Chapter 1: Introduction to Accounting

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Short Answers — Questions for Practice — Short Answers

Q1 Define accounting.

SOLUTION

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

The American Accounting Association (AAA) defined it in 1966 as 'the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of information'.

The AICPA (1941) described accounting as 'the art of recording, classifying, and summarising in a significant manner and in terms of money, transactions and events which are, in part at least, of financial character, and interpreting the results thereof'.

Answer: Accounting is the process of identifying, measuring, recording and communicating the economic events of an organisation to its interested users.

Q2 State the end product of financial accounting.

SOLUTION

Financial accounting assists in keeping a systematic record of financial transactions and in the preparation and presentation of financial reports.

The end products of financial accounting are the financial statements, namely:

1. Profit and Loss Account (or Income Statement) — shows whether the business has earned a profit or incurred a loss during the accounting period.
2. Balance Sheet (Position Statement) — shows the financial position of the business by listing assets and liabilities at the end of the accounting period.

These statements are prepared to arrive at a measure of organisational success and financial soundness, and are communicated to all stakeholders.

Answer: The end products of financial accounting are the Profit and Loss Account and the Balance Sheet.

Q3 Enumerate main objectives of accounting.

SOLUTION

The primary objectives of accounting are:

1. Maintenance of Records of Business Transactions: To keep a systematic and complete record of all financial transactions so that they can be verified and used as evidence.

2. Calculation of Profit and Loss: To ascertain the profit earned or loss sustained by a business during an accounting period by preparing a profit or loss account.

3. Depiction of Financial Position: To ascertain the financial position of the business in the form of its assets and liabilities at the end of every accounting period through a balance sheet.

4. Providing Accounting Information to Users: To communicate relevant financial information to internal users (management) for planning, controlling and decision-making, and to external users (investors, creditors, government, etc.) through financial statements.

Answer: Main objectives: (1) Maintenance of business records, (2) Calculation of profit or loss, (3) Depiction of financial position, (4) Providing accounting information to users.

Q4 Who are the users of accounting information?

SOLUTION

The users of accounting information are divided into two broad categories:

Internal Users: These are people within the organisation. They include the Chief Executive, Financial Officer, Vice President, Business Unit Managers, Plant Managers, Store Managers, Line Supervisors, etc. They use accounting information for planning, controlling and decision-making.

External Users: These are groups outside the organisation. They include:

- Present and potential investors (shareholders) — assess return on investment and financial health.
- Creditors (banks, financial institutions, debenture-holders, lenders) — assess creditworthiness and ability to repay.
- Tax authorities — determine tax liabilities.
- Regulatory agencies (Department of Company Affairs, Registrar of Companies, SEBI) — ensure compliance with regulations.
- Labour unions and employees — assess stability and profitability.
- Customers — assess continued existence and supply of products.
- Government and other regulators — assess allocation of resources.
- Social responsibility groups — assess impact on the environment.
- Competitors — use information for strategic benchmarking.

Answer: Users of accounting information: (1) Internal users — management, supervisors; (2) External users — investors, creditors, tax authorities, regulatory agencies, employees, customers, government, competitors.

Q5 State the nature of accounting information required by long-term lenders.

SOLUTION

Long-term lenders (such as banks, financial institutions, debenture-holders and other lenders) are external users of accounting information.

They provide funds to a business for a long period and are primarily concerned with the following information:

1. Creditworthiness of the company — whether the business is financially sound enough to repay the principal amount.
2. Ability to pay interest — whether the business generates sufficient revenue and profit to service interest payments regularly.
3. Long-term financial stability — whether the business has adequate assets relative to its liabilities.
4. Liquidity — whether the company can pay its debts as they become due.

This information is obtained primarily from the Balance Sheet (to assess assets, liabilities and net worth) and the Profit and Loss Account (to assess earnings and repayment capacity).

Answer: Long-term lenders need information on the company's creditworthiness, ability to repay principal and interest, long-term financial stability, and liquidity.

Q6 Who are the external users of information?

SOLUTION

External users are groups outside the business entity who use accounting information to make decisions about the business.

They include:

1. Present and potential investors (shareholders) — to assess risks and return on investment.
2. Creditors (banks, financial institutions, debenture-holders, lenders) — to assess creditworthiness and ability to repay.
3. Tax authorities — to determine tax liabilities (Income Tax, VAT, Customs, Excise duties).
4. Regulatory agencies — such as Registrar of Companies, SEBI, RBI, to ensure compliance with laws.
5. Labour unions and employee groups — to assess stability, profitability and wealth distribution.
6. Customers — to assess whether the business will continue to supply goods and services.
7. Government — to assess resource allocation and compliance with regulations.
8. Social responsibility groups (e.g., environmental groups) — to assess the business's impact on society and the environment.
9. Competitors — for strategic benchmarking and comparative purposes.

External users have limited authority and resources to obtain information directly, so they rely mainly on published financial statements.

Answer: External users include investors, creditors, tax authorities, regulatory agencies (SEBI, Registrar of Companies), employees, customers, government, social responsibility groups, and competitors.

Q7 Enumerate information needs of management.

SOLUTION

Management is an internal user of accounting information. Its information needs are more detailed and timely compared to external users.

The key information needs of management include:

1. Cost of sales and production costs — for pricing decisions and cost control.
2. Profitability of different products, departments or divisions — to assess performance.
3. Cash flow information — to plan for short-term liquidity requirements.
4. Sales forecast and purchase requirements — for planning and budgeting.
5. Manpower needs — for human resource planning.
6. Capital expenditure decisions — for long-term investment planning.
7. Budgeting information — to compare actual performance with planned targets.
8. Environmental and social data — for compliance with regulations and social responsibilities.

Management accounting draws relevant information from financial accounting and cost accounting to help management in planning, controlling and decision-making.

Answer: Management needs information on cost of sales, profitability, cash flows, sales forecasts, capital expenditure, budgeting, manpower needs and environmental data — for planning, controlling and decision-making.

Q8 Give any three examples of revenues.

SOLUTION

Revenue is the amount earned by a business by selling its products or providing services to customers.

Three examples of revenues are:

1. Sales Revenue — amount earned by selling goods or services to customers (cash or credit sales).
2. Commission — fees earned for acting as an agent or for providing a specific service.
3. Interest received — income earned on money lent or invested.

Other common examples of revenue include: dividends received, rent received, and royalties received.

Answer: Three examples of revenues: (1) Sales revenue, (2) Commission received, (3) Interest received.

Q9 Distinguish between debtors and creditors; profit and gain.

SOLUTION

Distinction between Debtors and Creditors:

Debtors: Persons and/or other entities who owe money to an enterprise for goods or services received on credit. They are shown as Sundry Debtors on the asset side of the Balance Sheet.

Creditors: Persons and/or other entities to whom the enterprise owes money for goods or services provided to it on credit. They are shown as Sundry Creditors on the liabilities side of the Balance Sheet.

Example: If Ram buys goods on credit from Shyam, Ram is a debtor (for Shyam's books) and Shyam is a creditor (for Ram's books).

Distinction between Profit and Gain:

Profit: The excess of revenues over related expenses during an accounting period, arising from the normal business operations. It increases the owner's investment. Example: Revenue Rs 6,00,000 minus Expenses Rs 5,40,000 = Profit Rs 60,000.

Gain: A profit that arises from events or transactions that are incidental to the business (not from regular operations). Examples: profit on sale of a fixed asset, winning a court case, appreciation in the value of an asset.

Key difference: Profit arises from regular business operations; gain arises from incidental or non-recurring transactions.

Answer: Debtors owe money to the enterprise (asset side); creditors are owed money by the enterprise (liabilities side). Profit = excess of revenue over expenses from regular operations; gain = incidental profit from non-recurring transactions like sale of fixed assets.

Q10 'Accounting information should be comparable'. Do you agree with this statement? Give two reasons.

SOLUTION

Yes, the statement is correct. Accounting information should be comparable.

Comparability means that users of financial reports should be able to compare various aspects of an entity over different time periods and with other entities.

Two reasons why comparability is important:

1. Inter-period comparison: Comparability allows users to compare the financial results and position of a business across different accounting periods. This helps in identifying trends in performance — whether the business is improving or declining over time.

2. Inter-firm comparison: Comparability allows users to compare the financial data of one enterprise with that of other enterprises in the same industry. This helps investors and other stakeholders assess the relative strengths and weaknesses of different businesses before making decisions.

To achieve comparability, accounting reports must use a common accounting period, common units of measurement, and a common format of reporting.

Answer: Yes. (1) It enables inter-period comparison — tracking trends in performance over time. (2) It enables inter-firm comparison — assessing one enterprise against others in the same industry.

Q11 If the accounting information is not clearly presented, which of the qualitative characteristics of the accounting information is violated?

SOLUTION

If accounting information is not clearly presented, the qualitative characteristic of Understandability is violated.

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

A message (or accounting report) is said to be effectively communicated when it is interpreted by the receiver in the same sense in which the sender intended.

Accountants must present comparable information in the most intelligible manner without sacrificing relevance and reliability. Poor or unclear presentation makes information difficult to understand, thereby reducing its decision usefulness.

Answer: The qualitative characteristic of Understandability is violated when accounting information is not clearly presented.

Q12 'The role of accounting has changed over the period of time.' Do you agree? Explain.

SOLUTION

Yes, the role of accounting has changed significantly over the period of time.

Historically, accounting was confined mainly to the financial record-keeping functions of the accountant. The accountant was primarily a recorder of transactions.

However, today's rapidly changing business environment has forced accountants to reassess their roles and functions within the organisation and society. The role has shifted from a mere recorder of transactions to a member of the decision-making team.

The modern roles of accounting include:

1. As a language of business — communicating financial information about enterprises to users.
2. As a historical record — maintaining a chronological record of financial transactions.
3. As current economic reality — determining the true income and wealth of an entity.
4. As an information system — linking the accountant (information source) to a wide variety of users through financial reports.
5. As a commodity — providing specialised information as a service in demand in society.

Accountants now work in exciting new growth areas such as forensic accounting (solving financial crimes), e-commerce (designing web-based payment systems), financial planning, and environmental accounting.

The scope of accounting has also broadened to include human resource accounting, social accounting, cost accounting and management accounting.

Answer: Yes. Accounting has evolved from mere record-keeping to an information system supporting decision-making. Modern roles include language of business, historical record, information system, and a commodity providing specialised services like forensic accounting and environmental accounting.

Q13 Giving examples, explain each of the following accounting terms: Fixed assets, Revenue, Expenses, Short-term liability, Capital.

SOLUTION

Fixed Assets (Non-Current Assets): Assets that are held for long-term use in the business and are not meant for resale. They provide economic benefit over more than one accounting period.
Example: Machinery, land and building, furniture, motor vehicles.

Revenue: The amounts earned by a business by selling its products or providing services to customers. It also includes other incomes like interest, commission, rent received, dividends and royalties.
Example: Sales of goods worth Rs 5,00,000; commission earned Rs 20,000; interest received Rs 10,000.

Expenses: Costs incurred by a business in the process of earning revenue. They are measured by the cost of assets consumed or services used during an accounting period.
Example: Rent paid, salaries, wages, depreciation on machinery, telephone charges, cost of electricity.

Short-term Liability (Current Liability): Obligations or debts of a business that are to be paid within 12 months or within the normal operating cycle.
Example: Trade payables (sundry creditors), short-term borrowings, bills payable, salaries payable.

Capital: The amount invested by the owner in the firm. It may be brought in the form of cash or assets. For the business entity, capital is an obligation and a claim on the assets of business, shown on the liabilities side of the balance sheet.
Example: If Mr. Rama starts a business by investing Rs 10,00,000 in cash, this Rs 10,00,000 is his capital.

Answer: Fixed assets: long-term assets not for resale (e.g., machinery). Revenue: earnings from sales and services (e.g., sales, interest). Expenses: costs incurred to earn revenue (e.g., rent, salaries). Short-term liability: debt payable within 12 months (e.g., creditors). Capital: owner's investment in the business.

Q14 Define revenues and expenses.

SOLUTION

Revenues: These are the amounts earned by a business by selling its products or providing services to customers, called sales revenue. Other items of revenue common to many businesses are: commission, interest, dividends, royalties, rent received, etc. Revenue is also called income.

Expenses: Costs incurred by a business in the process of earning revenue are known as expenses. Generally, expenses are measured by the cost of assets consumed or services used during an accounting period. The usual items of expenses are: depreciation, rent, wages, salaries, interest, cost of heater, light and water, telephone charges, etc.

Answer: Revenue: amount earned by selling goods/services and from other sources like interest, commission, rent (also called income). Expenses: costs incurred in the process of earning revenue, such as rent, salaries, wages, depreciation.

Q15 What is the primary reason for the business students and others to familiarise themselves with the accounting discipline?

SOLUTION

The primary reason for business students and others to familiarise themselves with the accounting discipline is that accounting is the language of business.

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

Accounting as an information system collects and communicates economic information about an enterprise to a wide variety of interested parties — both internal (management) and external (investors, creditors, government, etc.).

Understanding accounting helps students and others to:

1. Read and interpret financial statements (Balance Sheet, Profit and Loss Account) to assess the financial health and performance of a business.
2. Make informed economic decisions — whether to invest, lend, or extend credit to a business.
3. Understand the roles and responsibilities of accountants in the modern business environment, which now extends to forensic accounting, e-commerce, financial planning and environmental accounting.

In essence, familiarity with accounting enables individuals to participate meaningfully in business and financial decision-making.

Answer: The primary reason is that accounting is the language of business — it enables students and others to read financial statements, make informed economic decisions, and participate effectively in business and financial decision-making.

Long Answers — Questions for Practice — Long Answers

Q1 What is accounting? Define its objectives.

SOLUTION

What is Accounting?

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

The American Accounting Association (AAA, 1966) defined accounting as 'the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of information'.

The process of accounting involves:

- Identification: Determining which economic events (transactions) are to be recorded.
- Measurement: Quantifying transactions in monetary terms (rupees and paise).
- Recording: Entering identified and measured transactions in books of account in chronological order.
- Communication: Preparing and communicating accounting reports to internal and external users.

Objectives of Accounting:

1. Maintenance of Records of Business Transactions: To keep a systematic and complete record of all financial transactions. Recorded information acts as evidence and enables verifiability. Without records, it is impossible for even the most capable manager to remember numerous transactions such as purchases, sales, receipts and payments.
2. Calculation of Profit and Loss: To ascertain whether the business has earned a profit or sustained a loss during the accounting period. This is done by preparing a Profit and Loss Account. Profit = Total Revenue minus Total Expenses. For example, if revenue is Rs 6,00,000 and expenses are Rs 5,40,000, profit = Rs 60,000. If expenses exceed revenue, the difference is a loss.
3. Depiction of Financial Position: To ascertain the financial position of the business — its assets (resources owned) and liabilities (claims of outsiders) — at the end of every accounting period. This is done through the preparation of a Balance Sheet.
4. Providing Accounting Information to Users: To communicate accounting information (through reports, statements, graphs and charts) to internal users (management) for planning, controlling and decision-making and to external users (investors, creditors, government, etc.) who rely mainly on published financial statements.

Answer: Accounting is the process of identifying, measuring, recording and communicating economic events to interested users. Its objectives are: (1) maintenance of business records, (2) calculation of profit or loss, (3) depiction of financial position, and (4) providing information to users.

Q2 Explain the factors which necessitated systematic accounting.

SOLUTION

The following factors necessitated systematic accounting:

1. Complexity and Volume of Business Transactions: As business grew in size and complexity, it became impossible for business owners or managers to remember all the transactions — purchases, sales, receipts, payments, etc. — that take place every day. Systematic accounting ensures that every transaction is recorded accurately and completely.
2. Need for Verifiability and Evidence: Proper and complete records of transactions serve as documentary evidence in case of disputes or legal proceedings. Recorded accounting information is verifiable and can be used as proof.
3. Assessment of Profit or Loss: Owners and managers need to know the net result of business operations periodically. Without systematic records of incomes and expenses, it is impossible to determine whether the business has earned a profit or sustained a loss.
4. Determination of Financial Position: To know the financial health of the business — what it owns (assets) and what it owes (liabilities) — systematic records are essential. The balance sheet, which depicts this position, can only be prepared from organised accounting records.
5. Information Needs of Multiple Users: Various users — investors, creditors, tax authorities, regulatory agencies, employees, government — need financial information about the business. Systematic accounting generates this information in a standard, reliable and comparable form.
6. Legal and Regulatory Requirements: Laws (such as the Companies Act 2013) and regulatory bodies (SEBI, Income Tax authorities, etc.) require businesses to maintain proper books of account and publish financial statements. This legal obligation necessitates systematic accounting.
7. Decision-Making by Management: Management requires timely information on costs, revenues, profitability, cash flows, etc. for planning, controlling and decision-making. Systematic accounting provides this information through management accounting and cost accounting reports.
8. Technological and Economic Development: Greater economic development and technological advancements have increased the scale and complexity of business operations, making systematic accounting indispensable for modern organisations.

Answer: Factors necessitating systematic accounting: (1) large volume and complexity of transactions, (2) need for verifiability and evidence, (3) assessment of profit or loss, (4) determination of financial position, (5) multiple user information needs, (6) legal and regulatory requirements, (7) management decision-making, (8) economic and technological development.

Q3 Describe the informational needs of external users.

SOLUTION

External users are groups outside the business entity who rely mainly on published financial statements to obtain information. Their informational needs differ based on their relationship with the business.

1. Investors and Potential Investors (Shareholders): They need information on the risks and return on investment to decide whether to buy, hold or sell shares. They assess the financial health and profitability of the company.
2. Creditors — Banks and Other Lenders: They need information on the creditworthiness of the company and its ability to repay loans and pay interest. They are particularly interested in liquidity (ability to pay debts as they become due) and long-term solvency.
3. Suppliers and Trade Creditors: They need information on whether amounts owed to them will be repaid when due and on the continued existence of the business, so they can decide whether to extend credit.
4. Customers: They need information on the continued existence and financial stability of the business, which assures them of a continued supply of products, spare parts and after-sales service.
5. Government and Regulatory Agencies (Registrar of Companies, SEBI, RBI, Custom Authorities, IRDA): They need information for the payment of various taxes (VAT, Income Tax, Customs and Excise duties), for protecting the interests of investors and creditors, and for ensuring compliance with the Companies Act 2013 and SEBI guidelines.
6. Labour Unions and Employee Groups: They need information on the stability, profitability and distribution of wealth within the business to assess job security and potential for pay awards or bonus deals.
7. Social Responsibility Groups (e.g., Environmental Groups): They need information on the impact of the business on the environment and society, and on what steps are being taken for environmental protection.
8. Competitors: They use accounting information mainly for strategic purposes — to assess the relative strengths and weaknesses of competition and for comparative and benchmarking purposes.

External users have limited authority and resources to obtain information directly from the business, so they depend heavily on published financial statements such as the Balance Sheet and Profit and Loss Account.

Answer: External users and their information needs: investors (risk and return), creditors/lenders (creditworthiness and repayment ability), suppliers (ability to pay debts), customers (business continuity), government/regulators (tax compliance and regulatory adherence), employees/unions (stability and pay), environmental groups (social impact), competitors (strategic benchmarking).

Q4 What do you mean by an asset and what are different types of assets?

SOLUTION

Meaning of Asset:

Assets are economic resources of an enterprise that can be usefully expressed in monetary terms. They are items of value used by the business in its operations, providing economic benefits. For example, a fleet of trucks owned by Super Bazar and used for delivering foodstuffs is an asset because it provides economic benefit to the enterprise.

Assets are shown on the asset side of the Balance Sheet.

Types of Assets:
Assets are broadly classified into two types: Current Assets and Non-Current (Fixed) Assets.

1. Current Assets:
Current assets are those assets which are expected to be converted into cash or used up within one year (or the normal operating cycle of the business). They are involved in the operating cycle and are primarily held for trading.
Examples of current assets include:
- Cash and cash equivalents
- Trade receivables (sundry debtors)
- Inventories (stock of goods)
- Short-term investments
- Prepaid expenses
- Bills receivable

2. Non-Current Assets (Fixed Assets):
Non-current assets are assets that are held for long-term use in the business — generally for more than one accounting year. They are not meant for resale in the normal course of business.
Non-current assets are further classified as:
(a) Tangible assets — physical assets that can be seen and touched: e.g., land and building, plant and machinery, furniture, motor vehicles, computers.
(b) Intangible assets — assets that do not have a physical existence but have economic value: e.g., goodwill, patents, trademarks, computer software.
(c) Long-term investments — investments held for a long period: e.g., investments in shares or debentures of other companies.
The distinction between current and non-current assets is important because: current assets are realised/settled within 12 months; non-current assets provide benefit over more than one year.

Answer: Assets are economic resources of the enterprise with monetary value. Types: (1) Current assets — convertible to cash within 12 months (e.g., debtors, stock, cash); (2) Non-current assets — held for long-term use, including tangible (machinery, building), intangible (goodwill, patents), and long-term investments.

Q5 Explain the meaning of gain and profit. Distinguish between these two terms.

SOLUTION

Meaning of Profit:
The excess of revenues of a period over its related expenses during an accounting year is called profit. Profit arises from the normal and regular business operations of the enterprise. It increases the investment of the owners.
Example: If total revenue for the year is Rs 6,00,000 and total expenses are Rs 5,40,000, then

Profit = Rs 6,00,000 minus Rs 5,40,000 = Rs 60,000.

Meaning of Gain:
A gain is a profit that arises from events or transactions which are incidental to the business — i.e., not from the regular or primary operations of the business.
Examples of gain: profit on sale of a fixed asset (e.g., selling old machinery for more than its book value), winning a court case, appreciation in the value of an asset.

Distinction between Profit and Gain:
1. Source: Profit arises from regular and recurring business operations (e.g., selling goods or services). Gain arises from incidental or non-recurring transactions (e.g., sale of a fixed asset or winning a legal case).
2. Frequency: Profit occurs regularly in the ordinary course of business. Gain is occasional and does not occur in the normal course of operations.
3. Nature of Transaction: Profit results from transactions that are central to the business purpose. Gain results from peripheral or incidental transactions.
4. Example: For a cloth merchant, profit arises from selling cloth (regular operations). Gain arises when he sells his old sewing machine at a price higher than its book value (incidental transaction).

Answer: Profit: excess of revenues over expenses from regular business operations; increases owner's investment (e.g., profit from sales). Gain: incidental profit from non-recurring transactions (e.g., profit on sale of fixed assets, winning a court case). Key difference: profit is from regular operations; gain is from incidental transactions.

Q6 Explain the qualitative characteristics of accounting information.

SOLUTION

Qualitative characteristics are the attributes of accounting information that enhance its understandability and usefulness for decision-making. To be decision-useful, accounting information must possess the following qualitative characteristics:

1. Reliability:
Reliability means users must be able to depend on the information. The reliability of accounting information is determined by the degree of correspondence between what the information conveys about transactions or events and what actually happened.
Reliable information should be: (a) free from error and bias, (b) faithfully representative of what it purports to show, (c) verifiable by independent parties using the same measurement method, and (d) neutral and credible.
Example: Financial statements audited by an independent auditor are more reliable.

2. Relevance:
To be relevant, information must be available in time, must help in prediction and feedback, and must influence the decisions of users by:
(a) Helping them form predictions about the outcomes of past, present or future events

(predictive value).
(b) Confirming or correcting their past evaluations (feedback value).
Information that is not timely loses its relevance even if it is accurate.
Example: Current year's sales figures are relevant for a prospective investor; figures from ten years ago are not.

3. Understandability:
Understandability means that decision-makers must be able to interpret accounting information in the same sense as it is prepared and conveyed to them. Accountants must present information in the most intelligible manner without sacrificing relevance and reliability.
A message is effectively communicated when the receiver interprets it in the same sense as the sender intended.
Example: Using clear headings, standard formats and simple language improves understandability.

4. Comparability:
It is not sufficient that accounting information is relevant and reliable at a particular time or for a particular entity. Users must also be able to compare various aspects of an entity over different time periods (inter-period comparison) and with other entities (inter-firm comparison).
To be comparable, accounting reports must use: a common period, common units of measurement, and a common format of reporting.
Example: Comparing two companies' balance sheets is only meaningful if both use the same accounting standards and format.

Answer: Qualitative characteristics of accounting information: (1) Reliability — free from error, verifiable, neutral and faithful; (2) Relevance — timely, predictive and feedback value; (3) Understandability — clearly presented so users interpret it correctly; (4) Comparability — allows inter-period and inter-firm comparison through common standards and formats.

Q7 Describe the role of accounting in the modern world.

SOLUTION

The role of accounting has changed significantly with the changes in economic development and increasing societal demands. In the modern world, accounting plays the following key roles:

1. Language of Business:
Accounting is regarded as the language of business. It describes and analyses the mass of data of an enterprise through measurement, classification and summarisation, and reduces those data into reports and statements that show the financial condition and results of operations. Like language, accounting communicates information about enterprises to users.

2. Historical Record:
Accounting is viewed as a chronological record of financial transactions of an organisation at actual amounts involved. It provides a permanent and verifiable record of all financial events,

which can be used for reference, comparison and legal purposes.

3. Current Economic Reality:
Accounting is viewed as the means of determining the true income of an entity — the change in wealth over time. It reflects the current financial position and performance of the business, not just a historical chronicle.

4. Information System:
Accounting is viewed as an information system that links an information source (the accountant) to a set of receivers (external users) through a channel of communication. As an information system, it collects and communicates economic information about an enterprise to a wide variety of interested parties — both internal (management) and external (investors, creditors, government, etc.).

5. Service Activity (Commodity):
Specialised accounting information is viewed as a service in demand in society, with accountants being willing and capable of providing it. Accountants now work in exciting new growth areas such as:
- Forensic accounting (solving financial crimes, computer hacking, internet fraud)
- E-commerce (designing web-based payment systems)
- Financial planning
- Environmental accounting
- Human resource accounting
- Social accounting
- Responsibility accounting

However, it must be kept in mind that accounting information relates primarily to the past and is quantitative and financial in nature. It does not provide qualitative and non-financial information. These limitations of accounting must be kept in view while making use of accounting information.

Answer: Role of accounting in the modern world: (1) language of business — communicates financial information; (2) historical record — chronological record of transactions; (3) current economic reality — reflects true income and wealth; (4) information system — links accountants to users; (5) service/commodity — provides specialised services including forensic accounting, environmental accounting, e-commerce and financial planning.