners (i.e. owner's capital).

Gain

It refers to a non-recurring profit that arises from events or transactions which are incidental to business.

Examples:

- Profit on sale of machinery by a manufacturing concern
- Winning a court case
- Appreciation in the value of land and building.

Loss

The excess of expenses of an accounting period over its related revenues its termed as 'loss'.

Loss = Expenses – Revenues

For example, if the total revenue of a given accounting period is ₹6,00,000 and total expenses related to that period are ₹6,40,000, then there will be loss equal to ₹40,000 (i.e.₹6,40,000 – ₹6,00,000).

- Loss 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.
- Loss also includes loss on sale of machinery, motor vehicle, etc.

Top Tip

Loss decreases owner's equity (i.e. capital).

Debtors (or Sundry Debtors)

Debtors are persons and/or other entities to whom the business enterprise has sold goods or services on credit, and the amount has not been received yet.

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.

Top Tip

Creditors may be:

1. **Trade Creditors (or Sundry Creditors):** They are the suppliers of goods purchased on credit who have not been paid yet.
2. **Loan Creditors:** These include bankers and other financial institutions, debentureholders and other lenders.

Discount

Discount is the deduction in the price of the goods sold.

It is offered in two ways — (i) Trade Discount and (ii) Cash Discount.

1. Trade Discount

Offering deduction of agreed percentage of list price at the time selling goods is called 'trade discount'. It is generally offered by manufacturers to wholesalers and by wholesalers to retailers.

2. Cash Discount

After selling the goods on credit basis the debtors may be given certain deduction 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 as cash discount.
- Cash discount acts as an incentive that encourages prompt payment by the debtors.

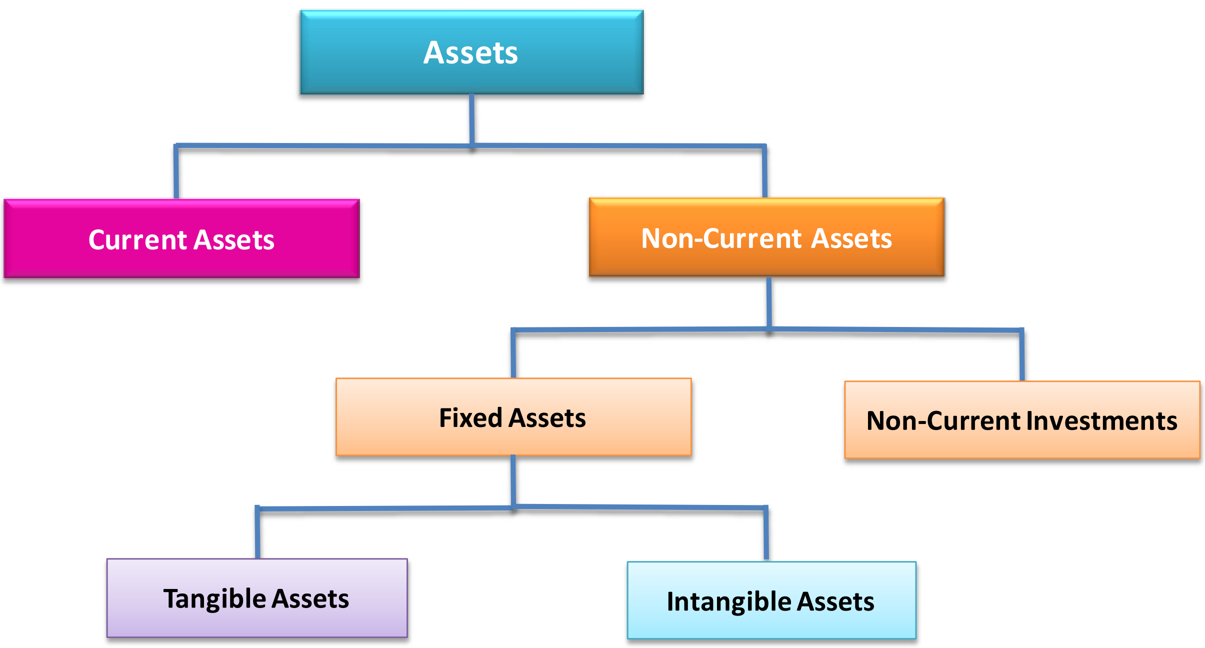
Top Tip

Trade Discount is not recorded in the books of accounts as it is deducted in the Invoice/Cash Memo.
On the other hand, Cash Discount is recorded in the books of accounts because it is given at the time of payment by the debtors while the sales have already been recorded in the books of accounts.

Assets

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. *For example,* a pen manufacturing enterprise owns machinery, which is used by it for producing pens. Thus, machinery provides economic benefit to the enterprise. Therefore, machinery is an asset for this enterprise.



CLASSIFICATION OF ASSETS

Assets can be broadly classified into two types — (i) Current Assets and (ii) Non-Current Assets

1. Current Assets

Current assets are those assets which are expected to get converted into cash or cash equivalents within a period of one year.

Examples of Current Assets (in order of their *liquidity*):

- Cash in hand
- Cash at bank, Cheques/Drafts in hand
- Marketable Securities
- Bills receivable
- Debtors
- Inventory of finished goods
- Inventory of semi-finished goods (Work in Progress)
- Inventory of raw materials
- Prepaid Expenses (e.g. Rent/Insurance premium paid in advance, Advance tax, etc.)

Key Terms

Liquidity: Liquidity of a current asset means its convertibility into cash or cash equivalents.

Cash Equivalents: Cash equivalents refer to short-term, highly liquid investments having insignificant risk of changes in value, with a maturity period of 3 months or less from the date of acquisition, e.g. Marketable Securities.

Bills receivable and Bills payable: Sometimes, when a business enterprise sells goods on credit, it draws a bill of exchange and gets it back after its due acceptance by the debtor. This bill of exchange is called 'Bills Receivable' for the business enterprise (Drawer) and 'Bills Payable' for the debtor (Drawee). This is done to avoid any possibility of delay or default. The date on which payment will be made is specified in the bill of exchange.

Top Tips

1. Inventory and Prepaid Expenses are considered as non-liquid current assets as they are not quickly convertible into cash.
2. 'Loose tools' and 'Stores and spares' are included in Inventories. However, they are used in business operations, not for sale.

Extra Shots

An asset is classified as current asset when it satisfies any one of the following conditions:

1. It is expected to be realised in, or sold or consumed in the operating cycle. Operating cycle is the time between acquisition of assets for processing and their realisation in cash or cash equivalents. If operating cycle cannot be identified, it is taken 12 months.
2. It is held for the purpose of trading.
3. It is expected to be realised within 12 months.
4. It is cash or cash equivalents.

2. Non-Current Assets

All assets other than current assets are classified as 'non-current assets'. Thus, non-current assets are held for long-term(more than one year) and used for normal business operations. *For example,* Land and Building, Machinery, Furniture and Fixture, Motor Vehicles, Office Equipment, etc.

Non-Current Assets mainly include:

- Fixed assets (both *tangible assets*, e.g. machinery and *intangible assets*, e.g. goodwill), and
- Non-current investments, e.g. purchase of shares of a company by a sole proprietorship concern.

Key Term

Goodwill: Over a period of time, well-established business firm (e.g. Haldiram's) develops an advantage of good name, reputation and wide business connections. This helps the business enterprise to earn more profits as compared to a newly set up business (e.g. Bablu Sweets Corner). In accounting, the monetary value of such advantage is known as 'goodwill'. It has a monetary value but no physical existence, so it is an intangible asset.

Top Tip

Even if the useful life of a fixed assets is less than 12 months, it will fall under non-current assets.

Fixed Assets

Fixed assets are those non-current assets which are acquired for the purpose of use in business operations, not for resale, e.g. Machinery, Furniture, etc.
Fixed assets may be classified into — (i) tangible assets and (ii) intangible assets.

1. Tangible Assets

Tangible assets are those fixed assets which can be seen and touched.
Examples:

- Land and Building
- Furniture and Fixture
- Office Equipments (e.g. computer)
- Plant and Machinery
- Motor Vehicles
- Livestock

2. Intangible Assets

Intangible assets are those fixed assets which are not tangible, i.e. which cannot be seen or touched.
Examples:

- Goodwill
- Computer Software
- Patents
- Brand/Trademark
- Copyrights
- Licenses and Franchise

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. For example, Sundry creditors, Bank loan, etc.
Liabilities are classified as — (i) current liabilities and (ii) non-current liabilities

1. Current Liabilities

Current liabilities are those payment obligations or debts of a business enterprise which are due for payment within one year/12 months.
Examples:

- Short-term borrowings (e.g. Bank overdraft, Bank loan for a period of 6 months, Short-term deposits payable on demand)
- Creditors *(payable within 12 months)*
- Bills payable *(to be settled within 12 months)*
- Outstanding expenses or Expenses Payable (e.g. outstanding salary, outstanding rent, etc.)
- Income received in advance, i.e. unearned income
- Interest accrued and due/not due on borrowings

Key Term

Bank Overdraft: If the excess amount is withdrawn from the bank than the amount deposited in the bank by the business enterprise, there will be negative balance in the current account. It is called 'Bank Overdraft'. Banks provide overdraft (OD) facility for the current accounts maintained by business enterprises for a short-period. Therefore, bank overdraft is a current liability for the business enterprise.

2. Non-Current Liabilities

Non-current liabilities are those payment obligations or debt of a business enterprise which are payable after a period of one year/12 months.
Examples:

- Long-term borrowings (e.g. Bank loan for 3 years)
- Long-term deposits from the public
- Debentures issued by a company with a maturity period of 5 years
- Creditors (to be settled after 12 months)

HOTS

Case-based/Source-based Integrated Question

Question:

Classify the following into (a) Current Assets, (b) Non-Current Assets, (c) Current Liabilities, and (d) Non-Current Liabilities:

Machinery	Investments	Licenses and Franchise	Stock of finished goods
Sundry Creditors	Loan from Bank	Work in Progress	Office Equipments
Cash at Bank	Sundry Debtors	Cheques and drafts	Debentures
Goodwill	Patents	Bank Overdraft	Raw materials
Bills Payable	Air-Conditioners	Stores and Spares	Advance tax
Land & Building	Loose tools	Term Loan from Bank	Bills payable
Furniture and fittings	Prepaid Insurance	Income received in advanced	Bills receivable
Computer Software	Trademark	Loan Payable on demand	Cash and Cash Equivalents
Motor Vehicles	Interest accrued on investments	Computer	Advance from customers
Inventory	Livestock	Copyright	Outstanding salary

Answer:

Items	Major Headings	Items	Major Headings
Machinery	Non-Current Assets	*Licenses and Franchise*	Non-Current Assets
Sundry Creditors	Current Liabilities	*Work in Progress*	Current Assets
Cash at Bank	Current Assets	*Cheques and drafts*	Current Assets
Goodwill	Non-Current Assets	*Bank Overdraft*	Current Liabilities
Bills Payable	Current Liabilities	*Stores and Spares*	Current Assets
Land & Building	Non-Current Assets	*Term Loan from Bank*	Non-Current Liabilities
Furniture and fittings	Non-Current Assets	*Advance Income*	Current Liabilities
Computer Software	Non-Current Assets	*Loan Payable on demand*	Current Liabilities
Motor Vehicles	Non-Current Assets	*Computer*	Non-Current Assets
Inventory	Current Assets	*Copyright*	Non-Current Assets
Investments	Non-Current Assets	*Stock of finished goods*	Current Assets
Loan from Bank	Non-Current Liabilities	*Office Equipments*	Non-Current Assets
Sundry Debtors	Current Assets	*Debentures*	Non-Current Liabilities
Patents	Non-Current Assets	*Raw materials*	Current Assets
Air-Conditioners	Non-Current Assets	*Advance tax*	Current Assets
Loose tools	Current Assets	*Bills payable*	Current Liabilities
Prepaid Insurance	Current Assets	*Bills receivable*	Current Assets
Trademark	Non-Current Assets	*Cash and Cash Equivalents*	Current Assets
Interest accrued on investments	Current Assets	*Advance from customers*	Current Liabilities
Livestock	Non-Current Assets	*Outstanding salary*	Current Liabilities

Capital

Amount invested by the owner in the firm is known as capital.

Capital may be brought in the form of cash or assets (or both) by the owner.

For the business entity, capital is an obligation and a claim on the assets of business. It is, therefore, shown on the liabilities side of the balance sheet.

Top Tip

Balance Sheet is a financial statement of a business entity which shows the financial position of the business at the end of an accounting period. In a balance sheet, *Capital* and *Liabilities* are shown on the left hand side and *Assets* on the right hand side.

Balance Sheet of .... as at 31 March 2020

Liabilities	Amount (₹)	Assets	Amount (₹)
Capital	xxx	Land and Building	xxx
Bank Loan	xxx	Machinery	xxx
Sundry Creditors	xxx	Furniture	xxx
Bills Payable	xxx	Closing Stock	xxx
Bank Overdraft	xxx	Sundry Debtors	xxx
		Cash	xxx
		Goodwill	xxx
	xxx		**xxx**

Drawings

Withdrawal of money and/or goods by the owner from the business for personal use is known as drawings.

For example, Cash withdrawn from business by the owner to pay his son's school fee or house rent or to purchase a scooter for personal use.

Top Tips

1. Drawings reduces the owner's capital.
2. If the owner withdraws money from the business to pay office rent or factory rent or to purchase a scooter for use in business, it is NOT treated as drawings.

Expenditure

Spending money or incurring a liability for some benefit, service or property received is called expenditure.

For example, payment of rent, salaries, etc., purchase of goods, purchase of machinery, purchase of furniture, etc. The expenditures are incurred with a viewpoint they would give benefits to the business. The benefit of an expenditure may extend up to one accounting year or more than one year.

1. Revenue Expenditure

If the benefit of an expenditure is exhausted within a year, it is called revenue expenditure.

For example, payment of salaries, rent, etc. The salaries paid in the current period will not benefit the business in the next accounting period, as the workers have put in their efforts in the current accounting period. They will have to be paid the salaries in the next accounting period as well if they are made to work.

2. Capital Expenditure

If the benefit of an expenditure lasts for more than one accounting year, it is called capital expenditure.

For example, purchase of machinery, furniture, etc. Machinery or furniture acquired in the current accounting period will give benefits for many accounting periods to come.

Differences between 'Revenue Expenditure' and 'Capital Expenditure'

Revenue Expenditure	Capital Expenditure
Revenue expenditure normally benefits one accounting year.	Capital expenditure benefits more than one accounting year.
Revenue expenditure is incurred to maintain the earning capacity.	Capital expenditure increases earning capacity of business.
Revenue expenditure is incurred on day-to-day conduct of business.	Capital expenditure is incurred to acquire fixed assets for operations of business.
Revenue expenditure is generally recurring expenditure.	Capital expenditure is non-recurring by nature.
Revenue expenditure (subject to adjustment for outstanding and prepaid amount) is shown in profit and loss account.	Capital expenditure (after deducting depreciation) is treated as an asset and recorded in balance sheet.

Top Tips

1. **Revenue expenditure (subject to adjustment for outstanding and prepaid amount) is treated as an expense for the current year and is shown in profit and loss account.**
   Example: Salary paid by the business firm during the year 2019-20 is ₹20,000. However, it may include salary paid in advance ₹2,000 which relates to the next accounting year 2020-21. So, prepaid salary ₹2,000 will be subtracted from salary paid since it is not related to the current year. Similarly, there may be outstanding salary related to the current year 2019-20, say ₹5,000. So, outstanding salary ₹5,000 will be added since it is related to the current year 2019-20 but still unpaid.
   Thus, the amount of salary as revenue expenditure/expense will be shown in profit and loss account as follows:

Profit and Loss Account of .... for the year ended 31 March 2020

Expenses/Losses	Amount (₹)	Revenues/Gains	Amount (₹)
Salary paid 20,000 *Less:* Prepaid Salary (2,000)* *Add:* Outstanding salary 5,000	23,000		

** In accounting, the figures in bracket indicate negative figures.*

2. **Capital expenditure (after deducting depreciation) is treated as an asset and is shown in the balance sheet.**
   Example: A machinery is purchased for ₹1,00,000 on 1st April 2019. Its useful life is estimated to be 5 years, after which its scrap value will be NIL. Therefore, depreciation expense to be charged per year is ₹20,000. Thus, at the end of the accounting year, i.e. on 31st March 2020 the machinery will be shown in the balance sheet on the assets side at ₹80,000 (₹1,00,000 – ₹20,000).
   Note that depreciation on machinery ₹20,000 will be shown as an expense in Profit and Loss Account.

Profit and Loss Account of .... for the year ended 31 March 2020

Expenses/Losses	Amount (₹)	Revenues/Gains	Amount (₹)
Depreciation	20,000		

Balance Sheet of .... as at 31 March 2020

Liabilities	Amount (₹)	Assets	Amount (₹)
		Machinery 1,00,000 *Less:* Depreciation (20,000)	80,000

DO YOU KNOW?

Deferred Revenue Expenditure

Sometimes, it becomes difficult to classify the expenditure into revenue or capital category. In normal usage, the advertising expenditure is termed as revenue expenditure. The heavy expenditure incurred on advertising is likely to benefit the business firm for more than one accounting period. Such revenue expenditures, which are likely to give benefit for more than one accounting period, are termed as *deferred revenue expenditure*.

HOTS

Case-based/Source-based Integrated Question

Question:

Mr. Sunrise started a business for buying and selling of stationery with ₹5,00,000 as an initial investment. Of which he paid ₹1,00,000 for furniture, ₹2,00,000 for buying stationery items. He employed a sales person and clerk. At the end of the month he paid ₹ 5,000 as their salaries. Out of the stationery bought he sold some stationery for ₹1,50,000 for cash and some other stationery for ₹1,00,000 on credit basis to Mr.Ravi. Subsequently, he bought stationery items of ₹1,50,000 from Mr. Peace. In the first week of next month there was a fire accident and he lost ₹30,000 worth of stationery. A part of the machinery, which cost ₹40,000, was sold for ₹45,000.

From the above, answer the following :

1. **What is the amount of capital with which Mr. Sunrise started business?**
2. **What are the fixed assets he bought?**
3. **What is the value of the goods purchased?**
4. **Who is the creditor and state the amount payable to him?**
5. **What are the expenses?**
6. **What is the gain he earned?**
7. **What is the loss he incurred?**
8. **Who is the debtor? What is the amount receivable from him?**
9. **What is the total amount of expenses and losses incurred?**
10. **Determine if the following are assets, liabilities, revenues or expenses:**
    Sales, Debtors, Creditors, Discount to debtors

Answer:

1. ₹5,00,000
2. Furniture ₹1,00,000
3. ₹2,00,000
4. Mr. Peace ₹1,50,000
5. Salaries paid ₹5,000
6. Profit on sale of machinery ₹5,000
7. Loss of goods by fire ₹30,000
8. Mr. Ravi; ₹1,00,000
9. ₹35,000
10. Sales – Revenues; Debtors – Assets, Creditors – Liabilities, Discount to debtors – Expense

Objective Type Questions 1.2

1. A person from whom money is receivable by the firm for sale of goods is called ____________. *(Choose the correct alternative)*
   (a) Creditor (b) Debtor
   (c) Supplier (d) Manager
2. In accounting, an Economic event is referred to as: *(Choose the correct alternative)*
   (a) Cash (b) Bank statement
   (c) Transaction (d) Exchange of money
3. Which of the following is the external user of financial statements? *(Choose the correct alternative)*
   (a) Manager of the business (b) CEO of the business
   (c) Creditor of the business (d) Controller of the business
4. Which of the following is an internal user of financial statements? *(Choose the correct alternative)*
   (a) Creditor of the business (b) Government agency
   (c) Shareholder of the business (d) Manager of the business
5. Liabilities are ____________ for the business. *(Choose the correct alternative)*
   (a) Resources (b) Obligations
   (c) Future benefits (d) Expenses
6. ____________ is an event involving some value between two or more entities. It can be in cash or credit. *(Fill up the blank with appropriate words)*
7. Goods refer to the items that are purchased by a business unit for the purpose of resale and not for use in the business. *(True/False)*
8. The items that are purchased for use in the business are called goods. *(True/False)*
9. For a stationery merchant, stationery is ___________, whereas for others it is an item of ___________, (not purchases). *(Fill up the blank with appropriate words)*
10. For a furniture dealer purchase of chairs and tables is termed as ___________, while for others it is a furniture and is treated as __________. *(Fill up the blank with appropriate words)*
11. Generally, __________ are measured by the cost of assets consumed or services used during an accounting period. *(Fill up the blank with appropriate words)*
12. Profit increases the owners' entity. *(True/False)*
13. The excess of revenues of a business over its related expenses during an accounting year is 'gain'. *(True/False)*
14. __________ refers to a profit that arises from events or transactions which are incidental to business. *(Fill up the blank with appropriate words)*
15. Which of the following is not described as 'loss'? *(Choose the correct alternative)*
    (a) The excess of expenses of a period over its related revenues.
    (b) Money or money's worth lost (or cost incurred) without receiving any benefit in return.
    (c) It decreases the owners' entity
    (d) None of the above
16. Match the following:

(a) The documentary evidence in support of a business transaction	(i) Cash Memo
(b) If we buy goods for cash, we get this document	(ii) Receipt
(c) If we buy goods on credit, we get this document	(iii) Invoice
(d) When we make a payment, we get this document.	(iv) Voucher

17. __________ are persons and/or other entities who owe to an amount for buying goods and services on credit. *(Fill up the blank with appropriate words)*
18. On the closing date, the total amount standing against persons and/or entities, who owe to the enterprise an amount for buying goods and services on credit, is shown in the balance sheet as __________ on the __________ side. *(Fill up the blanks with appropriate words)*

19. On the closing date, the total amount standing to the favour of persons and/or entities, who have to be paid by the business enterprise an amount for providing the enterprise goods and services on credit, is shown in the balance sheet as __________ on the __________ side. *(Fill up the blanks with appropriate words)*
20. Match the following:

(a) Goodwill	(i) Tangible Assets
(b) Computer Software	(ii) Intangible Assets
(c) Patents	
(d) Office Equipments	

21. Which of the following is not an intangible asset? *(Choose the correct alternative)*
    (a) Trademark (b) Copyrights
    (c) Livestock (d) Patents
22. Which of the following is a non-current asset? *(Choose the correct alternative)*
    (a) Cash and Cash equivalent (b) Machinery
    (c) Inventory (d) Bills receivable
23. ____________ is generally offered by manufacturers to wholesalers and by wholesalers to retailers. (Trade discount/Cash discount) *(Fill up the blank with appropriate words)*
24. ____________ acts as an incentive that encourages prompt payment by the debtors. (Trade discount/Cash discount) *(Fill up the blank with appropriate words)*
25. Cash discount is so called because ___________ *(Complete the sentence)*
26. Trade discount is not recorded in the books of account. *(True/False)*
27. Cash discount is not recorded in the books of account. *(True/False)*
28. Trade discount is not recorded in the books of accounts because __________. *(Complete the sentence)*
29. Cash discount is not recorded in the books of accounts because __________. *(Complete the sentence)*
30. __________ represent creditors' claims on the firm's assets. *(Fill up the blank with appropriate words)*
31. Amount invested by the owner in the firm is known as _____________. *(Fill up the blank with appropriate words)*
32. Capital may be brought in the form of cash only by the owner. *True/False? Give reason.*
33. Capital is shown on the liabilities side of the balance sheet because ____________. *(Complete the sentence)*
34. Withdrawal of money and/or goods by the owner from the business for personal use is known as ___________. *(Fill up the blank with appropriate words)*
35. Drawings reduces the investment of the owners. *(True/False)*
36. Mr. Rohit, the owner of a pen manufacturing firm, withdraws ₹70,000 from the business to buy a scooter for office use. Will it be treated as drawings? Give valid reason.
37. Whenever payment and/or incurrence of an outlay are made for a purpose other than the settlement of an existing liability, it is called: *(Choose the correct alternative)*
    (a) Expense
    (b) Expenditure
    (c) Asset
    (d) Capital expenditure
38. Payment of salaries is an example of revenue expenditure. *True/False? Give reason.*
39. Purchase of goods is capital expenditure. *True/False? Give reason.*
40. Payment of interest on loan is a __________ expenditure. (revenue/capital) *(Fill up the blank with appropriate words)*
41. Match the following:

(i) Office rent paid	(a) Revenue expenditure
(ii) Purchase of furniture for use in the business	(b) Capital expenditure

42. Revenue expenditure is treated as an expense, whereas capital expenditure is treated as an asset. *(True/False)*
43. A furniture of ₹50,000 if expected to be used for 5 years will be treated as expense @ ₹10,000 per year. The name given for the expense is ____________. *(Fill up the blank with appropriate words)*
44. Salary paid by the business firm is treated as an ___________ of the current year. (expense/expenditure) *(Fill up the blank with appropriate words)*

45. _____________ increases earning capacity of business whereas ____________ is incurred to maintain the earning capacity. (Revenue expenditure/Capital expenditure) *(Fill up the blank with appropriate words)*
46. _____________ is incurred on day-to-day conduct of business. (Revenue expenditure/Capital expenditure) *(Fill up the blank with appropriate words)*
47. Revenue expenditure is generally non-recurring by nature. *(True/False)*
48. In normal usage, the advertising expenditure is termed as ______________. *(Fill up the blank with appropriate words)*
49. The revenue expenditure, which is likely to give benefit for more than one accounting period, is termed as ______________. *(Fill up the blank with appropriate words)*
50. Give an example of a revenue expenditure, which is likely to benefit the business firm for more than one accounting period, due to which it is termed as deferred revenue expenditure.

Objectives, Advantages, Limitations and Role of Accounting

Objectives of Accounting

The primary objectives of accounting include the following:

1. Maintenance of Records of Business Transactions

Accounting is used for the maintenance of a systematic record of all financial transactions in the books of accounts.

A proper and complete records of all business transactions are kept regularly because:

- Even the most brilliant executive or manager cannot accurately remember all business transactions such as purchases, sales, receipts, payments, etc.
- Moreover, the recorded information enables verifiability and acts as an evidence.

2. Calculation of Profit and Loss

Another objective of accounting is to ascertain the profit earned or loss incurred by a business during an accounting period.

Profit/Loss can be easily worked out with help of record of incomes/gains and expenses/losses relating to the business by preparing a profit or loss account for the period.

3. Depiction of Financial Position

Accounting also aims at ascertaining the financial position of the business enterprise in the form of its assets, liabilities and capital at the end of every accounting period by preparing Balance Sheet.

Top Tip

Since a Balance Sheet depicts the financial position of a business enterprise at the end of an accounting period, it is also known as 'Position Statement'.

4. 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 interested users — both external and internal users. *For example,* the investors may be interested in knowing the extent of profit or loss earned by the firm during an accounting period and compare it with the performance of other similar enterprises. The suppliers of credit, say a banker, may be interested to know whether the firm is able to repay its debts with interest or not.

Advantages of Accounting

1. Describes and Analyses Data

Accounting describes and analyses data of an enterprise through measurement, classification and summarisation, and reduces those date into accounting reports and financial statements, which show the financial position and net results of business operations.

2. Provides Quantitative Financial Information

Accounting provides quantitative financial information that helps the users in various ways. Accounting as an information system collects and communicates economic information about an enterprise to a wide variety of interested parties.

3. Helps in Assessment of Tax Liabilities

Accounting helps a business enterprise in the assessment of its correct tax liabilities such as Income Tax (IT), Goods and Services Tax (GST), etc.

4. Helps in Planning, Controlling and Decision-Making

Accounting provides timely information on cost of sales, profitability, etc. which helps the management of a business enterprise in planning, controlling and decision-making.

Limitations of Accounting

1. Historical in nature

Accounting is historical in nature since the accounting information relates to the past transactions only. It does not reflect on the current and future positions of a business enterprise.

2. Ignores non-monetary and qualitative aspects

Accounting records only those transactions and events which are of financial character, i.e. which can be measured in monetary terms. Thus, it ignores non-monetary and qualitative aspects such as efficiency of management, quality of staff, customer satisfaction, etc.

3. Ignores Price Level Changes

The figures given in financial statements ignore price level changes, which makes comparison of financial figures of different accounting years invalid.

4. Affected by the personal ability and bias of accountants

Accounting is not free from personal ability and bias of accountants, *for example,* having different opinions regarding method of depreciation, method of inventory valuation, etc.

5. May lead to window dressing

It may lead to window dressing, i.e. showing better financial position by manipulating the books of accounts.

6. Difficulty in inter-firm comparison

As there may be difference in accounting policies followed by different firms, meaning inter-firm comparison may not be possible.

Role of Accounting in Modern Business

Accounting is not an end in itself. It is a means to an end. It plays the role of a :

1. Language of a Business

Accounting is perceived as the language of business which is used to communicate information on enterprises.

2. Historical record

Accounting is viewed as chronological record of financial transactions of an organisation at actual amounts involved.

3. Current economic reality

Accounting is viewed as the means of determining the true income of a business entity, i.e. the change of wealth over time.

4. Information system

Accounting 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.

5. Service to users

Specialised information is viewed as a service which is in demand in society, with accountants being willing to and capable of providing it.

Extra Shots

Major Branches of Accounting

1. **Financial Accounting**

   Financial accounting assists keeping a systematic record of financial transactions the preparation and presentation of financial reports in order to calculate profit/loss and assess the financial position of the business enterprise during an accounting period.

   - Financial accounting relates to the past period and is monetary in nature.
   - The purpose of this branch of accounting is to keep a record of all financial transactions so that:
     (a) the profit earned or loss sustained by the business during an accounting period can be worked out,
     (b) the financial position of the business as at the end of the accounting period can be ascertained, and
     (c) the financial information required by the management and other interested users can be provided.

2. **Cost Accounting**

   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**

   Management accounting assists the management in taking rational policy decisions and to evaluate the impact of its decisions and actions.

   - Management accounting draws the relevant information mainly from financial accounting and cost accounting which helps the management in decision-making, planning and controlling business operations.
   - Besides, 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. Such information includes sales forecast, cash flows, purchase requirement, manpower needs, environmental data, social responsibilities, etc.

Note: **The scope of accounting has become so vast, that new areas like human resource accounting, social accounting, responsibility accounting have also gained prominence.**

Types, Users and Qualitative Characteristics of Accounting Information

Types of Accounting Information

Accounting Information	What does it show?
1. Accounting Information relating to Profit and Loss, i.e. Income Statement	It shows the net result of business operations of a business enterprise during an accounting year. Income Statement shows expenses/losses on the left hand side and revenues/gains on the right hand side.
2. Accounting Information relating to Financial Position, i.e. Balance Sheet	It shows the financial position of a business enterprise at the end of an accounting year. Balance Sheet or Position Statement shows liabilities and capital on the left hand side and assets on the right hand side.
3. Additional Information in the form of 'Notes to Accounts'	It shows details of various items shown in Income Statement and Balance Sheet.

Interested Parties/Users of Accounting Information

Users	Why do they need accounting information?
1. Owners/Shareholders	• To see if they are getting a satisfactory Return on Investment (ROI). • To assess the financial health of their company/business.
2. Managers/Directors	• Management needs timely information on cost of sales, profitability, etc. for planning, controlling and decision-making. • Directors/Managers use accounting information for making both intra-firm and inter-firm comparisons to evaluate the performance of the business enterprise.
3. Employees and Labour Unions	• Employees need accounting information to see whether the business enterprise earns sufficient profits so that they get timely remuneration (wages/salaries) and their dues such as Provident Fund (PF), Employee State Insurance (ESI), etc. are deposited. • Labour Unions need accounting information to assess whether the business enterprise can presently afford a wage increase; and to check whether the enterprise can increase productivity or raise the prices of products/services to absorb a wage increase.
4. Lenders and Financial Institutions	• They are interested in information on the credit worthiness of the company. • They assess the ability of the company to repay loans and pay interest.
5. Investors (Present and Potential Investors)	• They are interested in information on the risks and return on investment. • Potential investors use accounting information to assess whether or not to invest their money in the company/organisation.
6. Government and Regulatory Agencies	• They need accounting information for the payment of various taxes such as Income Tax, Goods and Services Tax, etc. • They also need information on the allocation of resources and compliance of legal regulations imposed by The Companies Act, 2013 and SEBI (Securities and Exchange Board of India) from time to time.
7. Suppliers and Creditors	They need accounting information on whether amounts owed will be repaid when due, and on the continued existence of the business.
8. Customers	They need information on the continued existence of the business and thus, the probability of a continued supply of products, parts and after-sales service.
9. Competitors	They need accounting information on the relative strengths and weaknesses of their competitors to formulate their strategies. Thus, they require the information mainly for strategic purposes.
10. Others	• Social responsibility groups, such as environmental groups need information on the impact on environment and its protection. • The economists, researchers, etc. need accounting information to study the present business and economic conditions.

Top Tip

Intra-firm comparison and Inter-firm comparison

Intra-firm comparison (or inter-period comparison) means comparing profitability, financial position, etc. of the business enterprise at the end of two or more accounting periods, e.g. as on 31 March 2019 and 31 March 2020.

Inter-firm comparison, on the other hand, means comparing profitability, financial position, etc. of the business enterprise with other enterprises in the same industry as on a particular date, say on 31 March 2020, in order to ascertain the company's strengths and weaknesses.

HOTS

Case-based/Source-based Integrated Question

Question:

Which stakeholder group would be most interested in the following?

(a) The GST and other tax liabilities of the firm
(b) The potential for pay awards and bouns deals
(c) The ethical or environmental activities of the firm
(d) Whether the firm has a long-term future
(e) Profitability and share performance
(f) The ability of the firm to carry on providing a service or producing a product.

Answer:

(a) Government and regulatory agencies
(b) Management
(c) Social responsibility groups, such as environmental groups
(d) Lenders
(e) Suppliers and Creditors
(f) Customers

Qualitative Characteristics of Accounting Information

Qualitative characteristics are the attributes of accounting information which tend to enhance its understandability and usefulness.

In order to assess whether accounting information is decision useful, it must possess the characteristics of reliability, relevance, understandability and comparability.

1. Reliability

Reliability means the users must be able to depend on the information.

- To be reliable, information should be free from error and bias and faithfully represents what it is meant to represent.
- To ensure reliability, the information disclosed must be credible, verifiable by independent parties through source document, and be neutral and faithful.

2. Relevance

To be relevant, information must be available in time, must help in prediction and feedback, and must influence the decisions of users by :

- helping them form prediction about the outcomes of past, present or future events; and/or
- confirming or correcting their past evaluations.

3. Understandability

Understandability means decision-makers must interpret accounting information in the same sense as it is prepared and conveyed to them.

- A message is said to be effectively communicated when it is interpreted by the receiver of the message in the same sense in which the sender has sent.
- Accountants should present the comparable information in the most intelligible manner without sacrificing relevance and reliability, so that the users can understand it well.

4. Comparability

It is not sufficient that the financial information is reliable, relevant and understandable. But it is equally important that the users must be able to compare various aspects of the business, e.g. profitability, efficiency, liquidity and solvency over different time period and with other business entities.

To be comparable, financial statements must belong to a common period and use common unit of measurement.

Key Terms

Liquidity: Liquidity of business refers to the firm's ability to meet its current obligations/short-term liabilities, i.e. the firm's short-term debts paying capacity.

Solvency: Solvency of business is determined by its ability to meet its contractual obligations towards bankers, lenders, etc. i.e. the firm's long-term debts paying capacity.

Top Tip

For making the accounting information meaningful to its internal and external users, it is important that such information is reliable as well as comparable. The comparability of information is required both to make *inter-firm comparisons*, i.e. to see how a firm has performed as compared to the other firms, as well as to make *intra-firm comparison*, i.e. how it has performed as compared to the previous years. This becomes possible only if the information provided by the financial statements is based on consistent accounting policies, principles and practices. Such consistency is required throughout the process of identifying the events and transactions to be accounted for, measuring them, communicating them in the book of accounts, summarising the results thereof and reporting them to the interested parties. This calls for developing a proper **theory base of accounting**.

Objective Type Questions 1.3

1. When information about two different enterprises have been prepared and presented in a similar manner, the information exhibits the characteristic of: *(Choose the correct alternative)*
   (a) Verifiability (b) Relevance
   (c) Reliability (d) None of these
2. The primary qualities that make accounting information useful for decision-making are : *(Choose the correct alternative)*
   (a) Relevance and freedom from bias (b) Reliability and comparability
   (c) Comparability and consistency (d) None of the above
3. Internal users are the ____________ of the business entity. *(Fill up the blank with appropriate words)*
4. A ____________ would most likely use an entities financial report to determine whether or not the business entity is eligible for a loan. *(Fill up the blank with appropriate words)*
5. ____________ users are groups outside the business entity, who uses the information to make decisions about the business entity. *(Fill up the blank with appropriate words)*
6. Information is said to be relevant if it is _____________. *(Complete the sentence)*
7. Which qualitative characteristics of accounting information is reflected when accounting information is clearly presented? *(Choose the correct alternative)*
   (a) Understandability (b) Relevance
   (c) Comparability (d) Reliability
8. Use of common unit of measurement and common format of reporting promotes: *(Choose the correct alternative)*
   (a) Comparability (b) Understandability
   (c) Relevance (d) Reliability

9. Which of the following is not an external user of accounting information? *(Choose the correct alternative)*
   (a) Creditors (b) Lenders
   (c) Management (d) Tax
10. Financial accounting provides financial information to all of the following external users except: *(Choose the correct alternative)*
    (a) Government agencies (b) Investors
    (c) Creditors (d) Managers
11. As an information system, the basic objective of accounting is ________________. *(Complete the sentence)*
12. As an information system, the basic objective of accounting is to provide useful information to the interested group of users, both internal and external. The necessary information, particularly in case of external users, is provided in the form of _______________. *(Fill up the blank with appropriate words)*
13. The primary objective of accounting is: *(Choose the correct alternative)*
    (a) Maintenance of records of business transactions (b) Calculations of Profit & Loss
    (c) Depiction of financial position (d) All of the above
14. A proper and complete records of all business transactions are kept regularly because the recorded information enables _______________ and acts as ________________. *(Fill up the blanks with appropriate words)*
15. ________________ of business are keen to have an idea about the net results of their business operations periodically, i.e. whether the business has earned profits or incurred losses. *(Choose the correct alternative)*
    (a) Owners (b) Management
    (c) Creditors (d) Accountant
16. Profit/Loss of a business during an accounting period can be easily worked out with the help of record of _____________ and ______________ relating to the business by preparing a _______________ for the period. *(Fill up the blanks with appropriate words)*
17. Financial position of a business enterprise is ascertained in the form of its _________, _________ and _________ at the end of every accounting period by preparing a ____________. *(Fill up the blanks with appropriate words)*
18. A Balance Sheet is also called a ____________ since it depicts _____________.*(Fill up the blanks with appropriate words)*
19. Which of the following is a limitation of accounting? *(Choose the correct alternative)*
    (a) Accounting information relates to the past transactions.
    (b) Accounting formation is quantitative and financial in nature; it does not provide qualitative and non-financial information.
    (c) Accounting ignores price level changes
    (d) All of the above
20. Which of the following does not define the role of accounting in business? *(Choose the correct alternative)*
    (a) As a language of business (b) As an information system
    (c) As a historical record (d) None of the these
21. __________ need accounting information on whether amounts owed will be repaid when due, and on the continued existence of the business. *(Choose the correct alternative)*
    (a) Customers (b) Government and Regulatory Agencies
    (c) Suppliers and Creditors (d) Investors
22. __________ need information on the continued existence of the business and thus the profitability of a continued supply of products. *(Choose the correct alternative)*
    (a) Customers (b) Government
    (c) Creditors (d) Investors
23. In order to assess whether accounting information is useful, it must possess the qualitative characteristics of _____________. *(Fill up the blank with appropriate words)*
24. Which one of the following qualitative characteristics of accounting information means the users must be able to depend on the information? *(Choose the correct alternative)*
    (a) Reliability (b) Relevance
    (c) Understandability (d) Comparability

25. Accounting information must be available in time and must influence the decisions of users by helping them form prediction about the outcomes.

    Which one of the following qualitative characteristics of accounting information is highlighted above?

    (Choose the correct alternative)

    (a) Reliability (b) Relevance
    (c) Understandability (d) Comparability

26. ______________ means decision-makers must interpret accounting information in the same sense as it is prepared and conveyed to them. *(Choose the correct alternative)*

    (a) Reliability (b) Relevance
    (c) Understandability (d) Comparability

27. A message is said to be effectively communicated when it is interpreted by the receiver of the message in the same sense in which the sender has sent.

    Which one of the following qualitative characteristics of accounting information is highlighted above?

    (Choose the correct alternative)

    (a) Reliability (b) Relevance
    (c) Understandability (d) Comparability

Generally Accepted Accounting Principles (GAAP): Concept

In order to maintain uniformity and consistency in accounting records, certain rules or principles have been developed which are generally accepted by the accounting profession. These rules are called by different names such as principles, concepts, conventions, postulates, assumptions and modifying principles.

Definition

"Generally Accepted Accounting Principles (GAAP) refers to the rules or principles adopted for recording and reporting of business transactions, in order to bring uniformity in the preparation and the presentation of financial statements."

Key Terms

Principle: The term 'principle' has been defined by AICPA as 'A general law or rule adopted or professed as a guide to action, a settled ground or basis of conduct or practice'.
Concept: The term 'concept' refers to the necessary assumptions and ideas which are fundamental to accounting practice.
Convention: The term 'convention' connotes customs or traditions as a guide to the preparation of accounting statements.

Top Tip

CBSE and NCERT Guidelines

In practice, the same *principles* have been described by one author as *concepts*, by another as *postulates* and still by another as *conventions* or *assumptions* or *modifying principles*. This at times becomes confusing to the learners. Instead of going into the semantics of these terms, it is important to concentrate on the practicability of their usage. From the practicability view point, it is observed that the various terms such as principles, concepts, postulates, conventions, modifying principles, assumptions, etc. have been used interchangeably and are referred to as **Basic Accounting Concepts** in the present chapter.

Basic Accounting Concepts

Business Entity Concept

The concept of 'business entity' assumes that business has a distinct and separate entity from its owners.

Relevance/Implications

1. It means that for the purposes of accounting, the business and its owners are to be treated as two separate entities.

Examples:

(i) When the owner brings in some money as capital into his business, in accounting records, it is treated as liability of the business to the owner. Here, one separate entity (owner) is assumed to be giving money to another distinct entity (business).

(ii) Similarly, when the owner withdraws any money from the business for his personal expenses (drawings), it is treated as reduction of the owner's capital and consequently a reduction in the liabilities of the business.

(iii) Interest on owner's capital is treated as an expense like any other business expense.

2. The accounting records are made in the books of accounts from the point of view of the business and not from the point of view of the owner.

Examples:

(i) The personal assets and liabilities of the owner are not considered while recording the assets and liabilities of the business.

(ii) Similarly, personal transactions of the owner are not recorded in the books of the business, unless it involves inflow or outflow of business funds.

Money Measurement Concept

The concept of money measurement states that only those transactions and events are to be recorded in the books of accounts which can be expressed in terms of money such as sale of goods or payment of expenses or receipt of income, etc.

Relevance/Implication

The transactions are not recorded in the physical units but in the monetary unit (rupees).

For example, an organisation may, on a particular day, have a factory on a piece of land measuring 2 acres, office building containing 10 rooms, 30 personal computers, 30 office chairs and tables, a bank balance of ₹5 lakh, raw material weighing 20-tons, and 100 cartons of finished goods. These assets are expressed in different units, so cannot be added to give any meaningful information about the total worth of business. For accounting purposes, therefore, these are shown in money terms and recorded in rupees. In this case, the cost of factory land may be say ₹2 crore; office building ₹ 1 crore; computers ₹15 lakh; office chairs and tables ₹2 lakh; raw material ₹33 lakh and finished goods ₹4 lakh. Thus, the total assets of the enterprise are valued at ₹3 crore and 59 lakh.

Limitations

1. Money measurement concept ignores qualitative and non-financial aspects.

For example, the appointment of a manager, capabilities of its human resources, creativity of research department, image of the organisation among the general public, customer satisfaction, strikes, lockdowns, disputes, etc. do not find a place in the accounting records of a firm, even though these also affect the business operations significantly.

2. As the change in the value of money is not reflected in the book of accounts, the accounting data does not reflect the true and fair view of the affairs of an enterprise.

Due to the changes in prices, the value of money does not remain the same over a period of time. The value of rupee today on account of rise in prices is much less than what it was, say 10 years back. Therefore, in the balance sheet, when we add different assets bought at different points of time, say building purchased in 2010 for ₹2 crore, and plant purchased in 2020 for ₹1 crore, we are in fact adding heterogeneous values, which cannot be clubbed together.

Going Concern Concept (or Continuity Assumption)

The concept of going concern assumes that a business firm would continue to carry out its operations indefinitely, i.e. for a fairly long period of time and would not be liquidated in the foreseeable future.

Relevance/Implications

1. This concept provides the very basis for showing the value of assets in the balance sheet.

Fixed assets are shown in the balance sheet at *book value,* i.e. cost less depreciation till date.

Example: On 1 January 2020, a personal computer is purchased for ₹ 50,000, having estimated useful life of 5 years. It will not be fair to charge the whole amount of ₹ 50,000, from the revenue of the year 2020. Instead, that part of the computer which has been consumed or used during the year 2020 (i.e. depreciation of ₹10,000) should be charged from the profit and loss account and the remaining amount ₹40,000 should be carried forward to the next years, over its estimated life. Thus, we may charge ₹ 10,000 every year for 5 years from the profit and loss account.

On 31 December 2020, the computer will be shown in the balance sheet at book value ₹40,000(i.e. cost ₹50,000 minus depreciation ₹10,000).

Top Tip

In case the continuity assumption is not there, the whole cost ₹ 50,000 would be charged from the revenue in the year 2020 itself. We are charging ₹ 10,000 every year for 5 years from the profit and loss account on the basis of assumption that the business firm will continue to carry out its operations indefinitely.

2. Going concern concept provides the basis for classification of expenditures into revenue expenditure and capital expenditure.

If the benefit of an expenditure is exhausted within a year, it is called *revenue expenditure* (e.g payment of salaries, rent, etc.) On the other hand, if the benefit of an expenditure lasts for more than one accounting year, it is called *capital expenditure* (e.g. purchase of machinery, furniture, etc.)

Top Tip

When we say that the benefit of capital expenditure lasts for more than one accounting year, we simply make an assumption that the business firm would continue to carry out its operations for a fairly long-period of time and would not be liquidated in the foreseeable future.

3. Going concern concept provides the basis for classification of Assets and liabilities into current and non-current categories.

Current assets are expected to get converted into cash within one year, whereas non-current assets are held for more than one year for business operations.

Current liabilities are debts which are due for payment within one year, whereas non-current liabilities are payable after one year.

Accounting Period Concept

Accounting period refers to the span of time at the end of which the financial statements (Profit and Loss Account and Balance Sheet) of an enterprise are prepared.

Every business enterprise is interested to know whether it has earned profits or incurred losses during an accounting period and what exactly is the position of its assets and liabilities at the end of that period. No firm can wait for long to know the results of its business operation and the financial position.

Relevance/Implication

1. Financial information is required by different users at regular intervals for taking various decision at the appropriate time. Therefore, the financial statements are prepared at regular interval, normally after a period of one year, so that timely information is made available to the users.

2. The Companies Act 2013 and the Income Tax Act 1961 require that the income statements should be prepared annually. However, in case of certain situations, preparation of interim financial statements become necessary. *For example,* at the time of retirement of a partner, the accounting period can be different from 12 months period. Similarly, companies whose shares are listed on the stock exchange, are required to publish quarterly results to ascertain the profitability and financial position at the end of every 3 months period.

Cost Concept

The cost concept requires that all assets are recorded in the books of accounts at their historical cost/original cost (i.e., purchase price), which includes cost of acquisition, transportation, installation and making the asset ready to use.

Example: On 1 January 2020, Shiva Enterprise, which is into the business of manufacturing detergent powder, purchased an old machinery for ₹5 lakh. An amount of ₹10,000 was spent on transporting the machinery to the factory site. In addition, ₹ 15,000 was spent on repairs for bringing the machinery into running position and ₹25,000 on its installation.

Thus, ₹5,50,000 will be recorded as cost of machinery in the books of accounts on 1 January 2020.

The concept of cost is historical in nature as the purchase price of the machinery ₹5,50,000 was paid on the date of acquisition (in the past), which does not change year after year, though its market value may change. For instance, if the market value of the machinery, due to inflation, goes up to ₹7,00,000, then the increased value will not be recorded.

Top Tip

The historical cost (purchase price) of the machinery ₹5,50,000, however, will be systematically reduced year after year by charging depreciation and the machinery will be shown in the balance sheet at *book value*, i.e. cost minus depreciation till date. Suppose the remaining useful life of the machinery is estimated to be 5 years. Therefore, ₹1,10,000 (₹5,50,000/5) will be charged as depreciation every year for 5 years. Thus, on 31 December 2020, the machinery will shown in the balance sheet at ₹4,40,000 (₹5,50,000 – ₹1,10,000). Similarly, next year on 31 December 2021, the machinery will shown in the balance sheet at ₹3,30,000 (₹5,50,000 – ₹2,20,000) and so on.

Relevance/Implication

Adoption of historical cost brings in objectivity in recording as the cost of acquisition is easily verifiable from the purchase documents.

The market value basis, on the other hand, is not reliable as the value of an asset may change from time to time, making the comparisons between one period to another rather difficult.

Limitations

1. An important limitation of the historical cost basis is that it *does not show the true worth of the business*.
2. It *may lead to hidden profits*. During the period of rising prices, the market value or the cost at which the assets can be replaced are higher than the value at which these are shown in the book of accounts, leading to hidden profits.

Dual Aspect Concept

Dual Aspect concept states that every transaction has a dual or two-fold effect and should, therefore, be recorded at two places. *In other words*, at least two accounts will be involved in recording a transaction.

Examples

1. Ram started business by investing in a sum of ₹ 50,00,000. The amount of money brought in by Ram will result in an increase in the assets (cash) of business by ₹ 50,00,000. At the same time, the owner's equity or capital will also increase by an equal amount. Thus, the two accounts affected by this transaction are cash and capital accounts.
2. Suppose the firm purchased goods worth ₹10,00,000 for cash. This will increase an asset (stock of goods) on the one hand and reduce another asset (cash) on the other.
3. If the firm purchases a machine worth ₹ 30,00,000 on credit from Reliable Industries. This will increase an asset (machinery) on the one hand and a liability (Reliable Industries) on the other.

This type of dual effect takes place in case of all business transactions and is also known as 'duality principle'. The duality principle is commonly expressed in terms of *Fundamental Accounting Equation*, which is as follows :

Assets = Liabilities + Capital

Accounting Equation states that the Assets of a business are always equal to Capital (owners' equity) and Liabilities.

Relevance/Implication

Dual aspect is the foundation or basic principle of accounting. It provides the very basis for recording business transactions into the book of accounts.

- The two-fold effect of each transaction affects in such a manner that the equality of both sides of accounting equation is maintained.
- The two-fold effect in respect of all transactions must be duly recorded in the books of accounts of the business.
- In fact, Dual aspect concept forms the core of *Double Entry System of accounting*.

HOTS

Case-based/Source-based Integrated Questions

Q.1 Shyam Bros. bought a furniture for ₹20,000 on 1 April 2019. The estimated useful life of the furniture is 10 years with zero scrap value at the end. The accountant of the firm charged ₹20,000 from the revenue while preparing the financial statements for the year ended 31 March 2020.

(a) In which financial statement did the accountant show the purchase price of the personal computer?

(b) Was the accountant correct? Give valid reason in support of your answer,

(c) State the basic accounting concept that must be followed by the accountant.

Answer:

(a) The accountant charged the whole amount of purchase price of the furniture ₹20,000 from the revenue and showed it in the Profit and Loss account.

(b) No, the accountant was not correct.

Reason: It will not be fair to charge the whole amount of ₹ 20,000, from the revenue of the year 2019-20. Instead, that part of the furniture which has been consumed or used during the year 2019-20 (i.e. depreciation of ₹2,000) should be charged from the profit and loss account and the remaining amount ₹18,000 should be carried forward to the next years, over its estimated life. Thus, he should charge ₹2,000 every year for 10 years from the profit and loss account. On 31 March 2020, the furniture should be shown in the balance sheet at book value ₹18,000(i.e. cost ₹20,000 – depreciation ₹2,000).

(c) 'Going Concern' Concept must be followed by the accountant, which provides the very basis for showing the value of assets in the balance sheet. The concept of going concern assumes that a business firm would continue to carry out its operations indefinitely, i.e. for a fairly long period of time and would not be liquidated in the foreseeable future.

Q.2 On 1 July 2020 Radhey Enterprises, which is engaged into the manufacturing of paper bowls and plates, purchased an old machinery from Ahmedabad for ₹4,00,000. An amount of ₹20,000 was spent on transporting the machinery to the factory site in Noida. In addition, ₹50,000 was spent on repairs for bringing the machinery into running position and ₹30,000 on its installation. The market value of the machinery purchased was ₹6,00,000 on that date in Noida. The remaining useful life of the machinery is estimated to be 5 years.

(a) At what amount the machinery will be recorded in the books of account on 1 July 2020? Explain the relevant concept of accounting in support of your answer.

(b) State any two limitations of the above concept of accounting.

(c) At what amount the machinery will be shown in the balance sheet as on 31 December 2020? Explain.

(d) What is the limitation of recording assets at their market values?

Answer:

(a) ₹5,00,000 (i.e. cost of acquisition ₹4,00,000 + transportation cost ₹20,000 + repair cost ₹50,000 + installation cost ₹30,000) will be recorded as cost of machinery in the books of accounts on 1 July 2020.

This is based on 'cost concept' of accounting, which requires that all assets are recorded in the books of accounts at their historical cost (i.e., purchase price), which includes cost of acquisition, transportation, installation and making the asset ready to use. Adoption of historical cost brings in objectivity in recording as the cost of acquisition is easily verifiable from the purchase documents.

(b) Limitations:

(i) It does not show the true worth of the business.

(ii) It may lead to hidden profits.

(c) On 31 December 2020, the machinery will shown in the balance sheet at ₹4,50,000.

Explanation:

The historical cost (purchase price) of the machinery ₹5,00,000 will be systematically reduced year after year for 5 years by charging depreciation and the machinery will be shown in the balance sheet at book value, i.e. cost minus depreciation till date. Thus, ₹1,00,000 will be charged as depreciation every year. However, since machinery was purchased on 1 July 2020, depreciation for 6 months will be charged in the year 2020 (from 1 July 2020 to 31 December 2020) i.e. ₹50,000

Thus, on 31 December 2020, the machinery will shown in the balance sheet at ₹4,50,000 (₹5,00,000 – ₹50,000).

Revenue Recognition (Realisation) Concept

Revenue includes the income from the sale of goods and services by an enterprise and other incomes such as rent, commission, interest, royalties, dividends, etc.

The concept of revenue recognition requires that the revenue for a business transaction should be included in the accounting records only when it is recognised (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.**

General Rules of Revenue Recognition

The revenue recognition and receipt of payment are two different aspects.

1. Credit sales are treated as revenue on the date of sales, and not when money is received from the debtor.

For example, Nishtha sold goods on credit on 1 Feb. 2020 and received the payment from the debtor on 1 April 2020. Recognition of revenue of this transaction is 1 Feb. 2020, i.e. the date of sales since the legal right to receive the payment arose on 1 Feb. 2020 itself.

2. For the incomes such as rent, commission, interest, royalties, dividends, etc. revenue is recognised on the basis of time period to which they relate.

For example, rent for the month of March 2020, even if received in April 2020, will be taken into the profit and loss account of the financial year ending March 31, 2020 and not in financial year beginning with 1 April 2020.

Similarly, if interest for April 2020 is received in advance in March 2020, it will be taken to the profit and loss account of the financial year ending 31 March 2021.

Exceptions to the general rule of revenue recognition

1. In case of contracts like construction work, which take long time, say 2-3 years to complete, proportionate amount of revenue, based on the part of contract completed by the end of the period is treated as realised.
2. Similarly, when goods are sold on hire purchase, the amount collected in installments is treated as realised.

HOTS

Case-based/Source-based Integrated Question

Question:

The realisation concept determines when goods sent on credit to customers are to be included in the sales figure for the purpose of computing the profit or loss for the accounting period. Which of the following tends to be used in practice to determine when to include a transaction in the sales figure for the period?

When the goods have been:

(a) dispatched **(b) invoiced**

(c) delivered **(d) paid for**

Give reasons for your answer.

Answer:

(b) invoiced

Reason: According to the revenue recognisation (realisation) concept, revenue is recognised when a legal right to receive it arises. Thus, when the goods are invoiced, it is treated as the transfer of ownership of goods from the seller to the buyer and thus, hence the revenue is recognised since a legal right to receive it arises.

Matching Concept

The process of ascertaining the amount of profit earned (or loss incurred) during a particular period involves deduction of related expenses from the revenue earned during that period.

Profit = Revenues – Expenses

The matching concept emphasises that expenses incurred in an accounting period should be matched with the revenues recognised during the same period.

Rules of Matching Concept

1. The revenues and the expenses incurred to earn these revenues must belong to the same accounting period, while ascertaining the profit or loss of an accounting year.

- Revenue is recognised when a sale is complete or service is rendered rather when cash is received.
- Similarly, an expense is recognised not when cash is paid but when an asset or service has been used to generate revenue. For example, costs like depreciation of fixed asset is divided over the periods during which the asset is used.
- Expenses such as salaries, rent, insurance are recognised on the basis of period to which they relate and not when these are paid.

2. Cost of goods sold must be matched with their sales revenue while ascertaining the profit or loss of an accounting year.

We should not take the cost of all the goods produced or purchased during that period but consider only the cost of goods sold during that year. For this purpose, the cost of unsold goods should be deducted from the cost of the goods produced or purchased.

(Gross) Profit = Sales – Cost of goods sold

Conclusion

The matching concept implies that all revenues earned during an accounting year (whether received during the year or not) and all expenses/costs incurred to earn these revenues related to the current year (whether paid during the year or not) should be taken into account while ascertaining profit or loss for that year.

Full Disclosure Concept

The principle of 'full disclosure' requires that all material and relevant facts concerning financial performance of an enterprise must be fully and completely disclosed in the financial statements and their accompanying Notes to Accounts.

Relevance

1. To help the users to take sound decisions on the basis of the financial information provided.

Financial statements are the basic means of communicating financial information to all interested parties/users. Therefore, it becomes important that the financial statements makes a full, fair and adequate disclosure of all information which is relevant for taking financial decisions.

2. To give a true and fair view of profitability and the state of affairs.

Full disclosure of financial information is to enable the users to make correct assessment about the profitability and financial soundness of the enterprise and help them to take informed decisions.

DO YOU KNOW?

To ensure full disclosure of material accounting information, the Indian Companies Act 2013 has provided a format for the preparation of statement of profit and loss and balance sheet of a company, which needs to be compulsorily adhered to, for the preparation of these statements. The regulatory bodies like SEBI, have also made it mandatory for full disclosure of material accounting information by the companies.

Consistency Concept

Consistency concept states that accounting methods, policies and practices followed by a business enterprise should be uniform and consistent over a period of time so that results are comparable.

Relevance

The accounting information provided by the financial statements would be useful in drawing conclusions regarding the working of an enterprise only when it allows comparisons over a period of time as well as with the working of other enterprises. Thus, both *inter-firm* and *inter-period* (intra-firm) comparisons are required to be made. This can be possible only when accounting methods, policies and practices followed by enterprises are uniform and are consistent over the period of time.

Example: An investor wants to know the financial performance of an enterprise in the current year as compared to that in the previous year. He may compare this year's net profit with that in the last year. But, if the accounting policies adopted, say with respect to depreciation in the two years are different, the profit figures will not be comparable. Because the method adopted for charging depreciation in the past two years is inconsistent. It is, therefore, important that the concept of consistency is followed in preparation of financial statements so that the results of two accounting periods are comparable.

Top Tip

Consistency concept does not prohibit change in accounting policies. Necessary required changes are fully disclosed by presenting them in the financial statements indicating their probable effects on the financial results of business.

HOTS

Case-based/Source-based Integrated Question

Question:

Ruchica's father is the sole proprietor of 'Friends Gifts', a firm engaged in the sale of gift items. In the process of preparing financial statements, the accountant of the firm Mr. Goyal fell ill and had to proceed on leave. Ruchica's father was urgently in need of the statements as these had to be submitted to the bank, in pursuance of a loan of ₹ 5 lakh applied for the expansion of the business of the firm. Ruchica who is studying Accounting in her school, volunteered to complete the work. On scrutinising the accounts, the banker found that the value of building bought a few years back for ₹ 7 lakh has been shown in the books at ₹ 20 lakh, which is its present market value. Similarly, as compared to the last year, the method of valuation of stock was changed, resulting in value of goods to be about 15 per cent higher. Also, the whole amount of ₹ 70,000 spent on purchase of personal computer (expected life 5 years) during the year had been charged to the profits of the current year. The banker did not rely on the financial data provided by Ruchica.

Advise Ruchica for the mistakes committed by her in the preparation of financial statements in the context of basic concepts in accounting.

Answer:

The mistakes committed by her in the preparation of financial statements are as follows:

(i) "*The value of building bought a few years back for ₹ 7 lakh was shown in the books at ₹ 20 lakh, which is its present market value.*"

The 'Cost' concept was not followed here. The cost concept requires that all assets are recorded in the books of accounts at their historical cost (i.e., purchase price), which includes cost of acquisition, transportation, installation and making the asset ready to use. The market value basis is not reliable as the value of an asset may change from time to time, making the comparisons between one period to another rather difficult.

(ii) "*As compared to the last year, the method of valuation of stock was changed, resulting in value of goods to be about 15 per cent higher.*"

The 'Consistency' concept was not followed here. Consistency concept states that accounting methods, policies and practices followed by a business enterprise should be uniform and consistent over a period of time so that results are comparable.

(iii) " *The whole amount of ₹ 70,000 spent on purchase of personal computer (expected life 5 years) during the year had been charged to the profits of the current year.*"

The 'Going concern' concept was not followed here. It was not be fair to charge the whole amount of ₹ 70,000, from the revenue of the current year. Instead, that part of the computer which has been consumed or used during the current year (i.e. depreciation of ₹14,000) should be charged from the profit and loss account and the remaining amount ₹56,000 should be carried forward to the next years, over its estimated life.

Conservatism/Prudence Concept

The concept of conservatism (also called '*prudence*' principle) requires that profits/gains should not be recorded in the books of accounts until realised, but all losses (even those which may have a remote possibility) must be provided for in the books of accounts.

The objective of conservatism/prudence concept is to adopt a conscious approach in ascertaining income so that profits of the enterprise are not overstated.

Examples of the application of the principle of Conservatism/Prudence:

1. Closing stock (inventory) is valued at cost or market value whichever is lower.

For example, if the cost price of the goods purchased is ₹10 per unit and the market price is ₹12 per unit, then the closing stock will be valued @₹10 per unit.

- If market value of the goods purchased has fallen down, the loss must be recorded in the books of accounts. So, the closing stock will be shown at the reduced market value.
- But if the market value has gone up, the gain must not be recorded until the stock is sold. So, the closing stock will be **shown at cost price.**

This approach of providing for the losses but not recognising the gains until realised is called 'conservatism' approach.

2. Creating provision for bad and doubtful debts

Doubtful debts are those debtors who may pay but business firm is not sure about the collection of full amount from them. Some debtors are not likely to pay, hence treated as doubtful debts.

It is necessary to take into account such an expected loss while calculating true and fair profit/loss according to the principle of Prudence or Conservatism. Therefore, provision for bad debts or provision for doubtful debts is created.

Key Term

Bad Debt: The debtors from whom amounts cannot be recovered are treated in the books of accounts as bad and are termed as 'bad debts'.

3. Creating provision for discount on debtors

Cash discount is allowed to customers to encourage them to make prompt payment. The discount likely to be allowed to customers in an accounting year can be estimated and provided for by creating a provision for discount on debtors according to the principle of Prudence or Conservatism.

Top Tip

The concept of conservatism (also called 'prudence') provides guidance for recording transactions in the book of accounts and is based on the policy of playing safe. This may be reflecting a generally pessimist attitude adopted by the accountants but is an important way of dealing with uncertainty.

DO YOU KNOW?

The Conservatism/Prudence concept states that a conscious approach should be adopted in ascertaining income so that profits of the enterprise are not overstated. However, deliberate attempt to underestimate the value of assets should be discouraged as it will lead to hidden profits, called **secret reserves**.

HOTS Case-based/Source-based Integrated Question

Question:

A customer has filed a suit against a trader who has supplied poor quality goods to him. It is known that the court judgment will be in favour of the customer and the trader will be required to pay the damages. However, the amount of legal damages is not known with certainty. The accounting year has already been ended and the books are now finalised to ascertain true profit or loss.

The accountant of the trader has advised him not to consider the expected loss on account of payment of legal damages because the amount is not certain and the final judgment of the court is not yet out.

Do you think the accountant is right in his approach? Give valid reason in support of your answer.

Answer:

No, the accountant's advice to the trader – "*not to consider the expected loss on account of payment of legal damages because the amount is not certain and the final judgment of the court is not yet out*" is not justified.

Reason: Conservatism/Prudence concept is not followed by the accountant.

The concept of conservatism (also called 'prudence' principle) requires that profits/gains should not be recorded in the books of accounts until realised, but all losses (even those which may have a remote possibility) must be provided for in the books of accounts.

This concept provides guidance for recording transactions in the books of accounts and is based on the policy of playing safe. This may be reflecting a generally pessimist attitude adopted by the accountants but is an important way of dealing with uncertainty.

Materiality Concept

All information about material facts should be disclosed through the financial statements (Income Statement and Balance Sheet) and the accompanying Notes to Accounts, so that users can take relevant decisions. However, efforts should not be wasted in recording and presenting facts, which are immaterial in the determination of income.

The question that arises here is what is a material fact.

The materiality of a fact depends on its nature and the amount involved.

1. Nature of information – whether or not it would influence the decision of users of financial statements.

For example, money spent on creation of additional capacity of a theatre would be a material fact as it is going to increase the future earning capacity of the enterprise. Similarly, information about any change in the method of depreciation adopted or any liability which is likely to arise in the near future would be significant information.

2. The amount involved

In certain cases, when the amount involved is very small, strict adherence to full disclosure principle is not required. *For example*, stock of erasers, pencils, scales, etc. are not shown as assets. Whatever amount of stationery is bought in an accounting year is treated as the expense of that period, whether consumed or not. The amount spent on stationery is treated as revenue expenditure and taken to the profit and loss account.

Objectivity Concept

The concept of objectivity requires that accounting transactions should be recorded in an objective manner, free from the bias of accountants and others. This can be possible when every transaction is supported by verifiable documents or vouchers.

For example, the transaction for the purchase of materials may be supported by the cash receipt for the money paid, if the same is purchased on cash or copy of invoice and delivery challan, if the same is purchased on credit. Similarly, receipt for the amount paid for purchase of a machine becomes the documentary evidence for the cost of machine and provides an objective basis for verifying this transaction.

Top Tip

One of the reasons for the adoption of 'Historical Cost' as the basis of recording accounting transaction is that adherence to the principle of objectivity is made possible by it. The cost actually paid for an asset can be verified from the documents but it is very difficult to ascertain the market value of an asset until it is actually sold. Not only that, the market value may vary from person to person and from place to place, and so 'objectivity' cannot be maintained if market value is adopted for accounting purposes.

HOTS

Case-based/Source-based Integrated Questions

Q.1 Fill up the blanks with the correct 'Basic Accounting Concepts':

(i) If a firm believes that some of its debtors may 'default', it should act on this by making sure that all possible losses are recorded in the books. This is an example of the ___________ concept.

(ii) The fact that a business is separate and distinguishable from its owner is best exemplified by the ___________ concept.

(iii) The ___________ concept states that if straight line method of depreciation is used in one year, then it should also be used in the next year.

(iv) A firm may hold stock which is heavily in demand. Consequently, the market value of this stock may be increased. Normal accounting procedure is to ignore this because of the ___________.

(v) If a firm receives an order for goods, it would not be included in the sales figure owing to the ___________.

(vi) The management of a firm is remarkably incompetent, but the firms accountants can not take this into account while preparing book of accounts because of ___________ concept.

Answer:

(i) Conservatism/Prudence

(ii) Business Entity

(iii) Consistency

(iv) Conservatism/Prudence Concept

(v) Revenue Recognition(Realisation) Concept

(vi) Money Measurement

Q.2 Fill up the blanks with the correct 'Basic Accounting Concepts':

(i) Recognition of expenses in the same period as associated revenues is called _______________concept.

(ii) The accounting concept that refers to the tendency of accountants to resolve uncertainty and doubt in favour of understating assets and revenues and overstating liabilities and expenses is known as _______________.

(iii) Revenue is generally recongnised at the point of sale denotes the concept of _______________.

(iv) The _______________concept requires that the same accounting method should be used from one accounting period to the next.

(v) The_______________concept requires that accounting transaction should be free from the bias of accountants and others.

(vi) Everything a firm owns, it also owns out to somebody. This co-incidence is explained by the ___________ concept.

Answer:

(i) Matching

(ii) Conservatism/Prudence Concept

(iii) Revenue Recognition(Realisation)

(iv) Consistency

(v) Objectivity

(vi) Dual aspect

Objective Type Questions 1.4

1. During the life-time of an entity accounting produces financial statements in accordance with which basic accounting concept: *(Choose the correct alternative)*
   (a) Conservation
   (b) Matching
   (c) Accounting period
   (d) None of the above
2. The concept that a business enterprise will not be sold or liquidated in the near future is known as : *(Choose the correct alternative)*
   (a) Going concern
   (b) Economic entity
   (c) Monetary unit
   (d) None of the above
3. "Revenue is recognized when sale is made or service is rendered rather than cash is received" is based on ______________________. *(Choose the correct alternative)*
   (a) Going concern assumption
   (b) Matching Principle
   (c) Prudence Principle
   (d) Materiality Principle
4. Every business transaction has two aspects - a debit and a credit of equal amount is based on ___________. *(Choose the correct alternative)*
   (a) Dual Aspect Principle
   (b) Matching Principle
   (c) Accrual assumption
   (d) Full disclosure Principle
5. Transactions are recorded, analyzed and financial statement are prepared from business point of view and not the owner is based on _______________. *(Choose the correct alternative)*
   (a) Accrual assumption
   (b) Consistency assumption
   (c) Accounting Period Principle
   (d) Business entity Concept
6. "It is assumed that the business has neither intention to liquidate nor to scale down its operations significantly". The accounting concept highlighted above is _______________. *(Fill up the blank with appropriate words)*
7. ________________ concept takes into account all prospective losses but leaves all prospective profits. *(Fill up the blank with appropriate words)*
8. Match the following:

Statement	**Accounting concept**
(a) The calibre and quality of the manager is not disclosed in the balance sheet.	(i) Cost concept
(b) Advance received from customers is not taken as income or sales.	(ii) Revenue recognition concept
(c) Assets are recorded in books at the cost incurred for acquisition of such assets.	(iii) Accrual concept
(d) Revenue must be recorded when it is realised and expenses are recorded when incurred.	(iv) Money measurement

9. A business for which financial statements are prepared is separate and distinct from the owner of the entity. The accounting concept highlighted above is ___________. *(Fill up the blank with appropriate words)*

10. It is assumed that the business organisation will remain in business for and indefinite period of time. The accounting concept highlighted above is __________. *(Fill up the blank with appropriate words)*

11. Production manager of the company is interested to reflect the good industrial relations in account. The accounting concept violated is __________. *(Fill up the blank with appropriate words)*

12. A debtor who owes an amount to the firm is likely to be declared insolvent. The accountant makes provision for doubtful debt in the book of account. The accounting concept highlighted here is __________.

(Fill up the blank with appropriate words)

13. ____________ 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. *(Fill up the blank with appropriate words)*

14. Match the following:

(a) A general law or rule adopted or professed as a guide to action, a settled ground or basis of conduct or practice	(i) Concept
(b) Custom or traditions as a guide to the preparation of accounting statements.	(ii) Convention
(c) Assumptions and ideas which are fundamental to accounting practice.	(iii) Principle

15. As the change in the value of money is not reflected in the books of accounts, the accounting data does not reflect the true an fair view of the affairs of an enterprise.

The above statement is a limitation of ______________ assumption. *(Fill up the blank with appropriate words)*

16. ________________ assumption provides the very basis for showing the value of assets in the balance sheet.

(Fill up the blank with appropriate words)

17. Shonali bought a refrigerator for ₹40,000 for use in her business. The estimated useful life of the refrigerator is 10 years. The accountant should charge ___________ every year for 10 years from the ___________ because of the assumption of _____________. *(Fill up the blanks with appropriate words)*

18. Match the following:

Statement	**Basic Accounting concept**
(a) The financial statements are prepared at regular interval, normally after a period of one year, so that timely information is made available to the users.	(i) Business Entity concept
(b) Image of the organisation and creativity of its research department do not find a place in the accounting records of a firm.	(ii) Money measurement concept
(c) A business would continue to carry out its operations for a fairly long period of time and would not be liquidated in the foreseeable future.	(iii) Going Concern concept
(d) Personal transactions of the owner are not recorded in the books of the business, unless it involves inflow or outflow of business funds.	(iv) Accounting Period Concept

19. Financial statements of a business entity are always prepared annually. *True/False? Give reason.*

20. Interest on capital is treated as expense like any other business expense because of the ___________ concept.

(Fill up the blank with appropriate words)

21. Non- monetary events like death of any employee/manager, strikes, disputes, lockdowns, etc. are not recorded at all, even though these also affect the business operations significantly.

The basic accounting concept followed is _______________. *(Fill up the blank with appropriate words)*

22. _______________ is defined as interval of time, at the end of which the profit and loss account and balance sheet are prepared, so that the performance is measured at regular intervals and decisions can be taken at the appropriate time.

(Fill up the blank with appropriate words)

23. The concept of cost is historical in nature. *True/False? Give reason.*

24. Adoption of historical cost brings in objectivity in recording as _______________ (Complete the sentence)

25. _____________ concept is the foundation or basic principle of accounting and forms the core of Double Entry System of accounting.

26. Dual aspect concept holds that every transaction will be recorded in two accounts only. *True/False? Give reason.*

27. Revenue is assumed to be recognised (realised): *(Choose the correct alternative)*
    (a) When a legal right to receive it arises.
    (b) When the cash is received.
    (c) At the point of time when goods have been sold or service has been rendered.
    (d) Both (a) and (c)

28. Revenue is treated to be realised in case of credit sales _____________. (on the date of sales/when money is received from the debtor) *(Fill up the blank with appropriate words)*

29. Incomes such as rent, commission, etc. are recognised on the basis of _______________.
(Fill up the blank with appropriate words)

30.Rent for the month of March 2020 is received in April 2020. Rental income will be taken into the _____________ of the financial year ending _____________. *(Fill up the blanks with appropriate words)*

31. Interest for April 2020 is received in advance in March 2020, it will be taken to the ______________ of the financial year ending ______________. *(Fill up the blanks with appropriate words)*

32. An expense is recognised when _____________ (cash is paid/an asset or service has been used to generate revenue)
(Fill up the blank with appropriate words)

33. An expense is recognised not when cash is paid but when an asset or service has been used to generate revenue. Give an example of this.

34. The process of ascertaining the amount of profit earned (or loss incurred) during a particular period involves deduction of related expenses from the revenue earned during that period.
    Which of the following basic accounting concept emphasises exactly the above aspect? *(Choose the correct alternative)*
    (a) Accounting Period Concept
    (b) Matching Concept
    (c) Dual Aspect Concept
    (d) Conservatism Concept

35. The _____________ concept states that expenses incurred in an accounting period should be match with revenues during that period. (Matching/Accounting period) *(Fill up the blank with appropriate words)*

36. The revenues and the expenses incurred to earn these revenues must belong to the same accounting period, in order to ascertain profit (or loss) for that accounting period.
    The basic accounting concept highlighted above is _____________. *(Fill up the blank with appropriate words)*

37. The _____________ concept implies that all revenues earned during an accounting year (whether received during the year or not) and all expenses/costs incurred to earn these revenues related to the current accounting year (whether paid during the year or not) should be taken into account while ascertaining profit or loss for that year.
(Fill up the blank with appropriate words)

38. Expenses such as salaries, rent, insurance, etc. are recognised on the basis of _______________. (payment of these expenses/time period to which they related) *(Fill up the blank with appropriate words)*

39. While ascertaining the profit or loss of an accounting year, we should not take the cost of all the goods produced or purchased during the year but consider only the cost of goods sold during that year. For this purpose, the cost of unsold goods should be deducted from the cost of the goods produced or purchased.
    The basic accounting concept highlighted above is _____________. *(Fill up the blank with appropriate words)*

40. The financial statements should act as a means of conveying the information, and not concealing the material and relevant information.
    The basic accounting principle highlighted above is _____________. *(Fill up the blank with appropriate words)*

41. Why is full disclosure of all material and relevant facts important? *(Choose the correct alternative)*
    (a) To give a true and fair view of profitability and the state of affairs.
    (b) To help the users to take sound decisions on the basis of the financial information provided.
    (c) Both (a) and (b)
    (d) To make inter-firm and inter-period comparisons.
42. _____________ eliminates personal bias and helps in achieving results that are comparable. (Consistency/Matching) *(Fill up the blank with appropriate words)*
43. The concept of _____________ provides guidance for recording transactions in the books of accounts and is based on the policy of playing safe. This reflects a pessimist attitude adopted by the accountants. *(Fill up the blank with appropriate words)*
44. Deliberate attempt to underestimate profits will lead to hidden profits, called _____________. *(Fill up the blank with appropriate words)*
45. The approach of providing for the losses but not recording profit/gains until realised is called _____________ approach. *(Fill up the blank with appropriate words)*
46. Which of the following is not an example of the application of the principle of conservatism? *(Choose the correct alternative)*
    (a) Creating provision for doubtful debts
    (b) Creating provision for discount on debtors
    (c) Writing off intangible assets like goodwill, patents, etc. from the books of accounts
    (d) None of the above
47. Closing stock is valued at: *(Choose the correct alternative)*
    (a) Cost (b) Market value
    (c) Cost or market value whichever is lower (d) Cost or market value whichever is higher
48. If the market value of the goods purchased has fallen down the will be shown at __________ in the books. *(Fill up the blank with appropriate words)*
49. If the market value of the goods purchased has gone up due to inflation, the gain is __________ (recorded/not recorded) in the books of accounts until the stock is sold; and the stock is shown at ___________ (cost/market value). *(Fill up the blank with appropriate words)*
50. Valuing closing inventory at cost or market value whichever is lower is an example of ____________ concept of accounting. *(Fill up the blank with appropriate words)*
51. Stock of erasers, pencils, scales, etc. are not shown as assets. Whatever amount of stationery is bought in an accounting year is treated as the expense of that period, whether consumed or not. The amount spent of stationery is treated as ___________ and taken to ___________. The accounting concept followed here is ___________. *(Fill up the blanks with appropriate words)*
52. The concept of _____________ requires that accounting should focus on material facts. *(Fill up the blank with appropriate words)*
53. According to the Materiality Concept, the materiality of a fact depends on (i)____________ and (ii)_____________. *(Fill up the blanks with appropriate words)*
54. The materiality of a fact depends on its nature and the amount involved. In certain cases, when the amount involved is very small, strict adherence to ______________ principle is not required. *(Fill up the blank with appropriate words)*
55. The concept of ___________ requires that accounting transactions should be recorded in an objective manner, free from the bias of accountants and others. This can be possible when every transaction is supported by verifiable documents or vouchers. *(Fill up the blank with appropriate words)*
56. One of the reasons for the adoption of _____________ as the basis of recording accounting transaction is that adherence to the principle of objectivity is made possible by it. *(Fill up the blank with appropriate words)*

Systems of Accounting – Double Entry and Single Entry

The systems of recording transactions in the books of accounts are generally classified into two types:

(i) Double entry system, and
(ii) Single entry system.

Differences between 'Double Entry System of Accounting' and 'Single Entry System of Accounting'

Double Entry System of Accounting	Single Entry System of Accounting
It is based on the principle of "Dual Aspect" which states that every transaction has two-fold effects, viz. receiving of a benefit and giving of a benefit. Each transaction, therefore, involves two or more accounts and is recorded at different places in the **ledger**. The basic principle followed is that every **debit** must have a corresponding **credit**. Thus, one account is debited and the other is credited.	Single entry system is not a complete system of maintaining records of financial transactions. It does not record two-fold effect of each and every transaction. For some transactions, only one aspect is recorded, for others, both the aspects are recorded. Instead of maintaining all the accounts, only personal accounts and **cash book** are maintained under this system.
The Double entry system is accurate and more reliable as the possibilities of frauds and mis-appropriations are minimised.	The accounts maintained under this system are incomplete and unsystematic and therefore, not reliable.
The arithmetic inaccuracies in records can mostly be checked by preparing the **trial balance**.	Since it does not record two-fold effects of each and every transactions, therefore, trial balance cannot be prepared.
The system of double entry can be implemented by big as well as small organisations.	The system is followed by small business firms as it is very simple and flexible. Moreover, it is an inexpensive mode of maintaining records. Cost involved is low as specialised accountants are not appointed by the organisations.

Key Terms

Ledger: It is the principal book of accounting system. It contains different accounts where business transactions are recorded. *(You will learn to prepare ledger accounts in detail in chapter 2.)*
Debit and Credit: In accounting, the terms 'Debit' and 'Credit' indicate whether the transactions are to be recorded on the left hand side or right hand side of the account. In an account, the left hand side is called 'Debit' (often abbreviated as Dr.) and the right hand side is known as 'Credit' (often abbreviated as Cr.). *(You will learn the rules of debit and credit in chapter 2.)*
Cash Book: Cash Book is a book in which all transactions related to cash receipts and cash payments are recorded. *(You will learn to prepare a cash book in detail in chapter 2.)*
Trial Balance: A trial balance is a statement showing the balances, or totals of debits and credits, of all the accounts in the ledger with a view to verify the arithmetical accuracies in records. In a trial balance, the sum of debit balances equal the sum of credit balances. If they do not tally, it indicates that there is/are some error(s).
(You will learn to prepare a trial balance in detail in chapter 6.)

Top Tip

Double entry system of accounting is a complete system as both the aspects of a transaction are recorded in the book of accounts. Recording of accounting transactions follows 'Double entry system of accounting'.

Basis of Accounting – Cash Basis and Accrual Basis

From the point of view the timing of recognition of revenue and expenses/costs, there can be two broad approaches to accounting. These are:

(i) Cash basis of accounting; and

(ii) Accrual basis of accounting.

Differences between 'Cash basis of accounting' and 'Accrual basis of accounting'

Cash basis of accounting	Accrual basis of accounting
Under the cash basis of accounting, transactions are recorded in the books of accounts only when cash is received or paid and not when the receipt or payment becomes due. *For example,* if office rent for the month of December 2020 is paid in January 2021, it will be recorded in the books of accounts only in January 2021.	Under the accrual basis of accounting, revenues and expenses/costs are recognised in the period in which they occur, irrespective of whether cash is received/paid or not. A distinction is made between (i) the receipt of cash and the right to receive cash, and (ii) payment of cash and legal obligation to pay cash.
Cash basis of accounting is contrary to the matching principle, which states that the revenue of a period is matched with the cost of the same period.	Accrual basis of accounting is compatible with the matching principle. *For example,* raw material consumed are matched against the cost of goods sold.
Cash basis of accounting is inappropriate for most organisations as profit is calculated as the difference between cash receipts and cash payments for the given period rather than on happening of the transactions.	Accrual basis of accounting is a more appropriate basis for the calculation of profits as expenses are matched against revenue earned in relation thereto.
Under cash basis of accounting, adjustments for outstanding expenses and accrued incomes are not recorded as these are non-cash items.	It shows a complete picture of financial transaction as it records outstanding and prepaid expenses, accrued and unearned incomes, assets and liabilities.
The accounting process is simple; and does not require much skills.	The accounting process is more elaborate and more complicated; and requires adequate skills.

Top Tip

Accrual basis of accounting is a better basis of accounting than the cash basis as it gives a true and fair view of profit or loss and the financial position of a business enterprise.

DO YOU KNOW?

Under the Companies Act 2013, it is mandatory for all companies to maintain the books of accounts according to the 'Accrual basis' of accounting.

Accounting Standards – IFRS and Ind AS

Accounting Standards (AS): Meaning and Objectives

Meaning of Accounting Standards

Accounting Standards are written policy documents covering the aspects of recognition, measurement, treatment, presentation and disclosure of accounting transactions in financial statements.

- Accounting Standard is an authoritative statement issued by The Institute of Chartered Accountant of India (ICAI), a professional body of accounting in our country.
- Accounting Standards may call for disclosure of certain information which may not be required by law, but such information may be useful for general public, investors and creditors. Accounting Standards, however, cannot override the provisions of applicable laws, customs, usages and business environment in the country.

Definition of Accounting Standards

Accounting Standards are written statements of uniform accounting rules and guidelines in practice for preparing the uniform and consistent financial statements.

Objectives of Accounting Standards

1. To bring uniformity in different accounting policies in order to eliminate non-comparability of financial statements for enhancing reliability of financial statements.

2. To eliminate variations in accounting treatment to prepare financial statements by providing a set of standard accounting policies, valuation norms and disclosure requirements.

3. To enhance comparability of financial statements, both inter-firm and intra-firm (inter-period)comparisons. Such comparisons are very effective and widely used for assessment of firm's performance by the users of accounting.

DO YOU KNOW?

Applicability of Accounting Standards

Except the purely charitable organisation which does not have any commercial, industrial and business activity, accounting standard is applicable to:

1. Sole proprietorship concern	2. Partnership firm	3. Societies	4. Trusts
5. Hindu undivided family business	6. Association of persons	7. Cooperative societies	8. Companies

International Financial Reporting Standards (IFRS)

International Financial Reporting Standards (IFRS) is a set of accounting standards developed by an independent, not-for-profit organisation called the International Accounting Standards Board (IASB).

- IFRS are designed as a common global language for business affairs so that company accounts are understandable and comparable across international boundaries.
- IFRS are based on sound and clearly stated principles, from which interpretation is necessary. Therefore, IFRS are referred to as *principles-based accounting standards*.

Need for IFRS

1. IFRS help in synchronisation of accounting standards across the globe. Unless accounting activities are regulated, different countries will apply different set of accounting rules and regulations. This will restrict uniformity and comparability of financial statements.

2. IFRS create comparable, reliable, and transparent financial statements by helping to prevent to prevent material manipulation or errors in financial statements.

3. IFRS facilitate global investments by contributing to the free flow of cross-border capital raising funds.

Indian Accounting Standards (Ind AS): Applicability

The Ind AS are basically accounting standards that have been harmonised with the IFRS to make reporting by Indian companies more globally accessible.

Ind AS are often referred to as *rule-based accounting standards*.

Top Tip

In substance, Ind AS is not different from IFRS. But the name of this IFRS has been converged as Ind AS.

Applicability of Ind AS

The Ministry of Corporate Affairs (MCA), in 2015, had notified the Companies (Indian Accounting Standards(Ind AS)) Rules 2015, which stipulated the adoption and applicability of Ind AS in a phased manner beginning from the accounting period 2016-17. Thus, MCA notified a phase-wise convergence to Ind AS from current accounting standards.

Phase I

Mandatory applicability of Ind AS to all companies from 1st April 2016 (whether it is listed company or unlisted company), provided its *Net worth is greater than or equal to ₹500 crore.

**Net worth shall be checked for the previous three financial years (2013-14, 2014-15 and 2015-16)*

Phase II

Mandatory applicability of Ind AS to all companies from 1st April 2017, provided:

- It is a listed company or is in the process of being listed (as on 31 March 2016).
- Its ***Net worth is greater than or equal to ₹250 crore but less than ₹500 crore.**

**Net worth shall be checked for the previous four financial years (2013-14, 2014-15, 2015-16 and 2016-17)*

Phase III

Mandatory applicability of Ind AS to all Banks, Non-Banking Finance Companies (NBFCs), and Insurance Companies from 1st April 2018 whose Net worth is more than or equal to ₹500 crore with effect from 1st April 2018.

Phase IV

Mandatory applicability of Ind AS to all NBFCs from 1st April 2019 whose Net worth is more than ₹250 crore but less than ₹500 crore.

Ind AS and Existing Accounting Standards – *A List for Comparative Analysis*

Ind AS	Title	AS	Title
1	Presentation of Financial Statements	1 —	Disclosure of accounting policies Framework for preparation and presentation of financial statements
2	Inventories	2	Valuation of inventories

7	Cash Flow Statements	**3**	Cash Flow Statements
8	Accounting Policies, Changes in Accounting Estimates and Errors	**5**	Net profit or loss for the period, prior period items and changes in accounting policies
10	Events after the Balance Sheet Date	**4**	Contingencies and events occurring after the balance sheet date
11	Construction Contracts	**7**	Construction Contracts
12	Income Taxes	**22**	Accounting for taxes on income
16	Property, Plant and Equipment	**10** **6**	Accounting for fixed assets Depreciation accounting
17	Leases	**19**	Leases
18	Revenue	**9**	Revenue recognition
19	Employee Benefits	**15**	Employee Benefits
20	Accounting for Government Grants and Disclosure of Government Assistance	**12**	Accounting for government grants
21	The Effects of Changes in Foreign Exchange Rates	**11**	The Effects of Changes in Foreign Exchange Rates
23	Borrowing Costs	**16**	Borrowing Costs
24	Related Party Disclosures	**18**	Related Party Disclosures
27	Consolidated and Separate Financial Statements	**21**	Consolidated Financial Statements
28	Investments in Associates	**23**	Accounting for Investment in Associates in CFS
29	Financial Reporting in Hyper-inflationary Economics	**—**	
31	Interests in Joint Ventures	**27**	Financial reporting of interest in joint venture
32	Financial Instruments: Presentation	**31**	Financial Instrument: Presentation
33	Earnings Per Share	**20**	Earnings Per Share
34	Interim Financial Reporting	**25**	Interim Financial Reporting
36	Impairment of assets	**28**	Impairment of assets
37	Provisions, contingent liabilities and contingent assets	**29**	Provisions, contingent liabilities and contingent assets
38	Intangible assets	**30**	Intangible assets
39	Financial instruments: Recognition and measurement	**13**	Financial instruments: Recognition and measurement
40	Investment property	**13**	Accounting for investments
101	First time adoption of international financial reporting standards	**—**	
102	Share-based payments	**—**	G.N. on employee share based payment
103	Business combinations	**14**	Accounting for amalgamations
104	Insurance Contracts	**—**	
105	Non-current Assets held for Sale and Discontinued Operations	**24** **—**	Discontinuing Operation
106	Exploration for and Evaluation of Mineral Resources	**—**	
107	Financial Instruments: Disclosures	**32**	Financial Instruments: Disclosures
108	Operating Segments	**17**	Segment Reporting

Goods and Services Tax (GST)

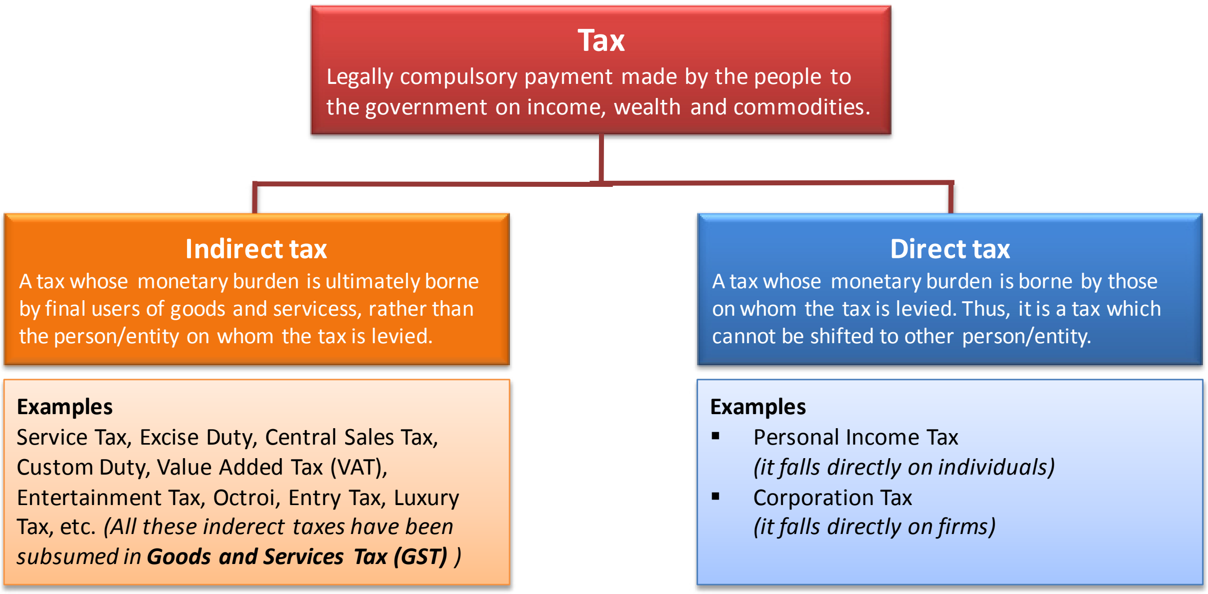
The Parliament passed a law, Goods and Services Tax Act, 2016, to simplify and introduce a unified indirect tax system in India. This law came into effect from 1 July, 2017.

Definition

GST is a destination based tax on consumption of goods and services levied at all stages right from manufacturer up to final consumption with credit of taxes paid at previous stages available as set off.

Objective

The objective of GST is to create 'one nation, one tax and one market'; to reduce tax evasion; and to generate additional revenue for the government.



Characteristics

1. GST is the single comprehensive indirect tax on supply of goods and services, right from the manufacturer/service provider to the final consumer.

GST has amalgamated a large number of central and state taxes

- The Central taxes like excise duty, service tax, custom duty, central sales tax, etc. have been subsumed under GST.
- The State taxes like Value Added Tax (VAT), Entry Tax, Luxury Tax, Octroi, etc. have been merged with GST.

Thus, introduction of GST has resulted in the abolition of multiple types of indirect taxes on goods and services.

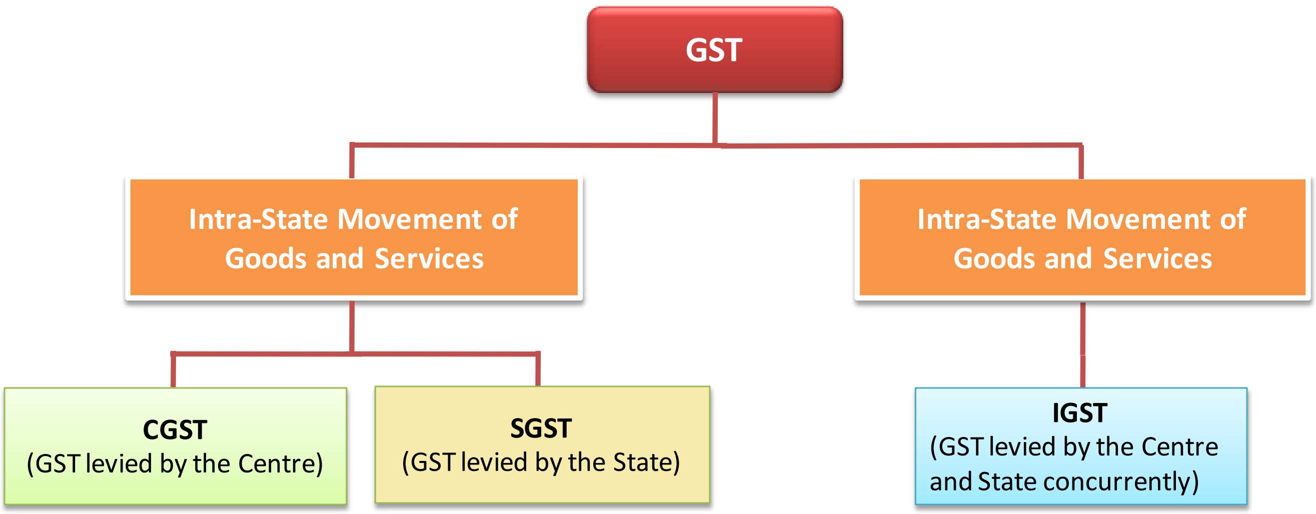
2. GST is applicable throughout the country with one rate for one type of goods/services.

- There are five tax slabs under GST, i.e. 0% (for essentials), 5%, 12%, 18% and 28% on supply of all goods and services across the country.
- GST is levied and collected on both goods and services at the same rate. Thus, it integrates goods and services into one unified indirect tax system in India. Earlier, goods and services were taxed differently.

3. GST is a destination based consumption tax with benefit of Input Tax Credit in the supply chain.

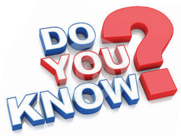
- The concept of destination based consumption tax' implies that the tax would accrue to the taxing authority which has jurisdiction over the place of consumption which is also termed as place of supply.
- Benefit of 'Input Tax Credit' in the supply chain implies that though GST is levied at every stage of the production process, but is refunded to all parties in the chain of production other than the final consumer. In a nutshell, only value addition will be taxed; and burden of tax is to be borne by the final consumer.

4. GST has three main components which are CGST, SGST and IGST.



(i) **CGST** means **Central Goods and Services Tax**, i.e. GST levied by the Central Government. Taxes collected under CGST will constitute the revenues of the Central Government.

(ii) **SGST** means **State Goods and Services Tax**, i.e. GST levied by the State Government. A collection of SGST is the revenue of the State Government.



Dual GST – The Centre and States simultaneously levying GST

India is a federal country where both the Centre and the States have been assigned the powers to levy and collect taxes through appropriate legislation. Both the levels of government have distinct responsibilities to perform according to the division of powers prescribed in the Constitution for which they need to rise resources. A dual GST will, therefore, be in keeping with the Constitutional requirement of fiscal federalism. Hence, Centre will levy and administer CGST & IGST while respective states will levy and administer SGST. The Constitution of India has been amended for this purpose.

Both CGST and SGST are levied on intra-state supply of goods and services (i.e. movement of goods/ services within the State) at 50% of the prescribed GST rate.

For example, Gopal, a dealer in Punjab sells goods to Balram in Punjab worth ₹10,000. If the GST rate is 18%, then 9% CGST (₹900) will go to the Central Government and 9% SGST (₹900) will go to the Punjab State Government.

Top Tip

GST under supply of goods and services taking place in Union Territories (UT) like Andaman and Nicobar Islands, Chandigarh, Delhi (National Capital Territory of Delhi), Lakshadweep, Puducherry, etc. is accounted under UTGST, instead SGST along with CGST.

(iii) **IGST** means **Integrated Goods and Services Tax**, i.e. GST levied by the Central Government and State Governments concurrently.

IGST is levied on inter-state supply of goods and services (i.e. movement of goods/services outside the state).

Revenue collected under IGST will entirely go to the Central Government.

For example, If Umesh in Uttar Pradesh sells goods to Rehan in Rajasthan worth ₹1,00,000 and applicable GST rate is 12% then the dealer will charge ₹12,000 as IGST that will go to the Central Government alone.

Top Tip

Imports of goods and services are also covered under IGST.

5. GST paid is set off against GST collected, called 'Input Tax Credit'.

- GST paid is categorised into Input CGST, Input SGST and Input IGST.
- GST collected is categorised into Output CGST, Output SGST and Output IGST.

GST paid is set off against GST collected in the prescribed order as given below:

(i) Input IGST is first set off against Output IGST, then against Output CGST and then against Output SGST, if required.

(ii) Input CGST is first set off against Output CGST and then against Output IGST, if required.

(iii) Input SGST is first set off against Output SGST and then against Output IGST, if required.

Input IGST	Input CGST	Input SGST
↓	↓	↓
Set off against the following in the order: (i) Output IGST (ii) Output CGST (iii) Output SGST	Set off against the following in the order: (i) Output CGST (ii) Output IGST	Set off against the following in the order: (i) Output SGST (ii) Output IGST

HOTS
Case-based/Source-based Integrated Question

Question:

State how the GST will be applicable if CGST is 9%, SGST is 9% and IGST 18% in each of the following situations:

(i) Goods worth ₹ 10,000 is sold by a Manufacturer 1 in Maharashtra to a Dealer A in Maharashtra.

(ii) Dealer A sells goods worth ₹25,000 to Dealer B in Gujarat.

(iii) Dealer B sells goods to Sunita in Gujarat worth ₹30,000.

(iv) Sunita sells goods to Ravindra in Rajasthan worth ₹65,000.

Answer:

(i) Both CGST and SGST are levied on intra-state sale of goods. Therefore, 9% CGST (₹900) will go to the Central Government and 9% SGST (₹900) will go to the Maharashtra State Government.

(ii) Since Dealer A of Maharashtra sells goods worth ₹25,000 to Dealer B in Gujarat, IGST is levied on inter-state sale of goods. Revenue collected under IGST will entirely go to the Central Government.

Applicable GST rate is 18% then the Dealer A will charge ₹4,500 (18% of ₹25,000) as IGST that will go to the Central Government.

(iii) Since Dealer B of Gujarat sells goods worth ₹30,000 to Sunita in Gujarat, it is intra-state sale of goods. Therefore, CGST ₹2,700 (9% of ₹30,000) will go to the Central Government and SGST ₹2,700 (9% of ₹30,000) will go to the Gujarat State Government.

(iv) Since Sunita of Gujarat sells goods worth ₹65,000 to Ravindra in Rajasthan, It is inter-state sale of goods. IGST @18% i.e. ₹11,700 will be charged from Ravindra that will entirely go to the Central Government.

Objective Type Questions 1.5

1. At the end of the accounting period, factory rent of the company is outstanding for ₹10,000, which has been recorded in the books of account.

   The basis of accounting concept highlighted above is __________. *(Fill up the blank with appropriate words)*
2. Under of accounting, revenues and expenses are recorded when they are recognized irrespective of fact whether cash is received or not. (cash basis/accrual basis) *(Fill up the blank with appropriate words)*
3. Under _____________ system of accounting, the basic principle followed is that every debit must have a corresponding credit — one account is debited and the other is credited. *(Fill up the blank with appropriate words)*
4. Under double entry system of accounting, the arithmetic inaccuracies in records can mostly be checked by preparing the ____________. *(Fill up the blank with appropriate words)*
5. Instead of maintaining all the accounts, only personal accounts of debtors and creditors and cash book are maintained under ____________ system of accounting. *(Fill up the blank with appropriate words)*
6. Under single entry system of accounting, only one aspect is recorded for all transactions. *True/False? Give reason.*
7. The single entry system of accounting is followed by small business firms as ______________ *(Complete the sentence)*
8. The system of double entry can be implemented by big organisations only. *(True/False)*
9. Cash basis of accounting is incompatible with the matching principle. *(True/False)*
10. Under cash basis of accounting, profit is calculated as the difference between the _____________ and _____________ for the given period rather than the happening of the transactions. *(Fill up the blanks with appropriate words)*
11. Under the ____________ basis of accounting, revenues and costs are recognised in the period in which they occur, irrespective of the fact whether cash is received/paid or not. *(Fill up the blank with appropriate words)*
12. Under cash basis of accounting, prepaid expenses and unearned income are not recorded. *(True/False)*
13. Under accrual basis of accounting, prepaid expenses and income received in advance are recorded in the books of accounts. *(True/False)*

14. __________ basis of accounting is more appropriate basis for the calculating of profits as __________.
(Fill up the blanks with appropriate words)
15. As per the Companies Act 2013, it is mandatory for all companies to follow _________ basis of accounting. (cash/accrual)
(Fill up the blank with appropriate words)
16. _____________ are written policy documents covering the aspects of recognition, measurement, treatment, presentation and disclosure of accounting transactions in financial statements. *(Fill up the blank with appropriate words)*
17. Accounting Standards cannot override the provisions of applicable laws, customs, usages and business environment in the country. *(True/False)*
18. Which of the following is <u>not</u> an objective of accounting standards? *(Choose the correct alternative)*
    (a) To bring uniformity in different accounting policies.
    (b) To eliminate variations in accounting treatment to prepare financial statements.
    (c) To enhance comparability of financial statements.
    (d) None of the above
19. ________________ is a set of accounting standards developed by the International Accounting Standards Board (IASB)
(Fill up the blank with appropriate words)
20. IFRS are rule-based accounting standards. *True/False? Give reason.*
21. Which of the following statement is true? *(Choose the correct alternative)*
    (a) IFRS help in synchronisation of accounting standards across the globe.
    (b) IFRS create comparable, reliable, and transparent financial statements.
    (c) IFRS facilitate global investments.
    (d) All of the above
22. ______________ are the accounting standards that have been harmonised with the International Financial Reporting Standards (IFRS) to make reporting by Indian companies more globally accessible. *(Fill up the blank with appropriate words)*
23. In substance, Ind AS is not different from IFRS. *(True/False)*
24. _________________, in 2015, had notified the Companies (Indian Accounting Standards(Ind AS)) Rules 2015, which stipulated the adoption and applicability of Ind AS in a phased manner beginning from the accounting period 2016-17.
(Choose the correct alternative)
    (a) The Parliament of India
    (b) The Government of India
    (c) The Ministry of External Affairs
    (d) The Ministry of Corporate Affairs
25. The objective of ____________ is to create 'one nation, one tax', and to reduce tax evasion and generate additional revenue for the government. *(Fill up the blank with appropriate words)*
26. There are four tax slabs under GST, i.e. 5%, 12%, 18% and 28% along with 0% for essentials. *(True/False)*
27. Imports of goods and services are covered under IGST. *(True/False)*

RECAP

Concept of Accounting

Accounting is the process of identifying, measuring, recording and communicating the required information relating the economic events of an organisation to the interested users of such information.

Features/Characteristics **Accounting – EIOU**

1. **Economic Events –** A business organisation involves economic events — both external and internal events.
2. **Identification, Measurement, Recording and Communication:** • Identification means determining what transactions to record, i.e., to identity events which are to be recorded. • Measurement means quantification of business transactions in monetary terms (e.g. in rupees). • Economic events are then recorded in books of account in a chronological order. • Accounting information is communicated to management and other internal and external users.
3. **Organisation –** An organisation can be a sole-proprietory concern, partnership firm, company, etc.

4. **Interested Users of Accounting Information –** Many users need accounting information in order to make important decisions. These users can be divided into two broad categories — internal users (managers and directors) and external users (investors, customers, creditors, etc.).

Basic Accounting Terms

1. **Business Transaction:** An economic event that affects the financial position of the business enterprise and can be measured in terms of money, e.g. purchase and sale of goods, payment of salaries, etc.
2. **Voucher:** The documentary evidence in support of a business transaction, e.g. Cash Memo, Invoice, Receipt, etc.
3. **Goods (or Merchandise):** The products in which the business enterprise is dealing, e.g. for a furniture dealer purchase of chairs and tables is termed as goods.
4. **Stock (or Inventory):** It is a measure of something on hand — goods, spares and other items in a business, e.g. Raw materials, Work in Progress), and finished goods.
5. **Purchases:** Total amount of goods procured by a business on credit and on cash, for resale or further processing.
6. **Revenue (or Income):** Amount received from selling goods or services, and other items like commission, interest, etc.
7. **Sales:** Total receipts from sale of goods sold or services to customers.
8. **Expenses:** Costs incurred in the process of earning revenue, e.g. depreciation, rent, wages and salaries, etc.
9. **Profit:** The excess of revenues over expenses during an accounting year.
10. **Gain:** A non-recurring profit that arises from events or transactions which are incidental to business, e.g. profit on sale of machinery, winning a court case, etc.
11. **Loss:** The excess of expenses of an accounting period over its related revenues and includes money or money's worth lost without receiving any benefit in return, e.g. goods destroyed by fire.
12. **Debtors:** Persons/entities to whom goods or services have been sold on credit, and the amount is due.
13. **Creditors:** Persons/entities from whom goods or services have been purchased on credit, and the amount is due. Creditors also includes bankers from whom loans have been obtained.
14. **Discount:** Deduction in the price of the goods sold. It is offered in two ways — (i) Trade Discount (Offering deduction of agreed percentage of list price at the time selling goods; not recorded in books of accounts) and (ii) Cash Discount (After selling goods on credit, discount allowed to debtors for prompt payment; recorded in books of accounts).
15. **Assets:** Economic resources of an enterprise that can be usefully expressed in monetary terms. Assets can be classified into two types — (i) Current Assets (those assets which are expected to get converted into cash within one year, e.g. cash, debtors, inventory, etc.) and (ii) Non-Current Assets (these are used for normal business operations, e.g. land and building, machinery, etc.)
16. **Fixed Assets:** Those non-current assets which are acquired for use in operations, e.g. Machinery, Furniture, Patents, Computer Software etc. Fixed assets may be classified into — (i) Tangible assets (those fixed assets which can be seen and touched, e.g. Land and Building, Plant and Machinery, Furniture, etc.)and (ii) Intangible assets (Those fixed assets which cannot be seen or touched, e.g. Goodwill, Patents, Computer Software, Copyrights, etc.)
17. **Liabilities:** Obligations or debts to be paid in future, e.g. sundry creditors, bank loan, etc. Liabilities are classified as — (i) Current liabilities (Those payment obligations or debts which are due for payment within one year, e.g. creditors, bills payable, outstanding expenses, etc.) and (ii) Non-current liabilities (Those payment obligations or debt which are payable after a period of one year, e.g. long-term bank loan, debentures, etc.)
18. **Capital:** Amount invested by the owner of the business, which may be brought in cash or assets.
19. **Drawings:** Withdrawal of money/goods by the owner from the business for personal use.
20. **Expenditure:** Spending money or incurring a liability for some benefit, service or property received. If the benefit of an expenditure is exhausted within a year, it is called revenue expenditure, e.g. payment of salaries, rent, etc. On the other hand, if the benefit of an expenditure lasts for more than one accounting year, it is called capital expenditure, e.g. purchase of machinery, furniture, etc.

Objectives of Accounting

Police – FIR

1. **Maintenance of Records of Business Transactions** such as purchases, sales, receipts, payments, etc. in a systematic order. The recorded information enables verifiability and acts as an evidence.
2. **Calculation of Profit or Loss** during an accounting period by preparing a profit or loss account.
3. **Depiction of Financial Position** of the business enterprise in the form of its assets, liabilities and capital at the end of every accounting period by preparing Balance Sheet.
4. **Providing Accounting Information** to the interested users — both external and internal users.

Advantages of Accounting

TIP De

1. **Describes and Analyses Data** through measurement, classification and summarisation, and shows the financial position and net results of business operations.
2. **Provides Quantitative Financial Information** that helps the users in various ways.

3. **Helps in Assessment of Tax Liabilities** such as Income Tax (IT), Goods and Services Tax (GST), etc.
4. **Helps in Planning, Controlling and Decision-Making** by providing timely information on cost of sales, profitability, etc.

Limitations of Accounting

PNB Hyderabad

1. **Historical in Nature –** Accounting information relates to the past transactions only. It does not reflect on the current and future positions of a business enterprise.
2. **Ignores Non-Monetary/Qualitative Aspects** such as efficiency of management, quality of staff, customer satisfaction, etc.
3. **Ignores Price Level Changes**, which makes comparison of financial figures of different accounting years invalid.
4. **Not free from Bias and Personal Ability of Accountants**, e.g., different methods of depreciation, inventory valuation, etc.

Role of Accounting in Business

HIT – Left

1. Accounting is the **Language of Business** which is used to communicate financial information.
2. Accounting is **Historical Record of Financial Transactions** in chronological record of an organisation.
3. Accounting is the **Means of Determining True Income** of a business entity.
4. Accounting is an **Information System** which provides financial information to its users.

Types of Accounting Information

1. Accounting Information relating to Profit and Loss, i.e. Income Statement
2. Accounting Information relating to Financial Position, i.e. Balance Sheet
3. Additional Information in the form of 'Notes to Accounts'

Interested Parties/Users of Accounting Information

S^2LIC^2E – OMG

1. **Owners/Shareholders:** Return on Investment (ROI), Financial health of the company/business
2. **Managers/Directors:** Information on cost of sales, profitability, etc. for planning, controlling and decision-making; Intra-firm and inter-firm comparisons to evaluate performance of the business enterprise
3. **Employees:** To see whether business earns sufficient profits so that they get timely wages/salaries.
4. **Lenders:** Information on the credit worthiness of the company; Assess the ability of the company to repay loans and pay interest
5. **Investors:** Information on the risks and return on investment.
6. **Government and Regulatory Agencies:** They need accounting information for the payment of various taxes such as Income Tax, Goods and Services Tax, etc.
7. **Suppliers and Creditors:** To assess whether amounts owed will be repaid when due; Continued existence of the business
8. **Customers:** Continued existence of the business; Continued supply of products, parts and after-sales service
9. **Competitors:** Relative strengths and weaknesses of their competitors; Require information for strategic purposes
10. **Social responsibility groups, such as environmental groups:** Information on impact on environment and its protection.

Qualitative Characteristics of Accounting Information

1. **Reliability –** Accounting information must be free from error and bias, faithful, verifiable and neutral.
2. **Relevance –** Accounting information must be available in time, must help in prediction and feedback, and must influence the decisions of users.
3. **Understandability –** Accounting information must be presented in a manner that it is understandable to different users. They must interpret it in the same sense as it is prepared and conveyed to them.
4. **Comparability –** Users must be able to compare profitability, efficiency, liquidity and solvency of the business over different time period and with other business enterprises.

Generally Accepted Accounting Principles (GAAP): Basic Accounting Terms

Generally Accepted Accounting Principles (GAAP) refers to the rules or principles adopted for recording and reporting of business transactions, in order to bring uniformity in the preparation and the presentation of financial statements.

1. **Business Entity Concept:** This concept assumes that business has a distinct and separate entity from its owners. For the purposes of accounting, the business and its owners are to be treated as two separate entities. The accounting records are made in the books of accounts from the point of view of the business and not from the point of view of the owner.
2. **Money Measurement Concept:** This concept states that only those transactions and events are to be recorded in the books of accounts which can be expressed in terms of money such as sale of goods or payment of expenses or receipt of income, etc. • It ignores qualitative and non-financial aspects, e.g. appointment of a manager, capabilities of its human resources, creativity of research department, strikes, lockdowns, etc. do not find a place in the accounting records of a firm. • As the change in the value of money is not reflected in the book of accounts, the accounting data does not reflect the true and fair view of the affairs of an enterprise.
3. **Going Concern Concept:** This concept assumes that a business firm would continue to carry out its operations indefinitely, i.e. for a fairly long period of time and would not be liquidated in the foreseeable future. This concept provides the basis for showing the value of assets in the balance sheet. That part of a fixed asset which has been consumed or used during the current year should be charged from the profit and loss account and the remaining amount should be carried forward to the next years, over its estimated life.

4. **Accounting Period Concept:** Every business enterprise is interested to calculate profits or loss during an accounting year and its financial position at the end of the year. Therefore, the financial statements are prepared at regular interval, normally after a period of one year (called accounting period), so that timely information is made available to the users.
5. **Cost Concept:** This concept requires that all assets are recorded in the books of accounts at their historical cost (i.e., purchase price), which includes cost of acquisition, transportation, installation and making the asset ready to use. Adoption of historical cost brings in objectivity in recording as the cost of acquisition is easily verifiable from the purchase documents. The market value basis is not reliable as the value of an asset may change from time to time, making the comparisons between one period to another rather difficult. However, historical cost does not show the true worth of the business. It may also lead to hidden profits.
6. **Dual Aspect Concept:** This concept states that every transaction has two-fold effect. At least two accounts will be involved in recording a transaction. The duality principle is commonly expressed in terms of Fundamental Accounting Equation: Assets = Liabilities + Capital. Accounting Equation states that the Assets of a business are always equal to Capital (owners' equity) and Liabilities. Dual aspect concept forms the core of Double Entry System of accounting.
7. **Revenue Recognition (Realisation) Concept:** It requires that the revenue should be included in the accounting records only when it is recognised (realised). In case of sales, revenue is assumed to be realised when a legal right to receive it arises, i.e. when goods have been sold. For the incomes such as rent, commission, etc. revenue is recognised on the basis of time period to which they relate.
8. **Matching Concept:** It implies that all revenues earned during an accounting year (whether received during the year or not) and all expenses/costs incurred to earn these revenues related to the current year (whether paid during the year or not) should be taken into account while ascertaining profit or loss for that year.
9. **Full Disclosure Concept:** It requires that all material and relevant facts concerning financial performance of an enterprise must be fully and completely disclosed in the financial statements and their accompanying Notes to Accounts, so that the users can take sound decisions. It also gives a true and fair view of profitability and the state of affairs.
10. **Consistency Concept:** It states that accounting methods, policies and practices followed by a business enterprise should be uniform and consistent over a period of time. Inter-firm and inter-period (intra-firm) comparisons can be possible only when accounting methods, policies and practices followed by enterprises are uniform and are consistent over the period of time.
11. **Conservatism/Prudence Concept:** It requires that profits/gains should not be recorded in the books of accounts until realised, but all losses (even those which may have a remote possibility) must be provided for in the books of accounts. The objective of conservatism/prudence concept is to adopt a conscious approach in ascertaining income so that profits of the enterprise are not overstated. <u>Examples of the application of the principle of Conservatism/Prudence</u>:
    (i) Closing stock (inventory) is valued at cost or market value whichever is lower.
    (ii) Creating provision for bad and doubtful debts and discount on debtors
12. **Materiality Concept:** All information about material facts should be disclosed through the financial statements (Income Statement and Balance Sheet) and the accompanying Notes to Accounts, so that users can take relevant decisions. In certain cases, when the amount involved is very small, strict adherence to full disclosure principle is not required. For example, stock of erasers, pencils, scales, etc. are not shown as assets, but treated as the stationery expense and taken to the profit and loss account.
13. **Objectivity Concept:** It requires that accounting transactions should be recorded in an objective manner, free from the bias of accountants and others. This can be possible when every transaction is supported by verifiable documents or vouchers.

Systems of Accounting

1. **Double Entry System:** It is based on the principle of "Dual Aspect" which states that every transaction has two-fold effects. Each transaction involves two or more accounts. This system is accurate and reliable as the arithmetic inaccuracies can be checked by preparing the trial balance.
2. **Single Entry System:** It is not a complete system of maintaining records of financial transactions. It does not record two-fold effect of each and every transaction. Instead of maintaining all the accounts, only personal accounts and cash book are maintained under this system. The system is followed by small business firms as it is very simple and flexible.

Basis of Accounting

1. **Cash Basis:** Transactions are recorded in the books of accounts only when cash is received or paid and not when the receipt or payment becomes due. It is contrary to the matching principle. Adjustments for outstanding expenses and accrued incomes are not recorded.
2. **Accrual Basis:** Revenues and expenses/costs are recognised in the period in which they occur, irrespective of whether cash is received/paid or not. It is compatible with the matching principle. Accrual basis of accounting is a better basis of accounting than the cash basis as it gives a true and fair view of profit or loss and the financial position of a business enterprise.

Accounting Standards (AS): Meaning and Objectives

Accounting Standards are written statements of uniform accounting rules and guidelines in practice for preparing the uniform and consistent financial statements.

Objectives of Accounting Standards

1. To bring uniformity in different accounting policies.
2. To eliminate variations in accounting treatment to prepare financial statements.
3. To enhance inter-firm and intra-firm (inter-period)comparisons.

International Financial Reporting Standards (IFRS)

IFRS is a set of principles-based accounting standards developed by International Accounting Standards Board (IASB). IFRS help in synchronisation of accounting standards across the globe; create comparable, reliable, and transparent financial statements; and facilitate global investments.

Indian Accounting Standards (Ind AS)

The Ind AS are basically rule-based accounting standards, notified by the Ministry of Corporate Affairs, that have been harmonised with the IFRS to make reporting by Indian companies more globally accessible. In substance, Ind AS is not different from IFRS. But the name of this IFRS has been converged as Ind AS.

Goods and Services Tax (GST)

GST is a destination based tax on consumption of goods and services levied at all stages right from manufacturer up to final consumption with credit of taxes paid at previous stages available as set off.

Objective

The objective of GST is to create 'one nation, one tax and one market'; to reduce tax evasion; and to generate additional revenue for the government.

Characteristics

1. GST is the single comprehensive indirect tax on supply of goods and services, right from the manufacturer/service provider to the final consumer.
2. GST is applicable throughout the country with one rate for one type of goods/services. There are five tax slabs under GST, i.e. 0% (for essentials), 5%, 12%, 18% and 28% on supply of all goods and services across the country.
3. GST is a destination based consumption tax with benefit of Input Tax Credit in the supply chain.
4. GST has three main components which are CGST, SGST and IGST.
   (i) CGST means Central Goods and Services Tax, i.e. GST levied by the Central Government. Taxes collected under CGST will constitute the revenues of the Central Government.
   (ii) SGST means State Goods and Services Tax, i.e. GST levied by the State Government. A collection of SGST is the revenue of the State Government.
   Both CGST and SGST are levied on intra-state supply of goods and services (i.e. movement of goods/services within the State) at 50% of the prescribed GST rate.
   (iii) IGST means Integrated Goods and Services Tax, i.e. GST levied by the Central Government and State Governments concurrently. IGST is levied on inter-state supply of goods and services (i.e. movement of goods/services outside the state). Revenue collected under IGST will entirely go to the Central Government.

Self Assessment Test 1

Theoretical Framework

- Introduction to Accounting
- Theory Base of Accounting

***Time allowed* : 1 hour** ***Maximum Marks* : 25**

Q.1 Match the columns: (1 mark)

(i) All anticipated losses should be accounted for but all unrealised gains should be ignored.	(A) Consistency
(ii) This concept states that accounting should focus on material facts.	(B) Materiality
(iii) Accounting transactions should be recorded in the manner so that it is free from the bias of accountants and others.	(C) Conservatism
(iv) Accounting policies and practices followed by enterprises should be uniform and consistent over a period of time so that results are comparable.	(D) Objectivity

Q.2 Which is the last step of accounting as a process of information? *(Choose the correct alternative)* (1 mark)
(a) Recording of data in the books of accounts
(b) Preparation of summaries in the form of financial statements
(c) Communication of information
(d) Analysis and interpretation of information

Q.3 ____________ refers to the amounts received by a business enterprise from selling its products or providing services to customers and includes other items like commission, interest, dividend, royalty and rent received.
(Fill up the blank with appropriate words) (1 mark)

Q.4 Financial accounting relates to past period and is monetary in nature. *(True/False)* (1 mark)

Q.5 Although the sales have not yet actually taken place, some reliable customers of the company have placed large orders from which company is expected to earn large profits. The accountant is interested to record the profits in the books of accounts. The accounting concept violated is _______________. *(Fill up the blank with appropriate words)* (1 mark)

Q.6 Rohit of Rajasthan sells goods worth ₹1,00,000 to Daksh of Delhi and applicable GST rate is 18%, then how much revenue will go to the Rajasthan State Government? *(Choose the correct alternative)* (1 mark)
(a) ₹18,000 (b) ₹9,000
(c) ₹36,000 (d) Nil

Q.7 A customer has filed a suit against a trader who has supplied poor quality goods to him. It is known that the court judgment will be in favour of the customer and the trader will be required to pay the damages. However, the amount of legal damages is not known with certainty. The accounting year has already been ended and the books are now finalised to ascertain true profit or loss.
The accountant of the trader has advised him not to consider the expected loss on account of payment of legal damages because the amount is not certain and the final judgment of the court is not yet out.
Do you think the accountant is right in his approach? Give valid reason in support of your answer. (3 marks)

Q.8 What is Ind AS? How is it different from IFRS? (3 marks)

Q.9 State how the GST will be applicable if CGST is 9%, SGST is 9% and IGST 18% in each of the following situations: (3 marks)
(i) Goods worth ₹ 40,000 is sold by a Manufacturer 1 in Haryana to a Dealer A in Haryana.
(ii) Dealer A sells goods worth ₹50,000 to Dealer B in Gujarat.

Q.10 "The role of accounting has changed over the period of time". Do you agree? Explain. (4 marks)

Q.11 Giving examples, explain each of the following accounting terms: (6 marks)
(i) Fixed assets (ii) Revenue (iii) Expenses
(iv) Current liability (v) Capital (vi) Loss

Self Assessment Test 2

Theoretical Framework

- Introduction to Accounting
- Theory Base of Accounting

***Time allowed* : 1 hour** **Maximum Marks : 25**

Q.1 Which of the following is not recorded in the books of accounts? *(Choose the correct alternative)* (1 mark)
(a) Sale of merchandise on credit
(b) Value of human resource
(c) Purchase of goods for cash
(d) Payment of salary to employees

Q.2 If Shiva Enterprises purchases goods for ₹10,000 on credit for a month from Fast Food Products on March 1, 2020. IT had also taken a loan from Punjab National Bank for ₹50,000 on 1 Oct., 2019. On the ___________ side of the balance sheet of Shiva Enterprises on 31 March 2020 ₹10,000 will be shown as ___________ and ₹50,000 as ____________. *(Fill up the blank with appropriate words)* (1 mark)

Q.3 The most brilliant executive or manager can accurately remember all the business transactions such as purchases sales, receipts, payments, etc. *(True/False)* (1 mark)

Q.4 No firm can wait for long to know the net results of its business operations and the financial position because such information is required by different users at regular intervals for taking various decisions. Therefore, the financial statements are prepared every year at the end. *(Choose the correct alternative)* (1 mark)
The basic accounting concept discussed above is:
(a) Going Concern Concept
(b) Business Entity Concept
(c) Accounting Period Concept
(d) Consistency Concept

Q.5 Ind AS are rule-based accounting standards. *(True/False)* (1 mark)

Q.6 Match the columns: (1 mark)

(i) For the purpose of accounting, business and its owners are to be treated as two separate entities.	(A) Money measurement concept
(ii) The records of the transactions are to be kept not in the physical units but in the monetary units.	(B) Business entity concept
(iii) A business firm would continue to carry out its operations for a fairly long period of time and would not be liquidated in the near future.	(C) Cost concept
(iv) All assets are recorded in the book of accounts at their purchase price, which includes cost of acquisition, transportation, installation and making the asset ready for the use.	(D) Going concern concept

Q.7 Explain briefly the following basic concepts of accounting: (3 marks)
(a) Full Disclosure
(b) Consistency
(c) Conservatism

Q.8 (a) Define Accounting Standards. Name any two types of Accounting Standards. (2 marks)
(b) "Capital is a liability for the business." Explain this statement with the principle applied. (2 marks)

Q.9 Distinguish between 'cash basis' and 'accrual basis' of accounting. (Any four points/basis) (4 marks)

Q.10 Mr. Rohit started business for buying and selling of ready-made garments with ₹7,00,000 cash and household furniture worth ₹1,00,000. Out of this he paid ₹4,00,000 for the purchase of garments and ₹50,000 for furniture and ₹50,000 for computer and the remaining cash was deposited into the bank. He sold some of the ladies and kids garments for ₹3,00,000 for cash and for ₹1,50,000 on credit to Mr. Rajesh.

Subsequently, he bought men's garments of ₹2,00,000 from Mr. Satish. In the first week of the next month, a fire broke out in his office and stock of garments worth ₹1,00,000 was destroyed.

Later on, some garments which cost ₹1,20,000 were sold for ₹1,30,000. Expenses paid during the same period were ₹15,000. Mr. Rohit withdrew ₹20,000 from business to pay his quarterly house rent and kids garments costing ₹5,000 for his son.

From the above information, answer the following: (8 marks)

(a) What is the amount of capital with which Mr. Rohit started the business?
(b) What fixed assets did he buy?
(c) What is the value of the goods purchased?
(d) Who is the creditor? State the amount payable to him.
(e) Who is the debtor? What is the amount receivable from him?
(f) What is the total amount of revenue expenditure?
(g) What is the amount of drawings?
(h) How much is the amount of 'loss'?

Self Assessment Test 3

Theoretical Framework

- Introduction to Accounting
- Theory Base of Accounting

***Time allowed* : 1 hour** **Maximum Marks : 25**

Q.1 Which of the following is not a business transaction? *(Choose the correct alternative)* (1 mark)
(a) Bought furniture of ₹10,000 for business
(b) Paid for salaries of employees ₹ 5,000
(c) Paid son's fees from her personal bank account ₹ 20,000
(d) Paid son's fees from the business ₹ 2,000

Q.2 "Accounting is not free form personal bias".
Which is the following describes the above statement ? *(Choose the correct alternative)* (1 mark)
(a) Manipulation in accounts to present a more favourable financial position of a business enterprise
(b) Different opinions regarding accounting policies and methods
(c) Does not reflect the present worth of the business enterprise.
(d) Recording of financial transactions only

Q.3 The duality principle is commonly expressed in terms of ________________.
(Fill up the blank with appropriate words) (1 mark)

Q.4 Define the following terms: (3 marks)
(a) Bad Debt (b) Drawings (c) Profit

Q.5 State any two advantages and any one disadvantage of accrual basis of accounting. (3 marks)

Q.6 "Accounting Standards have been evolved to improve the reliability and credibility of financial statements." In the light of this statement state any three objectives of accounting standards. (3 marks)

Q.7 You are a senior accountant of Ramona Enterprises Limited. What three steps would you take to make your company's financial statements understandable and decision useful? (3 marks)

Q.8 Many People in today's society think of an accountant as simply a glorified bookkeeper. But the role of an accountant is continually changing. What is the difference between book-keeping and accounting? Discuss the role of accounting in business. (4 marks)

Q.9 Ruchica's father is the sole proprietor of 'Friends Gifts', a firm engaged in the sale of gift items. In the process of preparing financial statements, the accountant of the firm Mr. Goyal fell ill and had to proceed on leave. Ruchica's father was urgently in need of the statements as these had to be submitted to the bank, in pursuance of a loan of ₹ 5 lakh applied for the expansion of the business of the firm. Ruchica who is studying Accounting in her school, volunteered to complete the work. On scrutinising the accounts, the banker found that the value of building bought a few years back for ₹ 7 lakh has been shown in the books at ₹ 20 lakh, which is its present market value. Similarly, as compared to the last year, the method of valuation of stock was changed, resulting in value of goods to be about 15 per cent higher. Also, the whole amount of ₹ 70,000 spent on purchase of personal computer (expected life 5 years) during the year had been charged to the profits of the current year. The banker did not rely on the financial data provided by Ruchica.

Advise Ruchica for the mistakes committed by her in the preparation of financial statements in the context of basic concepts in accounting. (6 marks)

Self Assessment Test 4

Theoretical Framework

- Introduction to Accounting
- Theory Base of Accounting

***Time allowed* : 1 hour** **Maximum Marks : 25**

Q.1 Match the columns: (1 mark)

(i) Every transaction has a dual or two-fold effect on various accounts and should therefore be recorded at least at two places.	(A) Revenue Recognition
(ii) Revenue for a business transaction should be considered realised when a legal right to receive it arises.	(B) Matching principle
(iii) The revenue and expenses incurred to earn these revenue must belong to the same accounting period.	(C) Full disclosure concept
(iv) All material and relevant facts concerning financial performance of an enterprise must be fully and completely disclosed in the financial statements and their accompanying footnotes.	(D) Dual aspect concept

Q.2 An accounting system is always devised for a specific business entity (also called accounting entity). *(True/False)* (1 mark)

Q.3 Which of the following is not a type of accounting information? *(Choose the correct alternative)* (1 mark)
(a) Accounting information relating to Profit and Loss, i.e. Income Statement
(b) Accounting information relating to financial position, i.e. Balance Sheet
(c) Notes to Accounts
(d) None of the above

Q.4 The cost concept requires that all assets are recorded in the books of accounts at ____________
(Complete the sentence) (1 mark)

Q.5 Charu of Chandigarh sells goods worth ₹50,000 to Chirag, who also lives in Chandigarh. Applicable GST rate is 18%.
The tax revenue will go to: *(Choose the correct alternative)* (1 mark)
(a) Central Government ₹9,000 as CGST
(b) Central Government ₹4,500 as CGST and Chandigarh Government ₹4,500 as SGST
(c) Central Government ₹4,500 as CGST and Chandigarh Government ₹4,500 as UTGST
(d) Chandigarh Government ₹9,000 as SGST

Q.6 Which stakeholder group would be most interested in the following? (3 marks)
(a) The GST and other tax liabilities of the firm
(b) The potential for pay awards and bouns deals
(c) The ethical or environmental activities of the firm
(d) Whether the firm has a long-term future
(e) Profitability and share performance
(f) The ability of the firm to carry on providing a service or producing a product.

Q.7 State any three limitations of accounting. (3 marks)

Q.8 Mr. Abhay started a business for buying and selling of stationery with ₹5,00,000 as an initial investment. Of which he paid ₹1,00,000 for furniture, ₹2,00,000 for buying stationery items. He employed a sales person and clerk.

At the end of the month he paid ₹ 5,000 as their salaries. Out of the stationery bought he sold some stationery for ₹1,50,000 for cash and some other stationery for ₹1,00,000 on credit basis to Mr. Madhav. Subsequently, he bought stationery items of ₹1,50,000 from Mr. Keshav. In the first week of next month there was a fire accident and he lost ₹30,000 worth of stationery. A part of the machinery, which cost ₹40,000, was sold for ₹45,000.

From the above, answer the following : (4 marks)

(a) What is the amount of capital with which Mr. Abhay started business?

(b) What are the fixed assets he bought?

(c) What is the value of the goods purchased?

(d) Who is the creditor and state the amount payable to him?

(e) What are the expenses?

(f) What is the gain he earned?

(g) What is the loss he incurred?

(h) Who is the debtor? What is the amount receivable from him?

Q.9 (a) Why is it important to adopt a consistent basis for the preparation of financial statements? Explain. (2 marks)

(b) What is matching concept? Why should a business concern follow this concept? Discuss. (2 marks)

Q.10 On 1 July 2020 Radhey Enterprises, which is engaged into the manufacturing of paper bowls and plates, purchased an old machinery from Ahmedabad for ₹4,00,000. An amount of ₹20,000 was spent on transporting the machinery to the factory site in Noida. In addition, ₹50,000 was spent on repairs for bringing the machinery into running position and ₹30,000 on its installation. The market value of the machinery purchased was ₹6,00,000 on that date in Noida. The remaining useful life of the machinery is estimated to be 5 years.

(a) At what amount the machinery will be recorded in the books of account on 1 July 2020? Name the relevant concept of accounting in support of your answer.

(b) State any one limitation of the above concept of accounting.

(c) At what amount the machinery will be shown in the balance sheet as on 31 December 2020? Explain.

(d) What is the limitation of recording assets at their market values? (6 marks)

Self Assessment Test 5

Theoretical Framework

- Introduction to Accounting
- Theory Base of Accounting

***Time allowed* : 1 hour** **Maximum Marks : 25**

Q.1 Which of the following is not an example of 'loss'? *(Choose the correct alternative)* (1 mark)

(a) Loss on sale of fixed assets.
(b) Cash or goods lost by theft or a fire accident, etc.
(c) Depreciation on fixed assets
(d) None of the above

Q.2 Accounting provides timely financial information an cost of sales, profitability, etc. which is useful to ___________ for planning, controlling and decision-making. *(Choose the correct alternative)* (1 mark)

(a) Owners
(b) Management
(c) Creditors
(d) Tax authorities

Q.3 Cost of Pen is accounted as an expense and not shown as an asset in a final statement of a business entity due to ____________ concept. *(Choose the correct alternative)* (1 mark)

(a) Materiality
(b) Cost
(c) Matching
(d) Money measurement

Q.4 Pulkit of Punjab sells goods worth ₹30,000 to Harshit of Haryana. CGST is 9% and SGST is 9%. How much revenue will go to the Central Government? *(Choose the correct alternative)* (1 mark)

(a) ₹2,000
(b) ₹5,400
(c) ₹30,000
(d) Nil

Q.5 State any three advantages or objectives of accounting. (3 marks)

Q.6 (a) If the accounting information is not clearly presented, which qualitative characteristic of the accounting information is violated?

(b) Distinguish between profit and gain.

(c) State the end product of financial accounting.

(d) State the nature of accounting information required by long-term lenders. (4 marks)

Q.7 (a) What is the money measurement concept? Which one factor can make it difficult to compare the monetary values of one year with the monetary values of another year? (3 marks)

(b) 'The accounting concepts and accounting standards are generally referred to as the essence of financial accounting'. Comment. (3 marks)

Q.8 (a) What is the objective of Goods and Services Tax (GST)? State any three characteristics of GST. (4 marks)

(b) Distinguish between single entry and double entry systems of accounting. (Any four points/basis) (4 marks)

Check List to Objective Type Questions

Objective Type Questions 1.1

1. Economic Transactions
2. Time-gap
3. Identifying the transactions and communicating information
4. Monetary
5. Chronological
6. (a) Quantifiable economic event
7. (d) Identifying → recording → communicating
8. (c) Recording financial information
9. (b) Communication of financial information
10. (a) Identifying an economic event or transaction
11. Forensic Accounting
12. Accounting
13. An economic event
14. internal economic event
15. (c) Supply of raw material or components by the stores department to the manufacturing department.
16. (a) Identification
17. (d) None of the above
18. (b) Measurement
19. not shown; these events cannot be quantified in monetary terms
20. accounting reports, financial statements, graphs and charts
21. True
22. Accounting
23. Organisation
24. Accounting; it is a means by which necessary financial information about business enterprise is communicated to management and other interested users of accounting information
25. to provide useful information for decision-making.
26. Since the primary function of accounting is to provide useful information for decision-making, 'it is a means to an end, with the end being the decision that is helped by the availability of accounting information.
27. accounting information; final decision
28. (b) Line Supervisors
29. (d) Both (b) and (c)
30. (c) Customers
31. (b) Plant Managers
32. Book-keeping

Objective Type Questions 1.2

1. (b) Debtor
2. (c) Transaction
3. (d) Creditor of the business
4. (d) Manager of the business
5. (b) Obligations
6. Business transaction
7. True
8. False
9. goods; expenses
10. goods; an asset
11. expenses
12. True
13. False
14. Gain
15. (d) None of the above
16. (a) — (iv), (b) — (i), (c) — (iii), (d) — (ii)
17. Debtors
18. Sundry Debtors; assets
19. Sundry Creditors; liabilities
20. (a) — (ii), (b) — (ii), (c) — (ii), (d) — (i)
21. (c) Livestock
22. (b) Machinery
23. Trade discount
24. Cash discount
25. this deduction is given at the time of payment on the amount payable by the debtors.
26. True
27. False
28. it is deducted in the Invoice/Cash Memo.
29. it is given at the time of payment by the debtor while sales have already been recorded in the books of accounts.
30. Liabilities
31. Capital
32. False; it may be brought in the form of cash or assets by the owner.
33. for the business entity, capital is an obligation and a claim on the assets of business
34. drawings
35. True
36. No, it is not treated as drawings since the money is withdrawn to buy a scooter for office use, not the personal use of the owner, Mr. Rohit.
37. (b) Expenditure
38. True; since salaries paid will not benefit the business in the next accounting period.
39. False; purchase of goods is a revenue expenditure. Capital expenditures are incurred on fixed assets which are expected to be productive assets for a long period of time.
40. revenue 41. (i) — (a), (ii) — (b)
42. True
43. depreciation
44. expense
45. Capital expenditure; Revenue expenditure
46. Revenue expenditure
47. False
48. revenue expenditure
49. deferred revenue expenditure
50. Heavy expenditure incurred on advertising

Objective Type Questions 1.3

1. (d) None of these
2. (b) Reliability and comparability
3. Management/Employees
4. Creditor
5. External

6. Free from bias
7. (a) Understandability
8. (a) Comparability
9. (c) Management
10. (d) Managers
11. to provide useful information to the interested group of users, both internal and external.
12. financial statements — Profit and Loss Account and Balance Sheet
13. (d) All of the above
14. verifiability; an evidence
15. (a) Owners
16. expenses/losses; incomes/gains; Profit and Loss Account
17. assets; liabilities; capital; Balance Sheet
18. Position Statement; the final position of a business at the end of an accounting period.
19. (d) All of the above
20. (d) None of the these
21. (c) Suppliers and Creditors
22. (a) Customers
23. reliability, relevance, understandability and comparability
24. (a) Reliability
25. (b) Relevance
26. (c) Understandability
27. (c) Understandability

Objective Type Questions 1.4

1. (c) Accounting period
2. (a) Going concern
3. (b) Matching Principle
4. (a) Dual Aspect Principle
5. (d) Business entity Concept
6. Going concern concept
7. Conservatism/Prudence
8. (a) — (iv), (b) — (ii), (c) — (i), (d) — (iii)
9. Business entity Concept
10. Going Concern Concept
11. Money measurement Concept
12. Conservatism/Prudence Concept
13. Generally Accepted Accounting Principles (GAAP)
14. (a) – (iii), (b) – (ii), (c) – (i)
15. Money Measurement
16. Going concern/continuity
17. ₹4,000; Profit and Loss Account; Going concern concept
18. (a) — (iv), (b) — (ii), (c) — (iii), (d) — (i)
19. False: In case of certain situations, preparation of interim financial statements become necessary. For example, at the time of retirement of a partner, the accounting period can be different from 12 months period.
20. Business Entity
21. Money measurement concept
22. Accounting period
23. True: Because the purchase price of the asset was paid on the date of acquisition and does not change year after year, even though its market value may change.
24. the cost of acquisition is easily verifiable from the purchase documents.
25. Dual Aspect
26. False: At least two accounts will be involved in recorded a transaction. More than two accounts may be involved in recording a transaction.
27. (d) Both (a) and (c)
28. on the date of sales
29. time period to which they relate
30. Profit and Loss Account; March 31, 2020
31. Profit and Loss Account; March 31, 2021
32. an asset or service has been used to generate revenue
33. Cost of a fixed asset is divided over the periods during which the asset is used to generate revenue. The expense here is called 'depreciation'.
34. (b) Matching Concept
35. Matching
36. Matching Concept
37. Matching
38. time period to which they related
39. Matching Concept
40. Full disclosure principle
41. (c) Both (a) and (b)
42. Consistency
43. Conservatism/Prudence
44. secret reserves
45. conservatism
46. (d)None of the above
47. (c) Cost or market value whichever is lower
48. market value
49. not recorded; cost
50. conservatism/prudence
51. revenue expenditure; Profit and Loss Account; Materiality concept
52. Materiality
53. (i) its nature (i.e. whether or not it would influence the decisions of users of financial statements); (ii) the amount involved
54. full disclosure
55. Objectivity
56. Historical Cost

Objective Type Questions 1.5

1. Accrual basis
2. accrual basis
3. double entry
4. trial balance
5. single entry
6. False: For some transactions, only one aspect is recorded, for others, both the aspects are recorded.
7. it is very simple, flexible and inexpensive.
8. False
9. True
10. cash receipts; cash payments
11. accrual
12. False
13. True
14. Accrual; it is compatible with the matching principle, i.e. expenses are matched against revenues earned related to the current year
15. accrual
16. Accounting Standards
17. True
18. (d) None of the above
19. International Financial Reporting Standards (IFRS)
20. False: IFRS are principles-based accounting standards.
21. (d) All of the above
22. Ind AS
23. True
24. (d)
25. GST
26. True
27. True

Notes