

Syllabus

BCA Part-II

BCA 201 : Business Accounting

Questions Paper pattern for Main University Examination

Max Marks : 100

Part-I (very short answer) consists 10 questions of two marks each with two questions from each unit. Maximum limit for each question is up to 40 words.

Part-II (short answer) consists 5 questions of four marks each with one questions from each unit. Maximum limit for each question is up to 80 words.

Part-III (Long answer) consists 5 questions of twelve marks each with one questions from each unit with internal choice.

UNIT-I

Basics of Bookkeeping and Accounting : Financial Accounting : Definition, Scope and Objective of Financial Accounting. Users of accounting information, Limitations of Financial Accounting. Financial Accounting Principles, Concepts and Conventions.

Unit-I

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|---|--|------------|
|  1. | Accounting : An Introduction | 1.1 – 1.12 |
|  2. | Generally Accepted Accounting Principles :
Concepts and Conventions | 2.1 – 2.08 |



Accounting : An Introduction

Accounting is as old as human civilisation. Even a layman has to account for his dealings and check that the balance remained with him is correct. It applies particularly to trade and industries since it is said to be the language of Business and Finance. It is a discipline which provides financial and other information essential for the efficient conduct and valuation of business activities. It communicates the results of business operations to different parties who have some stake in the business. In fact, it is *“a means of collecting, summarising, analysing and reporting in monetary terms, the information about the Business.”*

Meaning and Definition of Accounting

“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 or at least of a financial character and interpreting the results thereof : ”

—AICPA

“Accounting is the science of recording and classifying business transactions and events, primarily of a financial character and the art of making significant summaries, analysis and interpretations of these transactions and events and communicating the result to persons who must make decisions or form Judgments”.

—Smith And Ashburne

“Accounting may be defined as “the identifying, measuring, recording and communicating of financial information.”

—Harold Bierman and Alan R. Drebin

“The process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of information.”

—The American Accounting Association Committee (AAAC)

On analysing the above definitions, the following conclusions are drawn :

- (i) Accounting is the art of recording and classifying business transactions.
- (ii) The business transactions may be completely or partially of financial nature.
- (iii) Generally the business transactions are described in monetary terms.
- (iv) In accounting process, the business transactions are summarised and analysed so as to arrive at meaningful conclusions.
- (v) The analysis and interpretation thus obtained are communicated to those who are responsible to take decisions, to determine the future course of business.

Nature of Accounting

- (i) Accounting has evolved over a period of time.
- (ii) It is man made and is practised in a social system.
- (iii) It is a systematic exercise and follows flexible and not a rigid approach.
- (iv) It is a language having a very well defined syntax of its own.
- (v) It communicates financial information of a business enterprise for making decision by the management.

Objectives of Accounting

The primary purpose of accounting is to provide information about financial transactions and using such accounting information in the process of making decisions. Some of them are stated below:

- (1) To provide information about financial transactions.
- (2) To determine the profits earned by the firm.
- (3) To know the exact reasons leading to net profit.
- (4) To assess the taxable income, service tax and, vat tax, wealth tax liability etc.
- (5) To provide requisite information to different parties i.e., owners, creditors, employees, government, banks, management, investors, financial institutions etc.
- (6) To facilitate management control.
- (7) To show the financial position of a firm at the close of the financial year by way of preparing the Balance Sheet.

Evolution of Accounting as a Social Science

Basically the art and science of accounting was developed to record business transactions. Generally it became a media to report business performance to the interested parties. However, a business, when operated uses social resources. Therefore, it owes certain responsibilities towards the society also. It is now a well established fact that accounting has a responsibility towards society to submit a correct picture of the business. Now a days the function of accounting is not limited to record the business transactions but it has now become a social science and has to fulfill its social responsibilities, as well.

Book-Keeping, Accounting and Accountancy

These terms seem to have the same meaning, but there is a fundamental difference among them.

Book-Keeping—It is mainly concerned with the maintenance of books of accounts, which includes the following—

- (i) Selecting financial transactions out of the various transactions.
- (ii) Measuring the selected transactions in terms of money.
- (iii) Recording those transactions in the books of original entry.
- (iv) Posting the recorded transaction in the Ledger.
- (v) Balancing of various Accounts opened in Ledger and extracting Trial Balance.

Thus, the function of book-keeping is of routine and clerical nature which can be performed by a person having limited knowledge of accounting. Now a day, this work is being done by means of computers.

Accounting—Accounting begins where book-keeping ends. It includes the following—

- (i) Summarising the classified information contained in Trial Balance, by preparing Trading and Profit and Loss Accounts and the Balance Sheet etc.
- (ii) Analysing and drawing the meaningful information from the final accounts of a business enterprise.
- (iii) Communicating the aforesaid information to interested parties.

Thus, the accounting work shall be performed by an Accountant having an expert knowledge of principles of accounting. The work of an accountant goes beyond that of the Book-keeper.

Accountancy—It is a wider term which refers to entire body of theory and practice of accountancy. It means a systematic knowledge of accounting apart from the knowledge of principles and techniques which are needed in accounting. The term includes how to prepare the books of accounts, how to classify and summarize them, how to communicate the information to interested parties etc.

Difference Between Book-keeping & Accountancy

We have seen above that book-keeping and accounting differ from each other. The following are the main points of distinction between the two—

- (i) Book-keeping is a primary stage, whereas Accounting, a secondary one. Accounting begins where book-keeping ends.
- (ii) The book-keeping function is of routine and clerical nature, which may be performed by a Junior member, whereas accounting function is analytical in nature to be performed by a senior member of staff.
- (iii) Book-keeper need not possess analytical skill whereas an Accountant is required to possess analytical and interpreting skill.
- (iv) Book-keeping work may be performed by a person having limited knowledge of accounting, whereas accounting work has to be performed by a person having expert knowledge in accounting.
- (v) The scope of the work of book-keeping includes, identifying, measuring, recording and classifying the business transactions, whereas accounting apart from book-keeping includes summarising, analysing and communicating of accounting information.

Functions of Accounting

Accounting embraces of the following functions :

(1) **Recording** : The first function of accounting is to keep a systematic record of financial transactions to post them to ledger accounts and ultimately prepare financial statements.

(2) **Classifying** : The second function of accounting is that it facilitates classification of all business transactions recorded in the Journal. Classification of items is done according to the nature of account. One with similar nature are classified under similar appropriate heads. This work of classification is done in a book called the Ledger.

(3) **Summarising** : Next comes the summarisation of the classified records. This process of summarisation is done in a manner which is useful to the internal as well as external users. Internal users are those persons who manage the business; whereas external users are persons like Investors, Creditors, Tax authorities, Trade associations, Labour unions, Shareholders etc. because all have same interest particularly to known about the financial soundness and liquidity of the Business.

(4) **Interpreting** : After summarising, comes the process of interpreting the summarised financial data embodied in final accounts. This is a very important function from the point of view of management, owners and the third parties as it helps them in decision making.

(5) **Information System** : Accounting is also held in communicating the results obtained from arranging of data, to interested parties like Proprietors, Investors, Creditors, Government Officials, Employees, Researchers etc.

(6) **Legal Requirements** : The last function of accounting is to devise such a system which will meet legal requirement. According to the provisions of law, a business has to file various statements, e.g. income tax returns, returns for sales tax purpose and so on. Accounting system aims at fulfilling this requirement of law also.

Branches of Accounting :

(1) **Financial Accounting :** According to Kohler's Dictionary for Accountants, financial accounting is the accounting for revenues, expenses, assets and liabilities that it commonly carried on in the general office of a business. It is primarily concerned with record keeping directed toward the preparation of profit and loss account and balance sheet. The main purpose of financial accounting are : (i) recording of the transactions concerning and affecting the business; (ii) preparation of necessary accounts and balance sheet as required by statutes; (iii) apprising the owners of the business about the results of the business over a period of time.

(2) **Cost Accounting :** Cost Accounting is the process of accounting for costs. It is a systematic procedure for determining the unit cost of output produced or services rendered. The primary functions of cost accounting are to ascertain the cost of product and to help the management in the context of cost. An efficient system of cost accounting is essential to ensure the best possible use of scarce resources, such as, materials, labour and overheads.

(3) **Management Accounting :** Management is primarily concerned with the supply of information which is useful to management in decision-making for the efficient running of the business and, thus in maximising profit. Management accounting is the presentation of accounting and related information in such a way as will enable the management to take decisions and to control activities. It also helps in reviewing existing policies, laying down new policies and preparing further plans.

(4) **Tax Accounting** – It is a branch of Accounting which is used for tax purposes. It helps in computing income tax, service tax, VAT tax, wealth tax etc. on the basis of Accounting.

(5) **Inflation Accounting :** The price of all types of goods and assets have recorded an increase during last three-four decades. This increase in price makes financial statements uncomparable. To remove the effect of inflation from the accounts, various items of assets are deflated on the basis of prices of Price Indices. The accounts prepared on the basis of deflated figures are known as Present Value Accounts or Inflation Accounting. Now-a-days many companies are presenting inflation accounting as an appendix to the main accounts.

(6) **Human Resource Accounting (HRA) :** Traditionally the physical assets like building, furniture, plant and machinery etc. are recognized as assets in the books of accounts but the live asset i.e. human being which operate all other assets is not recorded as an asset. In the human resource accounting, the human being i.e., employees of an organisation are valued and included in the assets of an organisation. Many companies in India and abroad have started presenting the human resource accounts.

(7) **Social Accounting :** The society supplies the infrastructure and the facilities without which trade and business cannot be operated at all. Hence the trade and business also have a responsibility to the society. Presently, there is a growing demand for reports on activities which reflect the contribution of an organisation to the society. Social accounting is a process of identifying, measuring and communicating the contribution of trade or business to the society e.g. providing employment financial and manpower support for public activities, customer satisfaction etc.

Groups Interested in Accounting Information :

(1) **Proprietors :** The main aim of accounting is to provide necessary information to the owners related to his business. Owners are one of the several parties who are interested in the information disclosed by the accounting records. They are proprietors in sole proprietorship concerns and the

partners in partnership concerns, while in the case of a company, are the shareholders. These accounting information helps the businessmen or the owner to know about the profits and losses of the business. They also assist in decision making, formulating future policies and in course evaluating present projects and policies.

(2) **Management :** The management of business are interested in the information relating to their business. They need accounting information related to setting up targets for future periods, usually the next financial year; measuring and evaluating the performance in relation to the targets set up for the various units or departments of the business as also the firm as a whole; finding out the areas of shortfalls and controlling acquisition and maintenance of inventories receipts and payments of cash purchases and sales etc.

(3) **Prospective Investors :** The person who is counter placing an investment in a business will like to know about its profitability and financial position. They would also like to know that data relating to the past and present performance of the business and details of the decisions taken for future programmes. In simple words, a person who wishes to invest in a business would like to know about the profitability, earning capacity and financial position of the concern. All these information will be derived by him from the accounting reports as such or financial statements of the concern.

(4) **Creditors, Bankers and Other Lending Institutions :** Creditors, Bankers and Other Lending Institutions are interested in knowing whether an enterprise can settle its obligations (including internal charges) on scheduled dates in time. These accounting information helps them in judging such position of credit worthiness. When a business requires more funds for its expansion and development purposes, they are usually provided by commercial banks and financial institutions. Normally, they would lend money after satisfying themselves about the repaying capacity of the borrower; which is judged with the help of financial statements.

(5) **Government :** The Government is very much interested in the financial statements of business enterprises on account of taxation, labour and corporate laws and in collection and compiling statistics for National Accounting. Many products are, now a days, subject to excise duty and other taxes imposed by the central and the state governments which also require cost data.

(6) **Employees :** Employees are interested in financial statements of accounts because increase in their remuneration and payment of bonus depend on the volume of the profit earned. Now a days they are also offered 'Employee-quota-shares'.

(7) **Regulatory Agencies :** Various Government departments and agencies such as Company Law Board, Registrar of Companies, Tax Authorities etc. use accounting reports not only as a basis for tax assessment but also in evaluating how well these business organisations are operating under regulatory legislation.

(8) **Researchers :** Accounting data are also useful to the research scholars in their research in accounting theory as well as business affairs and practices and other related areas.

(9) **Citizens :** Lastly, an ordinary citizen is also interested in the Accounting Reports of a Government company, a Statutory corporation, a public utility concern as a voter and a Tax-payer. They would like to know the records of the institutions with which they come in contact in daily life for example Bank, University, Transportation, Electricity Companies, Gas Companies etc.

Important Terminology :

Our task of learning the language of Business becomes difficult and complicated since many terms used in Accounting may have different meaning as compared to general and popular meaning.

It is, therefore, essential to learn and understand the meaning of certain basic accounting terms which are frequently used in the business world :

(1) **Business** : The term business means works, efforts and acts of people, which are connected with the production of wealth. In other words, the activities which are directly related with the object of making profit. The term business also includes the performance or rendering of services for others on payment.

(2) **Transaction** : When goods or services are exchanged between the persons or parties, there is a transaction between them. Usually, the exchange is for a price. Mr. A pays cash to Mr. B, is a transaction, 'X sells goods to Y', is also a transaction. Events like depreciation in the value of Plant and Machinery, Loss of goods due to fire etc. cannot strictly be called as transactions. But in accountancy, such events are also referred as transactions.

(3) **Expenditure** : Expenditure means spending of money or exchange for other assets or commodities or a promise to make the payment at a later date. Expenditure may be of capital nature (e.g., to acquire an asset) or of revenue nature, (from which the benefit will soon be exhausted) e.g. salary, rent, wages etc. Similarly, expenditure, increases the profit earning capacity of the business in future.

(4) **Losses** : The term 'Losses' should be used for money's worth given up without any benefit i.e., the unwanted burden which the business is forced to bear. Examples are : Loss of goods due to theft or fire or flood or storm or accidents, payment of damages to others etc.

(5) **Assets** : The valuable things owned by the business are known as Assets. We can say that it is the expenditure which results in acquiring of some property or benefit of a lasting nature. In other words, Assets are the economic or valuable resources of an enterprise which may be expressed in monetary terms. Assets may be classified as : (i) Fixed Assets, (ii) Floating or Current Assets, (iii) Fictitious Assets, (iv) Intangible Assets, (v) Liquid Assets, (vi) Wasting Assets, etc. Examples of Assets are : Building, Plant or Machinery, Goodwill, Stock, Bill Receivable, Cash, Cash at Banks, Investments etc.

(a) **Fixed Assets** : These assets are acquired for relatively long period of time and for carrying on business of the firm. These are not meant for resale; for example, Land, Building, Furniture, Fittings, Plant and Machinery, Cars and Other Vehicles etc.

(b) **Current Assets** : Such assets are acquired with the intention of converting them into cash during normal business operations of the firm. Unsold stock, Debtors, Bills Receivable, Cash in hand, Bank balance, Accrued income are some examples of current assets.

(c) **Tangible Assets** : Tangible assets are those assets which can be seen and touched. In other words, those assets which have a physical existence such as Land, Building, Plant, Furnitures, Stock, Cash, Bills Receivable are called tangible assets, etc.

(d) **Intangible Assets** : Intangible Assets are those assets which do not have a physical existence and which cannot be seen or felt. Examples of such assets are Good-will, Patents, Trade Marks, Copy rights and Prepaid Expenses. Intangible assets are also valuable assets. For example, with the help of Patents (know-how) businessman is able to produce goods and then his goodwill helps in attracting the customers easily. Therefore, the intangible assets help the firm in earning profits as much as the tangible assets. Hence, both tangible and intangible assets are valuable assets which are based on the benefit and facility available to the business.

(e) **Wasting Assets** : These are such assets which are consumed through being used and worked such as mines, oil wells, forests etc. As soon as all the minerals are extracted, the mines become valueless. Oil wells and forests possess the same characteristics. Thus, wasting assets are those which get exhausted after certain period of time being worked. It may also include such assets which get exhausted with the lapse of time, such as Patents, Trade-marks, Leasesholds etc.

(f) **Fictitious Assets** : Assets which does not possess any real value but included in the Balance Sheet for legal and technical reasons are called fictitious assets. Preliminary expenses, Underwriting commission, Discount of Issue of shares and debentures in case of a company and other trade losses are some examples of such assets.

(6) **Capital** : It refers to the amount invested by the proprietor of business under taking. It is that amount which is used for further production or purchasing of goods and assets in the business. It is also known as Owner's Equity or Net Worth. Thus

$$\text{Capital} = \text{All Assets} - \text{External Liabilities or External Equity}$$

As such, Profit or Income will enhance the Capital and Loss will decrease it. Capital does not mean contribution by the owner in cash only. It may be in kind also, such as, Plant, Machinery, Land, Buildings, Furniture etc. It may be classified as : (i) Fixed Capital, (ii) Floating Capital, (iii) Working Capital, etc.

(i) **Fixed Capital** : Capital invested and represented by fixed assets in the business.

(ii) **Floating Capital** : Capital in the form of floating or current assets of an undertaking.

(iii) **Working Capital** : It is the excess of current assets over current liabilities or

$$\text{W.C.} = \text{CA} - \text{CL}$$

(7) **Liability** : Liability refers to the amount due by a business house to others. Sometimes, the term is used to include the amount due to the proprietors also. The business should have sufficient current assets to meet its current liabilities and reasonable amount of fixed assets to meet its fixed liability. Liabilities can be classified as : (i) Liability for Owners Equity, (ii) Liabilities to outside Creditors that may be for goods, for loan, for expenses etc. It can also be classified as Fixed Liability, Current Liability and Contingent Liability.

(a) **Fixed Liabilities** : All liabilities which are not current or not payable in one year (normal accounting cycle of the business enterprise) are called long term or fixed liabilities. Mortgage, Bank Loan, Debentures (in case of a company), Bonds, Public Deposits are examples of such liabilities which are not due in one year.

(b) **Current Liabilities** : The obligations which are due and payable within one year (one accounting year) and which are paid out of current assets are called current liabilities. Trade Creditors, Accrued expenses, Bills payables or Hundies, Short-term borrowing, Bank overdrafts etc. are examples of current liabilities.

(c) **Contingent Liabilities** : The obligations which may arise on happening of an event in future is called contingent liability. A bill received and discounted from Bankers may arise as a liability if it is dishonoured or a liability may arise on losing pending case in court of law are examples of such liabilities. These are not included in the financial statements of the firm but are shown as a footnote in Balance Sheet on liabilities side.

(8) **Revenue** : Income of a recurring nature from any source is known as "Revenue". It consists of an inflow of assets from customers or clients and which are related to sale of goods or rendering of services.

(9) Debtors : The term 'Debtors' represent the persons or parties who have purchased goods on credit from the Business from whom amount due is receivable by the firm. In simple words, debtor means a person or firm who owes money to the business for goods supplied or for services rendered. In case, the firm is a service institution and the payment for service still remains to be realised, beneficiaries of the service will also be known as 'Debtors'.

(10) Creditors : By creditors, we mean only trade creditors (i.e., creditors of goods purchased for resale), creditors for expenses and bills payable. Thus, the sellers of goods on credit to the firm are known as its creditors of the firm so far the full payment is not made to them.

(11) Stock or Inventory : Stock or Inventories are "tangible property (a) held for sale in the ordinary course of business, or (b) which are in the process of production for such sale, or (c) to be consumed in the production of goods or services for sale."

(12) Drawings : Amount of cash or goods withdrawn from business by the proprietor for his private or personal use is termed as 'drawings'. Acquiring personal assets with business funds are also drawings. Example are : Amount withdrawn by proprietor or owner for personal or domestic use, or using business vehicle for domestic use or goods taken by the proprietor for domestic use or payment of domestic expenses from business funds etc.

(13) Entry : Recording of transaction in any books of account is called an entry. In other words, an entry is the systematic record of business transactions in the books of accounts of the firm.

(14) Expenses : Expense is the cost incurred in producing and selling goods and services. It is the cost of things used and for services rendered in generating revenue. It includes cost of goods sold, indirect expenses incurred and depreciation etc.

(15) Discount – It is an allowance given by the seller to the purchaser. It is of two types –

(i) **Trade discount** – Trade discount is allowed by the seller to the customers for bulk purchases. It is allowed at a fixed percentage on the list price of the goods. Trade discount is simply deducted from gross value of goods sold but not recorded in books of accounts.

(ii) **Cash discount** – This discount is allowed to the customers for early or prompt payment of their dues. It is recorded in the books of accounts. Discount allowed to customers is a loss to a businessman, whereas if his creditor's also give discount to him, then it is a gain.

(16) Accounting Year : Books of accounts are closed annually. Generally, financial year (from 1st April to 31st March) is used as an Accounting Year. Adoption of financial year as accounting year had now become mandatory or the legal necessity for all businesses and corporate undertakings.

(17) Equity : A claim which can be enforced against the assets of a business enterprise is called Equity. There are two types of equity for the firm :

(i) **Owner's Equity :** Means capital employed by the owner or the proprietor along with the net revenue earned by the business. In other words, it means owner's initial investment and the accumulated earnings retained in business.

(ii) **External Equity :** Means obligations payable to outsiders, such as Trade Creditors, Bills Payable, Mortgage Loan, Bank or Institutional Loans etc.

18. Inventory – Tangible property held for sale in the ordinary course of business or in the process of production for such sale or of raw material needed in the production of goods or services for sale including maintenance supplier and consumables other than machinery and plant, and spares.

19. Deferred Expenditure – It refers to expenditure for which payment has been made or a liability incurred which is carried forward on the presumption that it will be beneficial over a subsequent period or periods. This is also referred to as deferred revenue expenditure.

Test Questions

Very Short Answer Type Questions & Answers (Not exceeding 40 words)

Q.1. What is Accounting ?

Ans. : Accounting may be defined as 'the identifying, measuring, recording and communicating of financial information'

Q.2. State any two objectives of Accounting.

Ans. : (i) To provide information about financial transactions.

(ii) To determine the profits earned by the firm.

Q.3. Enumerate any two functions of Accounting.

Ans. : (i) To keep systematic record of financial transactions in Journal.

(ii) To classify all business transactions recorded in Journal i.e. Ledger posting.

Q.4. Give one point of difference between Booking and Accounting.

Ans. : The function of book-keeping is of routine and clerical nature, whereas accounting functions is analytical in nature.

Q.5. What do you understand by Asset?

Ans. : Assets are valuable resources and tangible objects or intangible rights owned by an enterprise and carrying probable future benefits.

Q.6. What is meant by Turnover?

Ans. : The agreeable amount for which sales are effected or services rendered by an enterprise is called sales or turnover.

Q.7. What is meant by Trade discount?

Ans. : When discount is allowed by a seller of goods to the purchaser or to its customers a fixed percentage on the list price of the goods, it is known as trade discount. No entry is passed for trade discount in the books of the owner.

Q.8. What is Cash Discount ?

Ans. : When discount is allowed to customers for prompt payment of their dues, it is called cash discount. It is recorded in the books of Accounts.

Q.9. What do you mean by capital ?

Ans. : Capital refers to the amount invested in an enterprise by its owners, such as cash or any other assets or paid up share capital in a corporate enterprise. It is expressed as :

$$\text{Capital} = \text{Assets} - \text{External Liabilities}$$

Q.10. What do you mean by Liabilities ?

Ans. : The financial obligations of an enterprise or the amount which the firm owes to outsiders except the amount owed to proprietors, is called liabilities.

Q.11. What are Current Assets?

Ans. : Current Assets refer to cash and other assets which are expected to be converted in cash within a short period, normally one year.

Q.12. What are Current Liabilities ?

Ans. : Current Liabilities refer to such obligations which are to be paid within a short period, normally one year.

Q.13. What is an expense?

Ans. : Expense means cost incurred in the operation of business during an accounting period or cost incurred in producing and selling goods.

Q.14. What is Revenue ?

Ans. : Revenue refers to gross inflow of cash, receivables or other consideration arising in the course of ordinary activities of a business enterprise from the sale of goods or services rendered.

Q.15. What do you understand by Profit ?

Ans. : Profit in general refer to the excess of Revenue over related cost. When the result of this computation is negative it is called loss and if it is positive, it is called Profit.

Q.16. What is a Voucher ?

Ans. : A voucher is a document on the basis of which transactions are first recorded in financial books.

Q.17. Give four examples of Current Assets.

Ans. : Examples of Current Assets are :

Cash in hand, Cash at Bank, Sundry Debtors, Bills Receivable, Prepaid Expenses.

Q.18. Give the meaning and four examples of Intangible Assets

Ans. : Intangible assets are those assets which do not have physical existence.

Examples – Goodwill, Trademark, Patent, Prepaid Expenses.

Q.19. What are Contingent Liabilities ?

Ans.: Contingent liabilities refer to an obligation relating to an existing situation which may arise in future depending upon the occurrence of or non-occurrence of one or more uncertain future events.

Q.20. State two examples of Contingent Liabilities.

Ans. : Examples of Contingent Liabilities are :

1. B/R discounted awaiting its due date

2. A claim lying pending in a the court of law against the firm.

Q.21. State five examples of Current Liabilities.

Ans. : Examples of Current Liabilities are :

- (i) Sundry Creditors, (ii) Bank Overdraft
- (iii) Accrued Expenses, (iv) Proposed Income tax
- (v) Short term Loan.

Q.22. Calculate Owner's equity from the following details –

Mr. X invested capital in Business Rs. 2,00,000 Cash and Furniture worth Rs. 10,000. Revenue earned during the year was Rs. 6,00,000 and expenses incurred to earn Revenue was Rs. 5,00,000.

Ans. : Owner's Equity = Capital Invested + Profit for the year,

$$= \text{Rs. } 2,00,000 + 10,000 \text{ or } \text{Rs. } 2,10,000 + (\text{Rs. } 6,00,000 - \text{Rs. } 5,00,000) = \text{Rs. } 3,10,000.$$

Short Answer Type Questions & Answers : (Not exceeding 80 words)

Q.1. Define Accounting and give its two characteristics.

Ans. : Accounting means an art of recording, classifying and summarising in a significant manner and in terms of money transactions and events which are of a financial nature and interpreting the results thereof.

Characteristics :

- (i) It is an art of recording and classifying business transactions.
- (ii) The business transactions should be of financial nature.

Q.2. State the names of users of Accounting Information.

Ans. : Users of Accounting Information :

- (i) Owners or Proprietors of Business.
- (ii) Management of Business Enterprise
- (iii) Prospective Investors
- (iv) Creditors or Suppliers
- (v) Employees of a Business Enterprise
- (vi) Researchers
- (vii) Government and Tax Authorities.
- (viii) Regulatory Agencies.
- (ix) Public or Citizens of the Country.

Q.3. Enumerate different branches of Accounting.

Ans. : Branches of Accounting :

- (i) Financial Accounting
- (ii) Cost Accounting
- (iii) Management Accounting
- (iv) Inflation Accounting
- (v) Human Resource Accounting
- (vi) Tax Accounting
- (vii) Social Responsibility Accounting.

Q.4. State different types of assets and give two examples for each.

Ans. : Types of Assets

- (i) Fixed Assets e.g. Land & Building, Plant & Machinery.
- (ii) Current Assets e.g. Cash & Bank Balance and Sundry Debtors.
- (iii) Intangible Assets e.g. Goodwill and Patents
- (iv) Tangible Assets e.g. Furniture, Fittings and Plant & Equipment.
- (v) Fictitious Assets e.g. Discount on Issue of Shares and Debentures and Preliminary Expenses.

(vi) Wasting Assets e.g. Mines and Oil Wells.

Q5. Give any four examples of Revenue.

Ans. : Four examples of Revenue are :

- (i) Amount received from sale of goods.
- (ii) Amount received from the services provided to customers.
- (iii) Amount received for Commission, Interest & Dividends.
- (iv) Transfer fees received in a corporate organisation.

Q6. Distinguish between Expenses and Losses.

Ans. : If the benefit of an expenditure is exhausted within a year, it is called Expense. On the other hand excess of Expenditure for a particular period over the related Revenue of the same period is termed as a loss.

Q7. Differentiate between Debtors and Creditors.

Ans. : Debtors are persons of firms who owe an amount to the enterprise for the goods sold or services provided to them on credit basis. On the other hand creditors are the persons or firms who are entitled to receive an amount from the enterprise for supplying goods or raw material or for services received.

Q8. Give two characteristics of a business transaction.

Ans. : (i) It results in a change in the financial position of the firm, i.e. a change in the values of some of the assets, liabilities or capital.
(ii) The change must be capable of being expressed in terms of money.

Q9. What is the difference between fixed assets and current assets ? Explain with examples.

Ans. : Fixed assets refer to those assets which are bought and held for continued use in the business and which are not meant for resale. On the other-hand current assets are either meant for resale or which are expected to be converted in cash within a short period not exceeding one year. Examples of fixed assets are Land, Building, Plant, Machinery, Office Equipment Furniture & Fittings etc. Examples of Current Assets are Cash in hand, Cash at Bank, Sundry debtors, Stock of goods, Bills Receivable etc.

Essay Type or Long Answers Questions :

1. What is Accounting ? What are its characteristics and explain its functions.

(See page nps. 1.1 and 1.3)

2. Define Accounting. How does it differ from Book-keeping ? What are its objectives.

(See page nps. 1.1 and 1.3)

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2

Generally Accepted Accounting Principles : Concepts and Conventions

In the past accounting statements were generally and mostly needed by the Owners and Proprietors of Business. But during present era Accounting statements are needed by various parties who have some vested interest in the Business, directly or indirectly viz. Investors, Creditors, Government and many others to know about solvency, profitability, and liquidity of the business. It is therefore, essential that the accounting statements be prepared in some standard language and common rules. These rules are called 'Generally Accepted Accounting Principles' (GAAP). In other words, "Generally accepted accounting principles, concepts and conventions are the fundamental rules of Accounting which are universally used and accepted by the Accountants all over the world as general guidelines for preparing Accounting Statements." In other words, the rules and conventions of accounting are commonly referred to as 'Principles'. The word principle is here used to mean 'a general law or a rule adopted or professed as a guide to action, or a settled basis of conduct or practice. These principles have developed in accordance with usage, experience, historical precedents, professional bodies, government regulations with the passage of time and with changing need of business.

The Accounting Principle Board of AIOPA states "Generally accepted accounting principles incorporate the consensus at any time as to which economic resources and obligations should be recorded as assets or liabilities, which change in them should be recorded, how recorded assets and liabilities and changes in them should be measured, what information should be disclosed and how should it be disclosed and which financial statements should be prepared. These accounting principles are man-made and are derived from experience and reason, when they prove useful they become accepted as principles of accounting."

Accounting Principles are a body of doctrine commonly associated with the theory and procedure of accounting serving as an explanation of current practices and as a guide for selection of conventions or procedures where alternatives exist.

Kinds of Accounting Principle

The accounting principles are segregated as under :

- (1) Accounting Concept, and
- (2) Accounting Conventions.

(1) Accounting Concepts :

Accounting concepts may be considered as postulates or basic assumptions or conventions or doctrines upon which the science of accounting is based. Following are the important accounting concepts :

(1) Business Entity or Separate Entity Concept : According to this concept business is treated to have a distinct accounting entity from its owners, who controls the resources of the concern and

is accountable therefor. All the accounts are kept for a business entity as distinguished from the persons associated with it i.e. owners. They will record transactions between the owner and the firm; for instance if proprietor withdraws some Cash or Goods, such is treated as drawings but not as business expense. Thus capital of the owner is reduced by the amount of these drawings. This concept is based on the sense that proprietors resources are handed over to the management and the management is expected to use these resources to the best advantage of the firm, and to account for their sources placed at its disposal. The failure to recognize the business as a separate accounting entity, would make it extremely difficult to evaluate the performance of the business alone; since the private transactions would get mixed which will introduce bias in the results.

The overall effect of adopting this concept are –

- (i) Only those transactions which are related to business are recorded and not the personal transactions of the owners.
- (ii) All incomes or profits is the property of the business unless distributed to owners.
- (iii) Any personal assets of the owners or shareholders in case corporate sector, are not considered while recording and reporting the assets of business entity.

(2) Money Measurement Concept : In accounting, a record is made of only those transactions and events that can been expressed in terms of Money. Those events which can not be expressed in money terms do not find place in the accounts; for instance, salary paid to an employee is recorded in the books but his competence which cannot be expressed in monetary terms is not recorded in books. The applications of this concept makes accounting information and data relevant and easy to understand, homogeneous and comparable. The importance of money measurement concept is that, even a layman is able to understand and appreciate the things stated in money. Despite merits stated above, the concept suffers from the following limitations :

- (i) The value of money is not constant. It changes because of inflation or deflation in the country.
- (ii) business cannot be measured in money terms. It is very difficult to calculate the value of goodwill or measure the competency or morale of employees.

(3) Going Concern Concept : This concept assumes that the business will continue for a fairly long period to come. On the basis of this concept acquisitions of Assets is recorded on historical cost basis and the increase or decrease in their value is not considered. The going concept is based on the following assumptions :

- (i) The life of business is indefinite;
- (ii) Depreciation of assets is made on the basis of the expected life without caring for their current values;
- (iii) when new innovations and inventions take place the effect is measured in financial terms and assets are depreciated to allow for such changes.

(4) Cost Concept : According to this concept all transactions are entered in the books of accounts at the price actually paid to acquire it, that is, at its cost. This amount will be the basis for all subsequent accounting for the assets. But the cost concept does not mean that the assets will always be shown at cost. The assets may be recorded at cost at the time of its purchase but it may systematically be reduced in its value by charging depreciation. However, if it is certain that Business will last for a limited period of time, the accounting records will keep the expected life in view and treating all expenditures alike, may be capital or revenue. In case of revaluation of assets by the firm

in the long run if surplus or deficit is transferred to Capital Reserve, it is not a violation of going concern concept since revaluation is made on permanent basis to reflect current values of Assets.

The rationale for the cost concept is the application of three basic criteria of relevance, objectivity and feasibility. But this concept is not much relevant for investors and other users because they are more interested in knowing what the business is actually worth today rather than the original cost.

(5) Dual Aspect Concept : The Dual Aspect concept is based on double entry book-keeping, which means every transaction entered into by a firm or an institution will have two aspects. One entry consists of debit to one or more accounts and another entry consists of credit to some other one or more accounts. However, the total amount debited is always equal to the total amount credited. According to this concept, every receiver is also a giver and every giver is also a receiver. For example Mr. Ravi purchases furniture for cash Rs. 25,000. He receives furniture on one hand and pays cash Rs. 25,000 on the other.

As such this system of recording transactions on this principle is called, "Double Entry System". It is because of this principle that both the sides of Balance Sheet are always equal. Thus the following accounting equation will always hold good at any point of time :

$$\begin{aligned} \text{Assets} &= \text{Liabilities} + \text{Capital or Equity} \\ \text{or Capital} &= \text{Assets} - \text{Liabilities} \\ \text{or Equities} &= \text{Assets} \end{aligned}$$

Any change in one of them will lead to a change in any of the other. An increase in Assets without a corresponding increase in liabilities or a corresponding decrease in another assets must represent increase in Capital. Conversely an increase in liabilities without corresponding decrease in another liability will indicate decrease in Capital.

(6) Verifiable or Objectivity Concept : According to this concept every business record must be based and supported by documentary evidence and accounting should be definite, verifiable and free from manipulation and personal bias. In other words, financial information recorded in accounts should be capable of being substantiated by reference to generally accepted accounting principles and documented evidence of events.

(7) Accrual Concept : In accounting for recording of transactions, accrual basis is adopted. It provides more appropriate information about the performance of business entity as compared to cash basis. This concept is applicable equally for Revenue as well as for Expenses. In accrual concept, revenue is recognised and recorded when sales are effected or services are rendered whether cash is received or not; similarly, expenses are recorded in that accounting period during which they assist in earning revenue, whether cash is paid for them or not. As such, to find out true profit or loss for an accounting period and to show true financial position at the end of accounting period of the enterprise all expenses and incomes should be recorded in that accounting period for which they relate, whether actual cash has been paid or received or not. It is also described as matching concept.

(8) Matching Concept : This principle holds that expenses should be recognised in the same period as associated to revenues. It is very important for correct determination of profitability which is a measure of performance. Infact, according to this principle, expenses incurred in an accounting period should be matched with the revenues realised in the same period. If the revenue is realised on certain goods delivered during a particular period, all costs attributable to those goods should also be charged as expenses in the same period. To sum up, of the total amount spent, that part against which benefit will be received on revenue earned in the future is shown in the balance sheet as an asset and the rest is treated as an expense or the loss.

(9) **Principle of Full Disclosure :** This principle says that accounts must be honestly prepared and all significant information must be disclosed therein. Standard forms of balance sheet and schedule of contents of the profit & loss account are prescribed by law to make disclosure of all relevant facts of contents. Disclosing of material fact does not mean leaking out the business secrecy. But it means compulsorily. Disclosing of material fact does not mean leaking out the business secrecy. But it means disclosing all information of interest of the proprietors and investors. This is done for not to overburden accounts with information but to present facts without any malafide intention. As such various items or facts which do not find place in Accounting Statements are shown in the Balance sheet by way of footnote. For example :

- (i) Contingent liabilities,
- (ii) Market value of Investments,
- (iii) Change in the method of valuation of stock or change in the method of providing depreciation etc.

Accounting Conventions

To make the accounting information more reliable, relevant, meaningful, consistent and intelligible, accounting concepts and principles need to be modified. For instance materiality, consistency, conservatism, timeliness, industry's practices, cost benefit relationship and other considerations have to be taken into account for making the information useful and meaningful. Thus, these modifying principles known as accounting conventions which are as under :

(1) **Convention of Materiality :** The term material refers to the relative importance of an item or an event. Accounting should disclose all the material information and not to attempt to record so insignificant events which are not justified by the usefulness of the results. In other words, materiality here means the information which would have changed the results of the business if it would have been disclosed. Sometimes certain information may be furnished in footnotes as below—

- (a) Information regarding contingent liabilities,
- (b) Information regarding market price of investments etc. Materiality will differ with the size, nature and traditions of the business. International accounting standards-5 states that "All material information should be disclosed which is necessary to make the financial statements clear and understandable."

(2) **Convention of Consistency :** Since business is a going concern which has to continue indefinitely, so it is necessary to make accurate comparison and that the methods and practice of recording and presentation of accounts does not change. The procedure for determination of value of stock, the mode of charging depreciation etc. should continue to be the same. According to International Accounting Standard-1 consistency is a fundamental assumption and it is assumed that accounting policies are constant from one period to another. Where this convention is not followed, the fact should be disclosed clearly along with reasons thereof.

(3) **Convention of Conservation :** This convention holds that when more than one accounting or measurement alternative is permissible for a transaction, the one having the least favourable immediate effect on profits or capital usually should be adopted. Providing for all future possible losses and not to anticipate any future earning is a golden rule. According to international accounting standard, "uncertainties inevitably surround many transactions. This should be recognised by exercising prudence in financial statements. Prudence does not, however, justify the creation of secret or hidden reserves. Hence, convention of conservatism is the policy of 'Playing Safe'. Based on this convention, the stock in hand is shown at '*Lower of Cost or Market Price*', Provision for bad debts., Joint life policy

or Policies are shown not at actual amount of premiums paid but at surrender value etc. are few examples of conservatism. Based on this convention, the Stock in hand or certain categories of Investments are shown at "*lower of cost or market price*".

(4) **Convention of Timeliness :** Although information is useful which is relevant and reliable but it must also be furnished timely. Timeliness means having information available to decision makers before it loses its capacity to influence decision. In this regard it is rightly said that it is always better to have less reliable information in time, rather than furnishing more reliable information, very late.

(5) **Convention of Industry Practice :** There are many different accounting policies in use even in relation to the same subject. Judgment is required in selecting and applying those which in the circumstance of the enterprise are best suited to present properly its financial position and the results of its operation. Different industries such as mining, banking, electricity etc. have their own peculiar features and practices that required carefree considerations while preparing their financial statements. As accounting focuses on usefulness and feasibility, the industry practice at principle permits, special accounting treatment for specific items where there is a clear precedent in the industry based on uniqueness, usefulness and feasibility, may be adopted.

(6) **Convention of Cost Benefit Relationship :** According to this convention it should be ensured that the cost of applying the particular concept, principle or convention should not exceed the benefits derived from it. In other words, the benefits to be gained from providing any accounting information should be larger than the cost of providing it. It does not mean that to save cost, no information or very little information should be given to the Users. Infact cost benefit analysis has to face many difficulties. As cost can be of several kinds, it is more difficult to measure the benefits accruing to Investors and Users.

Fundamental Accounting Assumptions

As stated by the Indian Institute of Chartered Accountants in Accounting Standards (ASI), the basic concepts and conventions of accounting are (i) Going Concern, (ii) Consistency, and Accrual, which have been explained in, details in aforesaid pages.

Source Documents

Documents on the basis of which entries are recorded are known as source documents. They provide information about the nature of the transactions and the amount involved in it. Such a document may be generated within the business or may flow into the business from outside.

The source documents which originate from within an organisation, comprises of sales invoice, purchase orders, deposit pay-in slips, salary and wage sheets, bills payable, plant and machinery register etc. The source documents which originate from outside an organisation includes suppliers invoices, cheques received from customers, debit memos of the Banks and bills receivable etc. The first step in Accounting is to identify the origin of the transactions which are undoubtedly based on documentary evidence known as source documents.

Test Question

Very Short Questions & Answers (Not exceeding 40 words)

Q.1 Why do you understand by accounting concepts?

Ans. : Accounting Concepts may be considered as postulates or basic assumptions or doctrines or conventions on which the accounting science is based.

Q.2. What is meant by accounting principles ?

Ans. : Accounting principles are a body of doctrines associated with the theory and procedure of accounting serving as an explanation of current practices and as a guide for selection of convention.

Q.3. State two characteristics of accounting principles.

Ans. : (i) Accounting principles are man-made
(ii) Accounting principles are flexible

Q.4. What is going concern concept ?

Ans. : This concept assumes that business will continue for a fairly long period of time to come.

Q.5. What is dual aspect concept ?

Ans. : The dual aspect concept is based on double entry book-keeping which means every transaction has two aspects. One entry consists of debit to one or more accounts and another entry consists of credit to some other one or more accounts.

Q.6. What is meant by money measurement concept ?

Ans. : In accounting a record is made of only those transactions and events that can be expressed in terms of money. Those events which cannot be expressed in money terms do not find place in Accounts.

Q.7. What is Verifiable or Objectivity Concept ?

Ans. : According to this concept only those transactions of business must find place to be recorded in the books of accounts if the same are supported by documentary evidence.

Q.8. What is convention of Full disclosure.

Ans. : This convention states that all significant information should be disclosed in financial statements through foot notes which may be useful for the users.

Q.9. Define the convention of consistency.

Ans. : According to this convention, the accounting practices should remain the same from one year to another. In other words, the working rules once chosen should not be changed arbitrarily without notice to this effect.

Q.10. What is meant by Revenue Recognition concept ?

Ans. : According to this concept revenue is considered as being earned on the date on which it is realised that is either cash has been received or a legal obligation to pay has been assumed by the customer.

Q.11. What do you mean by Accrual Concept.

Ans. : In accounting, the accrual basis is used for recording of transactions. It provides more vital information about the performance of a business enterprise as against cash basis. Accrual concept is application for both, the expenses and the revenue.

Q.12. What do you mean by Matching Concept ?

Ans. : According to this concept in determining the Net Profit from business operations, all costs which are applicable to the revenue of the period should be charged against that Revenue. Accordingly for matching costs with revenue first revenue should be recognised and then cost incurred for generating that revenue should be recognised.

Q.13. How is the Closing Stock valued under Convention of Conservatism or Prudence.

Ans. : According to convention of prudence all anticipated losses should be recorded in the books of accounts, but all unrealised or anticipated gains or incomes should be ignored. As such, vide this convention closing stock is valued at cost price or market price, whichever is lower.

Q.14. What is Convention of Materiality?

Ans. : Items having an insignificant effect or being irrelevant to the users of financial statements need not be disclosed.

Short Answer Type Questions & Answers (Not exceeding 80 words)**Q.1. What are generally accepted accounting principles ?**

Ans. : Accounting is often called language of Business, through which normally a business house communicates with the outside world. With a view to make the language of accounting to convey the same meaning to all people as far as possible, it is necessary that it should be based on certain uniform standards, so that the accountants from all over the world have certain rules, procedures and conventions. These rules and conventions are called generally accepted principles.

Q.2. What is Accounting Period Concept ?

Ans. : The entire life of the Business Enterprise is divided into time intervals for the measurement of profit of the business. Twelve months period is usually adopted for this purpose. According to amended Income Tax Act., a business has to adopt financial year beginning with April 1 and ending on 31st March as the accounting period. It has become mandatory.

Q.3. Explain Money Measurement Concept.

Ans. : Only those transactions and events are recorded in accounting which can be expressed in terms of money. The event may be quite vital for the business but if its effect cannot be measured in terms of money, will not be recorded. For example, a business on a particular date has Rs. 20,000 in Cash, 5,000 kilogram of raw material, 4 tonnes of finished goods, three machines, 20 chairs, 10 fans etc. All these things cannot be added up unless expressed in terms of money. With a view to record these items, these should be expressed in monetary terms.

Q.4. What is Accounting Period Concept ?

Ans. : The accounting period concept indicates that the profitability of a business is to be measured periodically. The period for which income is measured is called the accounting period, which normally consists of 12 months. For the purpose income tax a business has to adopt financial years beginning on 1st April in any calendar year and ending on 31st March during next calendar year, as its accounting year. In short, it is now mandatory to adopt financial year as Accounting year.

Q.5. What is the nature of Accounting Principle ?

Ans. : Accounting principles are uniform set of guidelines developed to ensure uniformity and easy understanding of the Accounting Information. These principles are man made and are derived from experience with reasons. Ofcourse, these principles lack universal applicability like the principle of Physics and Chemistry. These principles are not static but changes with the passage of time with changes in business practices, government policies and necessity of the users of accounting information.

Q.6. What is the need of Accounting Principles ?

Ans. : With a view to make the accounting information meaningful to its internal and external users, they require comparable information for several years for the same enterprise or among various enterprises. This is possible only if the information provided by the financial statements is based

on some set of rules known as principles, postulates, conventions, usages or policies. Those rules and principles bring uniformity and consistency to the process of accounting, which increases its utility for the users.

Q.7. State the meaning of Accounting Conventions and enumarate any four of them.

Ans. : The term ‘convention’ denotes customs, traditions and the usages. These customs and traditions guide the Accountants while preparing accounting statements, viz., Balance Sheet and Profit & Loss statement. The following are some of the important conventions in use—

- (i) Convention of Conservatism,
- (ii) Convention of Full disclosure,
- (iii) Convention of Consistency,
- (iv) Convention of Materiality.

Essay Type or Long Answers Questions :

1. What is meant by the terms ‘Principles and Postulates of Accounting’ ? Explain.
(See page nps. 2.1) [MDS Univ., Ajmer 1998]
2. “Cost concept does not give a true and fair view of the state of affairs of a Business.” Comment.
(See page nps. 2.2) [MDS Univ., Ajmer 1996]
3. Write explanatory notes on :
 - (i) Generally Accepted Accounting Principles.(See page nps. 2.1) [MDS Univ., Ajmer 1996]
 - (ii) Going Concern Concept. (See page nps. 2.2) [MDS Univ., Ajmer 1997]
4. Discuss in brief the following concepts and conventions, giving examples :
 - (a) The Accrual Concept (See page nps. 2.3)
 - (b) The Matching Concept (See page nps. 2.3)
 - (c) The Materiality Convention (See page nps. 2.4) [MDS Univ., Ajmer 2001]
5. What do you mean by Accounting Concepts and conventions ? Explain any five important accounting concepts and conventions.
(See page nps. 2.1 to 2.5) [R.U. BCA, 2010, 2006]

