

Topic 1

Introduction to Financial Accounting

A. INTRODUCTION

- Business activities require **resources**,
- Success of a business depends on how **efficiently and effectively** these resources are managed
- Hence, there is a need to ensure that the **businessman tracks the use of these resources**

Two basic questions would have to be answered:

- What is the **result** of any business operations? (Whether it has made profit or loss?)
- What is the **position** of the resources acquired and used for business purposes? How are these resources financed? Where do the funds come from? (Balance sheet)

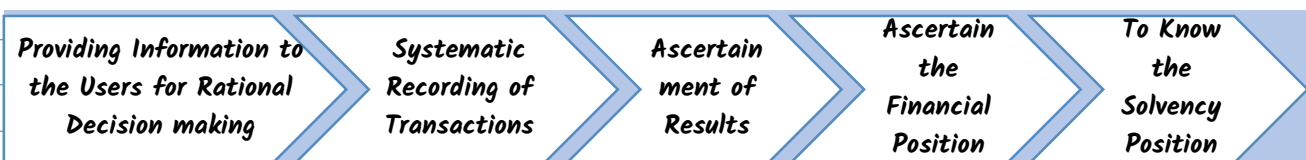
Definition

American Institute of Certified Public Accountants (AICPA): "Accounting is "the art of **recording, classifying and summarizing** in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character and interpreting the results thereof"

The above definitions discloses the following important points:

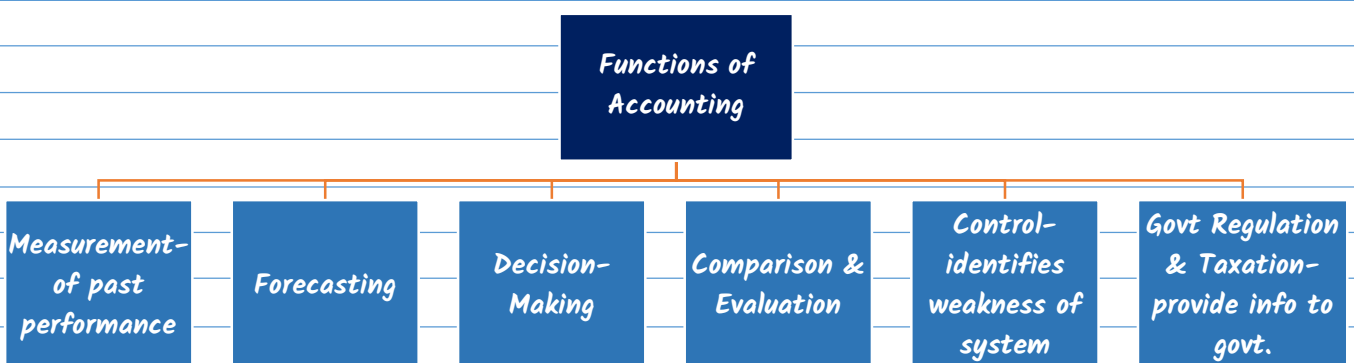
- Accounting is an art as it requires **skills** to record and prepare the accounts.
- Accounting is a process of **recording** the transactions in systematic manner.
- Accounting is concerned with transaction which is measurable in terms of **money**.
- Accounting is done with view to **communicate financial information / position** to interested parties.

B. OBJECTIVES OF ACCOUNTING:



- Providing **Information** to the Users for Rational Decision-making
- Systematic **Recording** of Transactions
- Ascertainment of **Results** of Above Transactions
- Ascertain the **Financial** Position of Business
- To Know the **Solvency Position**

C. FUNCTION OF ACCOUNTING:



- **Measurement:** Accounting measures past performance of a business entity and depicts its current financial position.
- **Forecasting:** Accounting helps in forecasting future performance and financial position of an enterprise using past data.
- **Decision-Making:** Accounting provides relevant information to the users of accounts to aid rational decision-making.
- **Comparison & Evaluation:** Accounting assesses performance achieved in relation to targets and discloses information regarding accounting policies and contingent liabilities
- **Control:** Identifies weaknesses of the operational system and provides feedbacks regarding effectiveness of measures adopted to check such weaknesses.
- **Government Regulation and Taxation:** Provides necessary information to the government to exercise control on the entity as well as in collection of tax revenues.

D. BOOK KEEPING

Carter says, Book-Keeping is a science as well as art of **correctly recording in books of accounts all those business transactions** that result in transfer of money or money's worth.

(Recording and classifying financial data in chronological order)

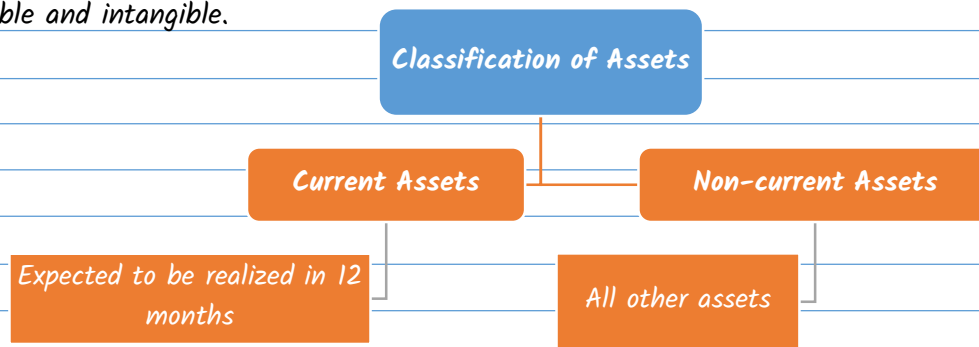
Book-keeping is a mechanical task which involving:

- **Collection** of basic financial information
- **Identification** of events and transactions with financial character
- **Measurement** of economic transactions in terms of money
- **Recording** of financial effects of economic transactions in order of its occurrence
- **Classifying** effects of economic transactions
- Preparing organized statement known as **Trial Balance**

Distinguish between: Book Keeping & Accounting

Book Keeping	Accounting
Recording transactions	Summarizing of the recorded transactions.
Work mainly routine and clerical in nature	Reqd. higher level of knowledge
Book-keeping constitute the base for accounting.	Language of business.
To follow Basic accounting concepts and conventions.	The methods and procedures for accounting may vary from firm to firm.
Financial statements not form part of book-keeping	Financial statements are prepared from the bookkeeping records.
Financial position of the business cannot be ascertained	To ascertain Financial position of the business

Asset: Asset is owned by a business with the purpose of using it for generating future profits. Assets can be tangible and intangible.



Current Assets– if it satisfies **any** of the following:

- It is expected to realize in, or is intended for sale or consumption in normal Operating Cycle,
- It is held primarily for the purpose of being traded,
- It is due to be realized within 12 months after the Reporting Date, or
- It is Cash or Cash Equivalent unless it is restricted from being exchanged or used to settle a Liability for at least 12 months after the Reporting Date.

Non-Current Assets– All other Assets classified as Non-Current Assets, e.g., Machinery held for use

Current Liabilities– when it satisfies **any** of the following:

- It is expected to be settled in the company's normal Operating Cycle;
- It is held primarily for the purpose of being traded;
- It is due to be settled within 12 months after the Reporting Date; or
- The company does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date (Terms of a Liability that, at the option of the counterparty, result in their settlement by the issue of Equity Instruments which do not affect its classification).

Non-Current Liabilities– All other liabilities shall be classified as Non-Current Liabilities. For example, loan taken for 5 years, Debentures issued etc.

Internal Liability: These represent proprietor's equity, i.e., all those amount which are entitled to the proprietor, like Capital, Reserves and Undistributed Profits.

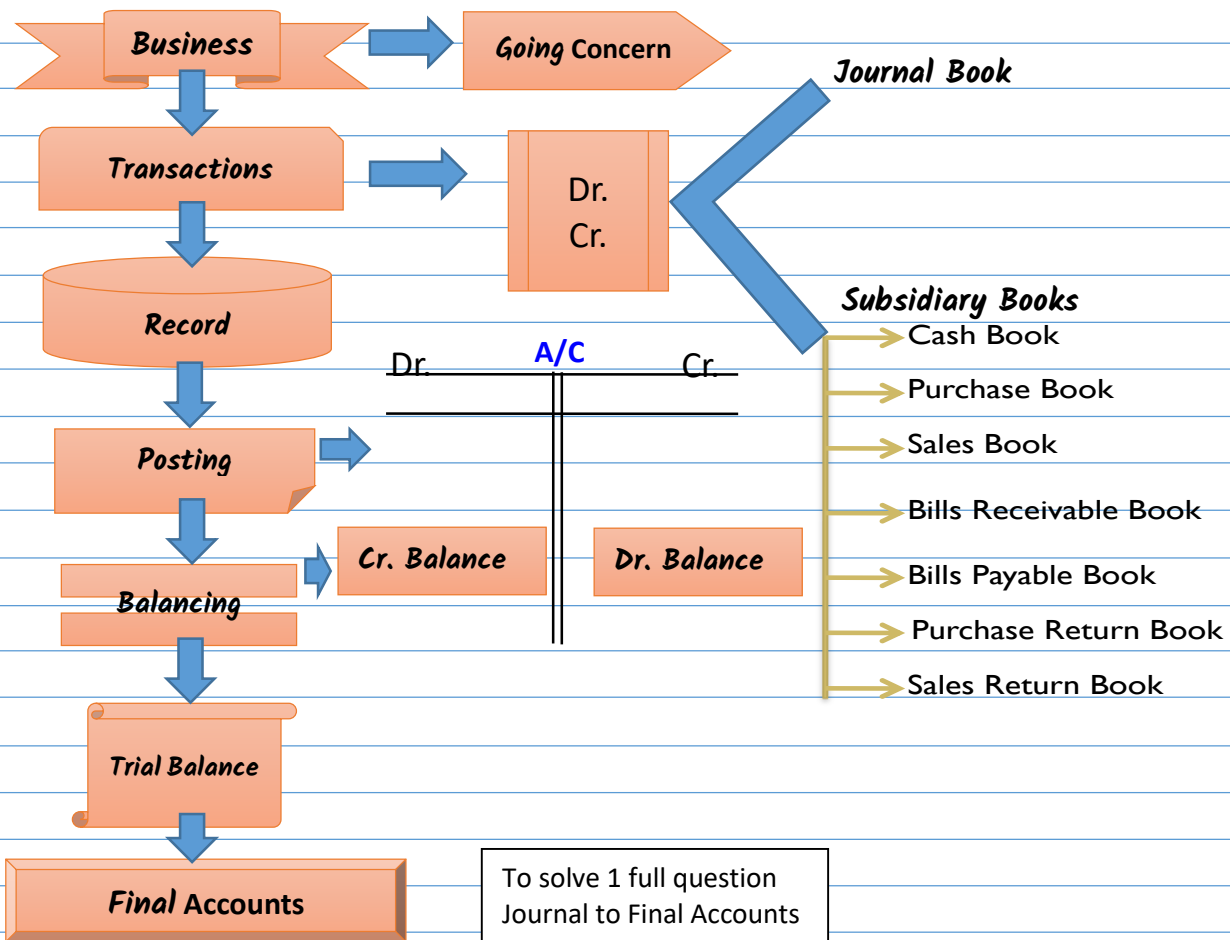
Contingent Liability: It represents a potential obligation that **could be** created depending on outcome of an event. For example, if a supplier of a business files a legal suit, it will not be treated as a liability because no obligation is created immediately. If verdict of the case is given in favour of the supplier then only the obligation is created. Till that it is treated as a contingent liability. Please note that contingent liability is not recorded in books, but disclosed a note through in the financial statements.

Wasting Assets: Like mines, quarries, etc., that become exhausted by their use are wasting assets.

Capital Expenditure: Represents expenditure incurred for purpose of acquiring a fixed asset which is intended to be used over long term for earning profits, e.g., amount paid to buy a computer for office use. At times expenditure may be incurred for enhancing production capacity of the machine. This will also be capital expenditure. Capital expenditure forms a part of the Balance Sheet.

Revenue Expenditure: Represents expenditure incurred to earn revenue of current period. Benefits of revenue expenses get exhausted in the year of incurrence. Example repairs, salary and wages, etc. Revenue expenditure results in reduction in profit or surplus. It forms become part of Income statement.

E. ACCOUNTING PROCEDURE



Phases of Accounting Cycle:

Recording	· Transaction to be recorded in primary book.
Journal	· The transactions are recorded in the journal chronologically.
Ledger	· All journals are posted into ledger chronologically in a classified manner.
Trial balance	· All the ledger balances transferred to Trial Balance for the preparation of FS
Adjustment entries	· Adjustment entries are to be recorded before preparing financial statements.
Adjusted T.B.	· After adjusted entries, adjusted Trial Balance may also be prepared.
Closing Entries	· Nominal accounts are to be transfer to Trading and Profit and Loss Account
Financial Statement	· Can now be easily prepared & will show true position and operating results.

F. DOUBLE ENTRY SYSTEM

- In 1494 Luca Pacioli, Italian mathematician, first published his principles of Double Entry System.
- Double entry system made it possible to record not only cash but mercantile transactions.
- It created an impact on auditing too, because it enhanced the duties of an auditor

Features of Double Entry System

- Every transactions have two Effects (Dr. & Cr.)
- Two A/c: One is receiver of benefit & other is giver
- If One A/c is Dr. other must be Cr. (Dr. = Cr.)

Advantages of Double Entry System

Advantages of Double Entry System	Complete Records (Both Effects)
	Ensure Arithmetical Accuracy
	Business Results
	Common Acceptance
	Minimize Frauds
	Receivable & Payable Balances can determined easily
	Decision Making
	Easy Tax Calculation
Helps in decision making	

Limitations of Double Entry System

- Not Disclose all errors
- Trial Balance does not disclose all the errors
- It costly (Required to maintain no. of a/c)

G. TYPES OF ACCOUNTS: Personal, Real & Nominal accounts.

ALL ASSETS, DRAWING, DEBTORS, EXPENSES & LOSSES → Dr. Balance ↑ Dr. ↓
ALL LIABILITIES, CAPITAL, CREDITORS, INCOMES & GAINS → Cr. Balance ↓ Cr. ↑

The rule for **personal** accounts is: **Debit the receiver, Credit the giver**

The rule for **real** accounts is: **Debit what comes in, Credit what goes out**

The rule for **nominal** accounts is: **Debit all expenses and losses, Credit all incomes and gains**

Valuation Account

- A valuation account is paired with an asset or liability account, and
- Is used to offset value of the assets or liabilities recorded in the account with which it is paired
- Result of this account pairing is a net balance, which is the carrying amount of the underlying asset or liability.

Examples:

- Provisions for depreciation [Valuation (Real)]
- Provisions for doubtful debts [Valuation (Personal)]
- Stock reserve [Valuation (Real)]
- Provisions for discount on creditors [Valuation (Personal)]

Accounting Equation

- Dual aspect concept says, two aspect of transaction should be considered, this concept is based on double entry book-keeping which means that record is made of the two aspect of each transaction.
- Accounting equation: $\text{Capital} = \text{Assets} - \text{Liabilities}$ OR $\text{Capital} + \text{Liabilities} = \text{Assets}$

H. JOURNAL

Journal is a book of prime entry in which all the business transactions are originally recorded in chronological order and from which they are posted to the ledger accounts at any convenient time.

I. SUBSIDIARY BOOKS OF ACCOUNT

- Journal is sub-divided into various parts known as subsidiary books or sub-divisions of journal.
- A register of this type is called a book of original entry or of prime entry.
- Each one of the subsidiary books is a special journal and a book of original or prime entry.
- There are no journal entries when records are made in these books.

Transaction	Subsidiary Book
All cash and bank transactions	Cash Book has columns: cash, bank & discount
All credit purchase of goods	Purchase Day Book or Purchase Register
All credit sale of goods	Sales Day Book or Sales Register
All purchase returns of goods back to suppliers	Purchase Return Book or Return Outward

All sales returns of goods back from Customers	Sales Return Book or Return Inward Book
All bill receivables bills accepted by Customers	Bills Receivable Book
All bills payable accepted by business to be honoured	Bills Payable Book
For all other transactions	Journal Proper

J. PETTY CASH BOOK

- A business house makes a number of small payments like telegram, textiles, cartage etc.
- Usually firms appoint a petty cashier who makes these small payments and keep record of these payments in a separate cash book which is called petty cash book.

Advantage of petty cash book:

- (1) Saving of time: Saving of time of the chief cashier.
- (2) Saving of labour: Saving in labour in writing up the cash book.
- (3) Control: It provides control over small payments.
- (4) Convenience in preparing ledger amounts.

Imprest System for petty cash book:

- The petty cashier is given a sum of money in the beginning of the period.
- During the period he makes payment out of this money.
- At end the firm reimburses him the amount paid by him so that the balance of cash with him remains same in the beginning of the period as well as at the end of the period.

K. JOURNAL (PROPER)/ GENERAL JOURNAL

Is used to record all the residual transactions which cannot find place in any of the subsidiary books. While recording, the entries are made in the journal covering both the aspects of the transaction. Examples of transactions which are entered in this book.

- (1) Opening entries and closing entries
- (2) Adjusting entries
- (3) Transfer entries from one account to another account
- (4) Rectification entries
- (5) Credit purchase / sale of an asset other than goods

MULTIPLE CHOICE QUESTIONS:

1. Accounting is "the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial	character and interpreting the results thereof". This definition is given by - (A) Institute of Chartered Accountant of India (B) Institute of Chartered Accountant of England
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(C) American Institute of Certified Public Accountants	(D) All of the above
(D) Institute of Chartered Accountant of Pakistan	
2. Which of these is not a function of Financial Accounting?	6. Which of the following is/are not the limitations of accounting?
(A) To provide financial information to the users of the financial statements.	(A) Provides information to interested parties
(B) To portray gloomy picture of the business in order to evade tax liabilities.	(B) Accounting information is expressed in terms of money
(C) To keep a systematic record of business transactions.	(C) Accounting information is based on estimates.
(D) To depict a true and fair view of the financial position of the business.	(D) All of the above
3. The process of grouping transactions or entries of the same type at one place is known as -	7. _____ is a system in which accounting entries are made only when cash is received or paid.
(A) Classifying	(A) Accrual system of accounting
(B) Recording	(B) Cash system of accounting
(C) Summarizing	(C) Hybrid system of accounting
(D) Numbering	(D) Mercantile system of accounting
4. Which of the following is the branch of accounting?	8. Which of the following is/are the essential features of accrual basis of accounting?
1. Human Resources Accounting	(A) Revenue is recognized when cash is received
2. Social Accounting	(B) Costs are matched against revenues on the basis of relevant time period to determine periodic income.
3. Security Accounting	(C) Costs which are not charged to income are carried forward and are kept under continuous review.
The correct answer is -	(D) Both (B) & (C)
(A) (I) & (II)	
(B) (II) & (III)	9. Which of the following is/are external users of accounting information's?
(C) (I) & (III)	(A) Shareholders/investors
(D) None of the above	(B) Creditors
5. Which of the following is/are NOT the advantages of accounting?	(C) Government agencies
(A) Helps in taxation matters	(D) All of the above
(B) Valuation of business	
(C) Accounting information is based on estimates.	On the basis of following information answer next 4 questions.

Mohan purchased a machinery amounting ₹10,000 on 1.4.2010. On 31.3.2019, similar machinery could be purchased for ₹20,000 but the realizable value of the machinery (purchased on 1.4.2010) was estimated at ₹15,000. The present discounted value of the future net cash inflows that the machinery was expected to generate in the normal course of business, was calculated as ₹12,000.

10. The current cost of the machinery is -

- (A) ₹ 10,000
- (B) ₹ 20,000
- (C) ₹ 15,000
- (D) ₹ 12,000

11. The present value of machinery is -

- (A) ₹ 10,000
- (B) ₹ 20,000
- (C) ₹ 15,000
- (D) ₹ 12,000

12. The historical cost of machinery is -

- (A) ₹ 10,000
- (B) ₹ 20,000
- (C) ₹ 15,000
- (D) ₹ 12,000

13. The realizable value of machinery is -

- (A) ₹ 10,000
- (B) ₹ 20,000
- (C) ₹ 15,000
- (D) ₹ 12,000

14. Accounts which represent a certain person or group of persons are termed as

- (A) Artificial or legal persons' account
- (B) Natural persons personal account
- (C) Representative personal accounts
- (D) Any of the above

15. The rule for nominal accounts is -

- (A) Debit the receiver, Credit the giver
- (B) Debit what comes in, Credit what goes out
- (C) Debit all expenses and losses, Credit all incomes and gains
- (D) All of the above

16. Provision for doubtful debts account, stock reserve account etc. are -

- (A) Valuation (Personal) accounts
- (B) Artificial or legal persons' personal account
- (C) Tangible real accounts
- (D) Nominal Accounts

17. Which of the following equation is correct?

- (A) Capital + Liabilities - Fixed Assets + Current Assets
- (B) Capital + Liabilities - Current Assets = Fixed Assets
- (C) Assets = Liabilities + Capital
- (D) All of the above

18. A businessman purchased goods for ₹25,00,000 and sold 80% of such goods during the accounting year ended 31st March, 2019. The market value of the remaining goods was ₹4,00,000. He valued the closing stock at cost. He violated the concept of -

- (A) Periodicity
- (B) Conservatism
- (C) Money measurement
- (D) Cost

19. On 31.3.2019 after sale of goods ₹2,000, Neelam is left with the closing inventory of ₹10,000. This is

- (A) An event

(B) A transaction	(C) It enables a great saving to be effected in the posting of small items to the ledger accounts.
(C) A transaction as well as an event	(D) All of the above
(D) Neither a transaction nor an event	
20. Provisions for doubtful debts, provision for discount on debtors are based on -	26. ₹3,50,000 cash paid to creditors for settlement of credit purchases will be recorded in -
(A) Prudence	(A) Sales Book
(B) Substance over form	(B) Purchase Book
(C) Materiality	(C) Journal Proper (General Journal)
(D) All of the above	(D) Cash Book
21. Journal is book of -	27. Expenses whose benefit expires within the year of expenditure and which are incurred to maintain the earning capacity of existing assets are termed as -
(A) Analytical record	(A) Capital expenditure
(B) Chronological record	(B) Revenue expenditure
(C) Alphabetical record	(C) Deferred revenue expenditure
(D) None of above	(D) None of the above
22. Purchases day book records -	28. Fee paid to a lawyer for checking whether all the papers are in order before land is purchased is _____. But if later a suit is filed against the purchaser, the legal costs will be.
(A) All cash purchases	(A) Capital expenditure, Revenue expenditure
(B) All credit purchases	(B) Revenue expenditure, Revenue expenditure
(C) Credit purchases of trading goods	(C) Deferred revenue expenditure, Revenue expenditure
(D) All of the above	(D) Revenue expenditure, Capital expenditure
23. When the goods are returned to the supplier, a is sent to him.	29. Which of the following is attribute of accounting?
(A) Credit note	(A) Accounting is social science.
(B) Debit note	(B) It involves recording, classifying and summarizing.
(C) Thank you note	
(D) All of the above	
24. Balance of cash column in cash book has	
(A) Dr. balance	
(B) Cr. Balance	
(C) Dr. or Cr. Balance	
(D) None of the above	
25. Which of the following is/are advantages of the imprest system?	
(A) It saves the time of the chief cashier	
(B) It reduces the chances of misuse of cash by the petty cashier.	

- (C) It records transaction of qualitative nature
(D) All of the above
30. Accounting involves -
(i) Recording
(ii) Classifying
(iii) Summarizing
Select the correct answer from options given below -
(A) (I)
(B) (I) & (III)
(C) (I) & (II)
(D) All of the above are correct
31. Which of the following involves the preparation of reports and statements from the classified data (ledger) understandable and useful to management and other interested parties?
(A) Classifying
(B) Recording
(C) Summarizing
(D) All of the above
32. Which of the following is/are the main functions of accounting?
(A) Keeping systematic records
(B) Protecting and controlling business properties
(C) Ascertaining the operational profit/ loss
(D) All of the above
33. Book-keeping is concerned with the ____ of transactions while Accounting is concerned with the _____ of the recorded transactions.
(A) Recording, summarizing
(B) Summarizing, Recording
(C) Posting, Recording
(D) Summarizing, Posting
34. _____ is a system in which transactions are recorded on the basis of amounts having become due for payment or receipt.
(A) Accrual system of accounting
(B) Cash system of accounting
(C) Hybrid system of accounting
(D) None of the above
35. Which of the following has no relevance whether the receipts pertain to previous period or future period?
(A) Accrual system of accounting
(B) Cash system of accounting
(C) Hybrid system of accounting
(D) None of the above
36. Cash system of accounting is suitable in which of the following cases?
(A) Where the organization is very small or in the case of individuals
(B) Where credit transactions are almost negligible and collections are uncertain
(C) Both (A) & (B)
(D) Neither (A) nor (B)
37. Which of the following is/are the essential features of accrual basis of accounting?
(i) Revenue is recognized only when cash is received.
(ii) Costs are matched against revenues on the basis of relevant time period to determine periodic income.
(iii) Costs which are not charged to income are carried forward and are kept under continuous review.
(iv) Receipts or incomes are recorded as and when cash is received or becomes due on the other hand payments are

recorded only when cash is actually paid.	organizations -
The correct answer is -	(A) Can be changed every year.
(A) (I) & (IV) only	(B) Should be consistently followed from year to year
(B) (I), (III) & (IV) only	(C) Can be changed after 5 years
(C) (III) & (IV) only	(D) None of the above
(D) (II) & (III) only	
38. Accounting is of primary importance to the -	43. Book value & Market value of machinery on 31.3.15 was ₹1,00,000 & ₹1,10,000 respectively. As on 31.3.19, if the company values the machinery at ₹1,10,000, which of the following valuation principle is being followed -
(A) Proprietors and the managers	(A) Historical Cost
(B) Creditors and workers	(B) Present Value
(C) Debtors & government	(C) Realisable Value
(D) Bankers & creditors	(D) Current Cost
39. Regulatory Agencies interested as users of accounting information's includes -	44. Personal accounts are of the following types.
(A) Various Government departments	(A) Natural, Real, Representative
(B) Agencies such as National Company Law Tribunal (NCLT)	(B) Artificial, Legal, Nominal
(C) Registrar of Companies (RoC)	(C) Natural, Artificial, Representative
(D) All of the above	(D) Any of the above
40. Which of the following is/are cannot be treated as role of accountant?	45. Which system of accounts recognizes the fact that every transaction has two aspects and records both aspects of each and every transaction?
(A) Strategy formulation	(A) Single entry system
(B) Internal Audit	(B) Double entry system
(C) Statutory Audit	(C) Double account system
(D) Maintenance of Books of Account	(D) Duplicate account system
41. _____ refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.	46. Mr. Ashok buys clothing of ₹50,000 paying cash ₹20,000. What is the amount of expense as per the accrual concept?
(A) Accounting methods	(A) ₹30,000
(B) Accounting policies	(B) ₹20,000
(C) Accounting concepts	(C) ₹50,000
(D) Accounting assumptions	(D) Nil
42. Accounting policies followed by	

47. Mr. Bhandari purchased a car for ₹50,000, making a down payment of ₹10,000 and signing a ₹40,000 bill payable due in 60 days. As a result of this transaction
- (A) Total assets increased by ₹50,000
 (B) Total liabilities increased by ₹40,000
 (C) Total assets increased by ₹40,000
 (D) Total assets increased by ₹40,000 with corresponding increase liability by ₹40,000
48. Transactions which are inter-connected and have taken place simultaneously are recorded by means of a-
- (A) Adjustment entry
 (B) Combined journal entry
 (C) Either (A) or (B)
 (D) Closing entry
49. At the end of the accounting year all the nominal accounts of the ledger book are -
- (A) Balanced but not transferred to profit and loss account
 (B) Not balanced and also the balance is not transferred to the profit and loss account
 (C) Balanced and the balance is transferred to the balance sheet
 (D) Not balanced and their balance is transferred to the profit and loss account.
50. The total of the purchases day book is posted periodically to the debit of -
- (A) Purchases account
 (B) Cash book
 (C) Journal proper
 (D) None of these
51. Cash sales are recorded in -
- (A) Journal proper
 (B) Sales Book
 (C) Cash Book
 (D) All of the above
52. When fixed assets or stationeries are purchased on credit, the entries are passed in the
- (A) General journal
 (B) Purchase day book
 (C) Purchase Account
 (D) Any of the above
53. Which of the following is not a column of a three-column cash book?
- (A) Discount column
 (B) Petty cash column
 (C) Bank column
 (D) Cash column
54. Rent due for the month of March will appear -
- (A) On the payment side of the cash book
 (B) On the receipt side of the cash book
 (C) Nowhere in the cash book
 (D) As a contra entry
55. Total of debit side discount column of cash book is posted to -
- (A) Cr. of Discount Received A/c
 (B) Dr. of Discount Received A/c
 (C) Cr. of Discount Allowed A/c
 (D) Dr. of Discount Allowed A/c
56. The balance in the petty cash book is -
- (A) a liability
 (B) an asset
 (C) a profit
 (D) an expense
57. _____ are passed for rectifying

errors which might have committed in books of a/c.	(B) Cash Book (C) Purchase Book (D) Sales Book
(A) Transfer Entries (B) Adjustment Entries (C) Rectification Entries (D) Opening Entries	
58. A trial balance will not balance if -	62. Outstanding salary ₹34,000 to be provided in the accounts will be recorded in -
(A) Correct journal entry is posted twice. (B) The purchase on credit basis is debited to purchases and credited to cash. (C) ₹500 cash payment to creditors is debited to creditors for ₹50 and credited to cash as ₹500. (D) None of the above.	(A) Bills receivable book (B) Journal proper (General Journal) (C) Purchases Return Book (D) Purchase book
59. Difference of totals of both debit and credit side of the trial balance is transferred to -	63. Amounts paid for wages, salary, carriage of goods, repair, rent & interest, etc. are items of-
(A) Miscellaneous account (B) Difference account (C) Trading account (D) Suspense account	(A) Capital expenditure (B) Revenue expenditure (C) Deferred revenue expenditure (D) None of the above
60. After preparing the trial balance the accountant finds that the total of debit side is short by ₹1,500. This difference will be -	64. Costs incurred to acquire an asset are but costs incurred to keep them in working condition or to defend their ownership are
(A) Credited to suspense account (B) Debited to suspense account (C) Adjusted to any of the debit balance account (D) Adjusted to any of the credit balance account	(A) Capital expenditure, Revenue expenditure (B) Revenue expenditure, Revenue expenditure (C) Deferred revenue expenditure, Revenue expenditure (D) Revenue expenditure, Capital expenditure
61. A second hand motor car was purchased on credit from B & Co. for ₹10,000. It will be recorded in -	65. All sums spent up to the point an asset is ready for use should also be treated as
(A) Journal Proper (General Journal)	(A) Capital expenditure (B) Revenue expenditure (C) Deferred revenue expenditure (D) None of the above