Introduction to Accounting

CBSE · Class 11 · Accountancy — exam notes

Accounting is the language of business — the systematic process of identifying, recording, classifying, summarising, and communicating a firm's financial transactions so that users can make sound decisions. This first chapter builds the vocabulary, objectives, characteristics, and basic terms on which every later topic in Accountancy rests.

Key terms & definitions

Accounting
The process of identifying, measuring, recording, classifying, summarising, analysing, interpreting and communicating the financial transactions and events of a business to its users. It is wider than book-keeping and is rightly called the 'language of business'.

Book-keeping
The part of accounting concerned only with identifying financial transactions and recording them in the books in a systematic, date-wise manner. It is the primary, routine stage; analysis and interpretation are NOT part of book-keeping.

Business transaction
An economic activity or event of a business that can be measured in money and that changes the financial position of the firm (e.g., buying goods, paying rent, taking a loan). Events not measurable in money are not recorded.

Capital
The amount (in cash or kind) invested in the business by its owner. To the business it is a liability owed to the owner (Business Entity Concept). Capital = Assets - Liabilities.

Drawings
The amount of cash or value of goods/assets withdrawn by the owner from the business for personal use. Drawings reduce the owner's capital.

Assets
Economic resources owned by the business that yield future benefit and have a money value. Non-current (fixed) assets are held long-term (land, building, machinery, goodwill); current assets are convertible into cash within a year (cash, debtors, stock).

Liabilities
Amounts a business owes to outsiders. Non-current (long-term) liabilities fall due after one year (long-term loans, debentures); current liabilities fall due within a year (creditors, bills payable, bank overdraft, outstanding expenses).

Expenditure vs Expense
Expenditure is spending money or incurring a liability to acquire assets, goods or services. Capital expenditure gives benefit for more than one year (buying machinery); revenue expenditure gives benefit within the year (rent, wages). An expense is the cost of resources used up to earn revenue in an accounting period (e.g., depreciation, salaries).

Revenue, Income, Gain, Profit
Revenue is the regular inflow from the firm's main operations (sales, commission, rent received, interest received). Profit is the excess of revenue over the expenses of a period and increases capital. Gain is profit of an irregular/non-recurring nature (e.g., profit on sale of a fixed asset). Income (in NCERT's wider sense) is the increase in the owner's net worth from business operations.

Goods vs Stock
Goods are items a firm purchases mainly to re-sell (its merchandise). Stock (inventory) is the value of goods lying unsold on a given date — opening stock at the start and closing stock at the end of the year.

Debtor vs Creditor
A debtor is a person/firm who owes money to the business (usually because goods were sold to them on credit). A creditor is a person/firm to whom the business owes money (usually because goods were bought from them on credit).

Voucher & Discount

A voucher is the written documentary evidence of a transaction (cash memo, invoice, receipt) on which an entry is based. Trade discount is a reduction in the list price allowed on bulk purchase — it is NOT recorded in the books. Cash discount is allowed for prompt/early payment — it IS recorded in the books.

Meaning and definition of accounting

- Accounting is the systematic process of identifying, recording, classifying, summarising, analysing, interpreting and communicating financial information to its users.
- The flow is: raw transactions to organised records (book-keeping) to summarised statements to useful information communicated to users.
- It is called the 'language of business' because it conveys the results and financial position of a business to all interested parties.
- Book-keeping is only the recording stage; accounting is the broader discipline. Accountancy is the body of knowledge/rules that governs how accounting is done.

Accounting as a source of information

- An accounting system is an information system: it processes financial data (input) into financial reports (output) for decision-makers.
- The main outputs are the Profit and Loss Account (which shows profit/loss for a period) and the Balance Sheet (which shows the financial position on a date).
- Good information must reach the right user, at the right time, in an understandable form.

Objectives of accounting

- To maintain a systematic, complete and permanent record of all financial transactions (the book-keeping objective).
- To ascertain the net profit or loss of the business for an accounting period by preparing the Profit and Loss Account.
- To ascertain the financial position of the business (assets, liabilities and capital) by preparing the Balance Sheet.
- To provide accounting information to interested users for sound decision-making.
- To assist management in planning, controlling, budgeting and decision-making.

Functions of accounting

- Maintaining systematic records of all transactions in money terms.
- Communicating results — profit/loss and financial position — to all users.
- Meeting legal requirements (Companies Act 2013, Income Tax Act, GST law) by providing records for assessment and filing of returns.
- Protecting business assets by keeping proper records that help control and prevent misuse.
- Assisting management with information for control, planning and decision-making.

Advantages of accounting

- Provides a complete and systematic record so the owner need not rely on memory.
- Helps ascertain profit or loss earned during the year.
- Helps ascertain the financial position of the business through the Balance Sheet.
- Provides information that helps management make decisions and control the business.
- Acts as legal evidence in courts and helps in the assessment of tax (income tax, GST).
- Helps in comparison of performance across years and with other firms.
- Assists in the valuation of the business at the time of sale, merger or admission of a partner.

Limitations of accounting

- Records only those transactions that can be measured in money; valuable non-monetary facts (skill of management, employee morale, market reputation) are ignored.
- Accounting information is based on historical cost and does not show the current market value or the effect of changing price levels (inflation).
- It can be influenced by the personal judgement of the accountant (e.g., choice of depreciation method, estimate of bad debts), so it may not be fully objective.
- It may be window-dressed (manipulated) to present a more favourable picture than the reality.
- It ignores the qualitative elements and shows only the quantitative, money-measurable side of the business.

Qualitative characteristics of accounting information

- Reliability — the information must be free from material error and bias and capable of being verified from source documents (invoices, receipts, vouchers).
- Relevance — the information must be useful for the decision at hand and available in time to influence it; irrelevant data is excluded.
- Understandability — the information must be presented so that a user with a reasonable knowledge of business can interpret it correctly.
- Comparability — the information must be prepared on consistent principles so it can be compared with earlier years (intra-firm) and with other firms (inter-firm).

Users of accounting information and their needs

- Internal users: Owners/proprietors (to know profit and return on investment), Management (to plan, control and decide), and Employees (to judge job security, bonus and pay).
- External users: Banks and lenders (to judge whether a loan will be repaid), Creditors/suppliers (to fix credit terms), Investors (to decide whether to buy/hold shares), Customers (to judge continuity of supply), Government and tax authorities (to assess tax and regulate), and Researchers/public (for studies and employment data).
- All users draw their answers from the same set of financial statements, but each asks a different question.

Role of accounting in business

- Accounting helps replace memory with permanent records as the business grows.
- It assists in fixing selling prices and controlling costs.
- It helps the owner plan future activities and assess past performance.
- It builds the trust of outsiders (banks, creditors, investors) by providing reliable, comparable figures.
- Modern accounting has moved from a mere record-keeping role to a vital management information and service function for decision-making.

Branches of accounting

- Financial Accounting — records transactions and prepares the Profit and Loss Account and Balance Sheet to ascertain profit/loss and financial position for external users.
- Cost Accounting — ascertains and controls the cost of producing goods or services and helps in cost reduction and price fixation.
- Management Accounting — supplies financial and cost information to management in a form useful for planning, control and decision-making.

Basic accounting terms (the vocabulary)

- Entity & Business Transaction — the business is treated as separate from its owner; a transaction is an event measurable in money that changes financial position.
- Capital & Drawings — Capital is the owner's investment (a liability to the firm); Drawings is what the owner takes out for personal use (reduces capital).
- Assets & Liabilities — Assets are resources owned (current vs non-current); Liabilities are amounts owed to outsiders (current vs non-current).
- Expenditure, Expense, Revenue, Income, Profit, Gain, Loss — distinguished by regularity and timing (see Key Terms).
- Purchases & Sales — buying of goods meant for resale (cash or credit) and selling of those goods (cash or credit); 'Purchases'/'Sales' refer only to goods, not to fixed assets.
- Goods & Stock — Goods are merchandise for resale; Stock is unsold goods on a date (opening/closing).
- Debtor & Creditor — Debtor owes the firm money; Creditor is owed money by the firm.
- Voucher & Discount — Voucher is documentary proof of a transaction; Trade discount (on bulk, not recorded) vs Cash discount (for prompt payment, recorded).

The accounting equation (foundation)

- Every business satisfies: Assets = Liabilities + Capital (equivalently Capital = Assets - Liabilities).
- This follows from the Dual Aspect Concept — every transaction affects two items and keeps both sides equal.
- Because the two sides always stay equal, the Balance Sheet always balances.

Formulas & formats

- `Accounting Equation: Assets = Liabilities + Capital`
- `Capital = Assets − Liabilities`
- `Profit = Total Revenue (Income) − Total Expenses (if negative, it is a Loss, which reduces Capital)`
- `Closing Capital = Opening Capital + Additional Capital + Profit − Drawings − Loss`
- `Cost of Goods Sold (intro level) = Opening Stock + Purchases − Closing Stock`

Important questions & model answers

1 mark **Define accounting. Why is it called the 'language of business'? (1 mark)**

- Accounting is the process of identifying, recording, classifying, summarising and communicating the financial transactions of a business to its users.
- It is called the 'language of business' because it communicates the results and financial position of the business to all interested parties, just as a language conveys meaning.

1 mark **Distinguish between book-keeping and accounting. (1 mark)**

- Book-keeping is only the identifying and recording of transactions in the books in a systematic way.
- Accounting is wider — it also classifies, summarises, analyses, interprets and communicates the information; thus book-keeping is a part (the first stage) of accounting.

3 marks **State any three objectives of accounting. (3 marks)**

- To maintain a systematic and complete record of all financial transactions.
- To ascertain the net profit or loss of the business by preparing the Profit and Loss Account.
- To ascertain the financial position of the business (assets, liabilities and capital) by preparing the Balance Sheet, and to provide information to users for decision-making.

4 marks **Explain the four qualitative characteristics of accounting information. (4 marks)**

- Reliability — information must be free from material error and bias and verifiable from source documents such as invoices and receipts.
- Relevance — information must be useful for the decision at hand and available in time to influence that decision.
- Understandability — information must be presented clearly so that a user with reasonable business knowledge can interpret it.
- Comparability — information must be prepared on consistent principles so it can be compared across years and with other firms.

4 marks **Who are the internal and external users of accounting information? State the need of any four users. (4 marks)**

- Internal users: owners (to know profit and return), management (to plan and control), employees (to judge job security and bonus).
- External users: banks/lenders (to judge repayment capacity before granting a loan), creditors/suppliers (to decide credit terms), investors (to decide whether to invest in shares), government/tax authorities (to assess and collect tax such as income tax and GST).
- Each user examines the same financial statements but seeks the answer to a different question.
- Hence accounting serves a wide range of decision-makers, not just the owner.

6 marks **Explain any four advantages and any two limitations of accounting. (6 marks)**

- Advantage 1 — Systematic record: provides a complete, permanent record so the owner need not depend on memory.
- Advantage 2 — Profit/Loss & financial position: helps ascertain profit or loss and the financial position through the P&L Account and Balance Sheet.
- Advantage 3 — Decision-making and control: provides information that helps management plan, control and take decisions.
- Advantage 4 — Legal evidence and tax: serves as evidence in courts and as the basis for assessing income tax and GST; also aids comparison and business valuation.
- Limitation 1 — Money measurement only: it ignores valuable non-monetary facts such as management skill, staff morale and reputation.
- Limitation 2 — Historical cost & subjectivity: it records assets at historical cost (ignoring inflation/market value) and can be affected by the accountant's personal judgement or window-dressing.

4 marks **Distinguish between (a) Trade discount and Cash discount, and (b) Goods and Stock. (4 marks)**

- Trade discount is a reduction in the list price allowed on bulk purchases; it is deducted on the invoice and is NOT recorded separately in the books.
- Cash discount is allowed for prompt or early payment; it IS recorded in the books as a discount.
- Goods are the items a firm purchases mainly for resale (its merchandise).
- Stock (inventory) is the value of goods remaining unsold on a particular date — opening stock at the start and closing stock at the end of the period.

3 marks **Differentiate between an asset and a liability, giving one example of each type (current and non-current). (3 marks)**

- An asset is a resource owned by the business that has money value and yields future benefit; a liability is an amount the business owes to outsiders.
- Assets: non-current (e.g., machinery, building) and current (e.g., cash, debtors, stock).
- Liabilities: non-current (e.g., long-term bank loan, debentures) and current (e.g., creditors, bills payable, bank overdraft).

6 marks **From the following, prepare the accounting equation: (i) Started business with cash ₹5,00,000; (ii) Bought furniture for cash ₹80,000; (iii) Bought goods on credit from Ravi ₹1,20,000; (iv) Took a bank loan of ₹2,00,000. (6 marks)**

- (i) Started business with cash ₹5,00,000 -> Assets: Cash 5,00,000 = Liabilities 0 + Capital 5,00,000.
- (ii) Bought furniture for cash ₹80,000 -> one asset (Cash) falls by 80,000, another asset (Furniture) rises by 80,000. Assets: Cash 4,20,000 + Furniture 80,000 = 5,00,000 = Liabilities 0 + Capital 5,00,000.
- (iii) Bought goods on credit ₹1,20,000 -> Stock (asset) +1,20,000 and Creditor (liability) +1,20,000. Assets: Cash 4,20,000 + Furniture 80,000 + Stock 1,20,000 = 6,20,000 = Liabilities 1,20,000 + Capital 5,00,000.
- (iv) Bank loan ₹2,00,000 -> Cash (asset) +2,00,000 and Loan (liability) +2,00,000. Assets: Cash 6,20,000 + Furniture 80,000 + Stock 1,20,000 = 8,20,000.
- Final equation: Assets ₹8,20,000 = Liabilities ₹3,20,000 (Creditor 1,20,000 + Loan 2,00,000) + Capital ₹5,00,000.
- The equation balances after every transaction, proving the Dual Aspect Concept.

3 marks **Explain the three main branches of accounting. (3 marks)**

- Financial Accounting — records transactions and prepares the P&L Account and Balance Sheet to find profit/loss and financial position, mainly for external users.
- Cost Accounting — ascertains and controls the cost of products or services and helps in cost reduction and price fixing.
- Management Accounting — presents financial and cost data to management in a form useful for planning, control and decision-making.

Exam tips

- In 'distinguish between' questions, always answer in a two-column / point-to-point form on the SAME basis (meaning, recording, timing) — the marking scheme awards a mark per valid point of difference.
- Never confuse book-keeping with accounting: book-keeping = recording only; accounting = recording + classifying + summarising + analysing + interpreting + communicating.
- Remember the official list is FOUR qualitative characteristics — Reliability, Relevance, Understandability, Comparability. Do not invent a fifth.
- Trade discount is NEVER recorded in the books; Cash discount IS recorded. This single line is a frequent 1-mark catch.
- Capital is a liability of the business to the owner (Business Entity Concept) — state this if asked why capital appears on the liabilities side.
- For accounting-equation sums, show the effect of EVERY transaction and write the final 'Assets = Liabilities + Capital' line; an unbalanced equation loses the final mark.
- Use Indian examples and the rupee sign in answers, but keep statements crisp — examiners reward precise definitions, not long paragraphs.

Quick revision

- Accounting = identify -> record -> classify -> summarise -> analyse -> interpret -> communicate. Book-keeping is only 'identify + record'.
- Objectives: systematic record, find profit/loss (P&L), find financial position (Balance Sheet), give information to users, aid management.
- Four qualitative characteristics: Reliability, Relevance, Understandability, Comparability.
- Users: Internal = owner, management, employees. External = banks, creditors, investors, customers, government, public.
- Advantages: record, profit/loss, position, decisions, legal/tax evidence, comparison, valuation. Limitations: money-measurement only, historical cost/inflation, subjectivity, window-dressing.
- Branches: Financial, Cost, Management accounting.
- Core terms to nail: Capital vs Drawings; Assets vs Liabilities (current/non-current); Revenue/Income/Gain/Profit; Expenditure (capital/revenue) vs Expense; Goods vs Stock; Debtor vs Creditor; Voucher; Trade vs Cash discount.
- Golden equation: Assets = Liabilities + Capital (Dual Aspect Concept) — every transaction keeps both sides equal.