

Introduction to Accounting

Kerala · Class 11 · Accountancy — exam notes

Accounting is the system a business uses to record what it earns, what it spends, what it owns and what it owes — and then to report that clearly to whoever needs it. This chapter sets up the vocabulary (assets, liabilities, capital, income, expenses, drawings), the accounting equation that ties them together, and the users who depend on the information. Everything later in Plus One Accountancy rests on these ideas.

Key terms & definitions

Accounting

The process of recording, classifying, summarising and interpreting financial transactions, and communicating the results to interested users.

Bookkeeping

The recording stage only — writing down financial transactions in a systematic way. It is one part of accounting, not a synonym for it.

Transaction

Any financial event that changes the position of the business and can be measured in money — a cash sale, a credit purchase, payment of rent.

Asset

A resource of value owned or controlled by the business, expected to give benefit in future — cash, stock, furniture, a delivery van, amounts owed by customers (debtors).

Liability

An amount the business owes to outsiders — a bank loan, unpaid supplier bills (creditors), outstanding wages, GST payable.

Capital

The owner's own investment in the business. Also called Owner's Equity. It increases with fresh capital and profit, and decreases with losses and drawings.

Drawings

Cash or goods taken out of the business by the owner for personal use. Drawings reduce capital — they are not a business expense.

Income (Revenue)

Amounts earned by the business from selling goods or rendering services, plus other gains such as commission or interest received.

Expense

The cost incurred to earn income during a period — rent, salaries, electricity, depreciation, carriage.

Accounting Equation

$\text{Assets} = \text{Liabilities} + \text{Capital}$. The relationship that must hold for every business on every date, after every transaction.

Internal users

People inside the business who use accounting information to run it — the proprietor, partners and managers.

External users

People outside the business who rely on its accounts — banks, suppliers, the GST and income-tax departments, prospective investors, employees and researchers.

What accounting is, in one line

- Accounting is the language of business: it turns day-to-day financial events into a report anyone can read.
- Four stages in order: RECORD the transaction, CLASSIFY it into accounts, SUMMARISE it into statements, INTERPRET what the statements mean.
- Think of a kirana shop in Thrissur buying rice on credit, selling to neighbours and borrowing before Onam — accounting is what tells the owner at month-end whether she actually made money.
- Only events measurable in money enter the books. A skilled worker resigning matters to the business but is not recorded, because it cannot be measured in rupees.

The four objectives of accounting

- To keep a systematic and permanent record of every financial transaction, so nothing depends on memory.
- To ascertain the PROFIT OR LOSS for an accounting period — done through the Trading and Profit & Loss Account.
- To ascertain the FINANCIAL POSITION on a particular date — what is owned and owed — shown in the Balance Sheet.
- To communicate this information to users so they can take better decisions.
- A useful memory hook: Record → Profit → Position → Communicate.

Bookkeeping versus Accounting

- Bookkeeping is mechanical and routine; accounting is analytical and judgement-based.
- Bookkeeping ends where accounting begins — the ledger balances are the bookkeeper's output and the accountant's input.
- Example: a bookkeeper records that ₹5,000 rent was paid. The accountant ensures that ₹5,000 is charged against the correct period's income, so the profit figure is true.
- A bookkeeper needs accuracy; an accountant needs accuracy plus interpretation.
- Accounting is the wider term — bookkeeping is contained inside it.

The six basic terms you must not confuse

- ASSETS are what the business OWNS; LIABILITIES are what it OWES to outsiders; CAPITAL is what it owes to the OWNER.
- INCOME is earned, EXPENSE is incurred — and the gap between them is profit or loss.
- DRAWINGS is the trap: money taken by the owner for personal use is NOT an expense of the business. It reduces capital.
- Debtors (customers who owe us) are an asset; creditors (suppliers we owe) are a liability.
- Capital is a liability of the business towards its owner — this follows from the business entity concept, where the owner and the business are treated as separate.

The Accounting Equation

- Assets = Liabilities + Capital. This holds on every single date, after every single transaction.
- It follows from the dual aspect idea: every transaction affects at least two items, and always keeps both sides equal.
- Arjun starts a stationery shop in Kottayam with ₹50,000 of his own money and borrows ₹30,000 from a relative. Cash (asset) = ₹80,000; Liability = ₹30,000; Capital = ₹50,000. Check: $80,000 = 30,000 + 50,000$. ✓
- Rearranged forms you will use: Capital = Assets – Liabilities, and Liabilities = Assets – Capital.
- If your equation does not balance, a transaction has been recorded on one side only — find it before moving on.

Internal users and what each one wants

- OWNER / PROPRIETOR: Is my business profitable? Is my capital growing? Should I invest more?
- MANAGEMENT: Which products earn most? Where are costs rising? Should we hire or cut back?
- Internal users can ask for any report in any format at any time, because they control the records.
- They typically need information more frequently — monthly or even weekly — not just once a year.

External users and what each one wants

- BANKS AND LENDERS: can this business repay the loan and the interest on time?
- SUPPLIERS / CREDITORS: is it safe to supply goods on credit to this business?
- GOVERNMENT (GST and Income-Tax departments): is the correct tax being computed and paid?
- INVESTORS: will my money grow if I invest here?
- EMPLOYEES: is the business stable enough for my job and my wages to be secure?
- CUSTOMERS AND RESEARCHERS: will this supplier survive; and what do these figures show about the industry?
- External users get only the published financial statements — they cannot demand extra detail.

Branches of accounting

- **FINANCIAL ACCOUNTING:** records transactions and prepares the Profit & Loss Account and Balance Sheet for outside users. This is what Plus One Accountancy mainly teaches.
- **COST ACCOUNTING:** works out the cost of producing each product or service, and helps control that cost.
- **MANAGEMENT ACCOUNTING:** presents information in whatever form helps managers plan and decide — budgets, forecasts, ratios.
- The three overlap: all three draw on the same underlying transaction records.

What makes accounting information good

- **RELIABILITY:** it can be verified against a document — a bill, a receipt, a bank statement.
- **RELEVANCE:** it actually helps the decision being taken, and it arrives in time to be useful.
- **UNDERSTANDABILITY:** it is presented so the intended user can follow it without special training.
- **COMPARABILITY:** the same methods are used year after year, and by similar businesses, so figures can be compared meaningfully.
- These four are the standard test of whether a set of accounts is worth relying on.

Advantages of keeping proper accounts

- Replaces memory with a permanent, verifiable record.
- Gives a reliable profit figure and a clear picture of financial position.
- Supports loan applications — a bank will ask for accounts before sanctioning credit.
- Makes GST and income-tax compliance straightforward, and provides evidence if a return is questioned.
- Helps detect errors and discourages fraud, because every entry leaves a trail.
- Provides a basis for valuing the business if it is sold or a partner is admitted.
- Acts as evidence in court in case of a dispute.

Limitations you must be able to state

- Records **ONLY** what can be measured in money — staff skill, customer goodwill and management quality are left out.
- Uses **HISTORICAL COST**, so a building bought in 1995 still appears at its old cost, not today's value.
- Involves **ESTIMATES** — the life of a machine, the amount of doubtful debts — so figures are approximate, not exact.
- Allows alternative methods (for example different depreciation methods), which makes comparison between firms harder.
- Can be manipulated through **WINDOW DRESSING** — presenting accounts to look better than the reality.
- Ignores the effect of price-level changes (inflation).

How this fits your Plus One course

- Your subject is Accountancy with AFS (Analysis of Financial Statements) — this chapter is the foundation the whole two-year course is built on.
- The accounting equation here becomes the rules of debit and credit in the next chapter, and the Balance Sheet later in the year.
- Get the six basic terms exactly right now: almost every mistake students make later is really a confusion between expense and drawings, or debtor and creditor.
- Kerala SCERT sets questions on definitions, on user groups, and on small accounting-equation problems — all three are covered above.

Formulas & formats

- Accounting Equation:
$$\text{Assets} = \text{Liabilities} + \text{Capital}$$
- Rearranged forms:
$$\text{Capital} = \text{Assets} - \text{Liabilities}$$
$$\text{Liabilities} = \text{Assets} - \text{Capital}$$
- Expanded equation (after a period of trading):
$$\text{Assets} = \text{Liabilities} + \text{Capital} + \text{Income} - \text{Expenses} - \text{Drawings}$$
- Profit or Loss for a period:
$$\text{Profit} = \text{Income} - \text{Expenses} \quad (\text{if negative, it is a Loss})$$
- Closing Capital:
$$\text{Closing Capital} = \text{Opening Capital} + \text{Additional Capital} + \text{Profit} - \text{Drawings} - \text{Loss}$$

Important questions & model answers

2 marks Define accounting.

- Accounting is the process of recording, classifying and summarising financial transactions in a significant manner and in terms of money.
- It also includes interpreting the results and communicating them to users who need the information for decision-making.

3 marks Distinguish between bookkeeping and accounting on any three points.

- SCOPE: Bookkeeping is only the recording of transactions; accounting includes recording, classifying, summarising and interpreting.
- STAGE: Bookkeeping is the primary/first stage; accounting begins where bookkeeping ends.
- SKILL: Bookkeeping is routine and clerical; accounting requires analytical skill and judgement.
- OBJECTIVE: Bookkeeping aims to maintain complete records; accounting aims to ascertain profit, position and to help decisions.

4 marks State the objectives of accounting.

- To maintain a systematic and permanent record of all financial transactions.
- To ascertain the profit earned or loss suffered during an accounting period.
- To ascertain the financial position of the business on a particular date.
- To communicate accounting information to interested internal and external users.
- To assist management in planning, controlling and decision-making.

4 marks Who are the external users of accounting information? State what any three of them need it for.

- External users are persons outside the business who rely on its published accounts.
- BANKS AND LENDERS: to judge whether the business can repay a loan with interest before sanctioning it.
- CREDITORS/SUPPLIERS: to decide whether it is safe to supply goods on credit.
- GOVERNMENT (GST / Income-Tax): to verify that the correct amount of tax has been computed and paid.
- INVESTORS: to judge the safety and likely return on money they may invest.
- EMPLOYEES: to assess the stability of the business and the security of their jobs and wages.

3 marks Explain the accounting equation with an example.

- The accounting equation states that $\text{Assets} = \text{Liabilities} + \text{Capital}$, and it holds true at every point of time.
- It arises from the dual aspect concept — every transaction has two effects that keep the equation balanced.
- Example: Arjun starts a shop in Kottayam with ₹50,000 of his own money and a ₹30,000 loan from a relative.
- Assets (cash) = ₹80,000; Liabilities (loan) = ₹30,000; Capital = ₹50,000.
- Check: ₹80,000 = ₹30,000 + ₹50,000. The equation balances.

5 marks Rajesh started a plumbing business on 1 June 2024. He borrowed ₹50,000 from a bank and invested ₹30,000 of his own savings. He bought tools for ₹35,000 in cash and a van for ₹45,000 on credit, and paid ₹2,000 for a business licence. Show his assets, liabilities and capital, and verify the accounting equation.

- ASSETS: Cash = $50,000 + 30,000 - 35,000 - 2,000 = ₹43,000$; Tools = ₹35,000; Van = ₹45,000.
- Total Assets = $43,000 + 35,000 + 45,000 = ₹1,23,000$.
- LIABILITIES: Bank loan ₹50,000 + Creditor for van ₹45,000 = ₹95,000.
- CAPITAL: Amount introduced ₹30,000 less the licence fee of ₹2,000 (an expense, which reduces capital) = ₹28,000.
- VERIFY: Assets ₹1,23,000 = Liabilities ₹95,000 + Capital ₹28,000 = ₹1,23,000. The equation balances.
- Note: the van bought on credit increases an asset AND a liability by the same ₹45,000, so the equation stays balanced.

2 marks Why are drawings not treated as an expense of the business?

- Drawings are cash or goods withdrawn by the owner for personal use, not a cost incurred to earn business income.
- Under the business entity concept the owner and the business are separate, so amounts taken by the owner reduce his capital rather than the profit of the business.
- Therefore drawings are deducted from capital in the Balance Sheet, not shown in the Profit & Loss Account.

4 marks State any four limitations of accounting.

- It records only those transactions that can be measured in money, so qualitative factors like staff skill and goodwill of customers are omitted.
- Assets are shown at historical cost, which may be far from present market value.
- It relies on estimates — such as useful life of an asset or provision for doubtful debts — so figures are approximate.
- Alternative accounting methods are permitted, which reduces comparability between businesses.
- Accounts can be window-dressed to present a more favourable picture than the truth.

3 marks Name the three branches of accounting and state the purpose of each in one line.

- **FINANCIAL ACCOUNTING:** to record transactions and prepare the Profit & Loss Account and Balance Sheet for external users.
- **COST ACCOUNTING:** to determine and control the cost of each product, job or service.
- **MANAGEMENT ACCOUNTING:** to supply information in a form that helps management plan, control and take decisions.

3 marks 'Accounting information should be reliable and relevant.' Explain these two qualitative characteristics.

- **RELIABILITY** means the information is free from material error and bias, and can be verified against source documents such as bills, vouchers and bank statements.
- **RELEVANCE** means the information is capable of influencing the decision being taken, and is available in time to influence it.
- Information that is reliable but too late, or timely but unverifiable, fails the test — both characteristics are needed together.
- The other two characteristics usually listed alongside them are understandability and comparability.

Exam tips

- When a question says 'define', give the full definition in one or two complete sentences — half-definitions lose the mark even if the idea is right.
- For 'distinguish between' questions, always answer in point form with a named BASIS for each difference (scope, stage, skill, objective). Loose paragraphs score poorly.
- In accounting-equation problems, write the effect of EACH transaction separately and re-check that both sides are equal before moving to the next one.
- A purchase on credit raises an asset AND a liability by the same amount — students often record only the asset and then cannot balance the equation.
- Never put drawings in the Profit & Loss Account. Deduct it from capital. This single error costs marks in several chapters later.
- If asked for users of accounting information, split your answer clearly into INTERNAL and EXTERNAL before listing — the split itself often carries a mark.
- Write amounts with the ₹ sign and use Indian formatting (₹1,23,000, not ₹123,000) as used in your textbook.

Quick revision

- Accounting = record → classify → summarise → interpret → communicate.
- Bookkeeping is only the recording stage; accounting is the whole process.
- Assets = what you own. Liabilities = what you owe outsiders. Capital = what you owe the owner.
- Accounting Equation: Assets = Liabilities + Capital — true on every date, after every transaction.
- Capital = Assets – Liabilities; Profit = Income – Expenses.
- Drawings reduce capital; they are never an expense.
- Internal users = owner and management. External users = banks, creditors, government, investors, employees.
- Four qualities of good accounting information: reliability, relevance, understandability, comparability.
- Main limitations: money measurement only, historical cost, estimates, alternative methods, window dressing.