1. Details of Module and its structure

Module Detail	
Subject Name	Accountancy
Course Name	Accountancy 01 (Class XI, Semester - 1)
Module Name/Title	Introduction to Accounting – Part 2
Module Id	keac_10102
Pre-requisites	Basic knowledge of process of accounting
Objectives	After going through this lesson, the learners will be able to understand the following: • Accounting as an information system • Need for accounting information by internal and external uses of information • Qualitative characteristics of accounting information
Keywords	Users of accounting information, AIS, qualitative characteristics, information system

2. Development Team

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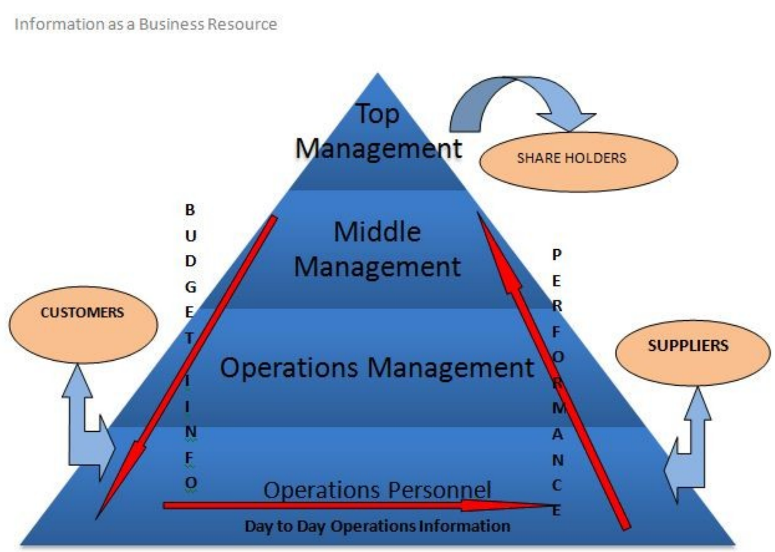
Information as a Business Resource

A Business organization is divided horizontally into several levels of activity. Business operates from the base of the pyramid. These activities consist of product oriented work of organization such as manufacturing, sales and distribution. Above the base level, organization is divided into three management tiers: Operations, Middle and Top. Operations management is directly responsible for day-to-day operations; Middle management is responsible for short term planning and coordination of the activities to be accomplished by the organization; Top management is entrusted with long term planning and setting organizational objectives. Every individual in an organization, working at any level, needs information for carrying out the tasks effectively (refer figure 1).



If we notice in the figure, we find that information flows in two directions within an organization: Horizontally and vertically. Horizontal flow supports operations-level tasks with highly detailed information on events such as sales (distribution) of goods, labour, material in production process, internal transfer of resources from one department to another. The vertical flow of information disseminates summarized information about operations and other activities upward to internal users of all levels. The third flow of information is disseminated to the external users. The external users include creditors, investors, financers, government, suppliers, vendors and society at large.

Hence, all user groups, external and internal, have unique information requirements. The nature and level of information differ considerably. For example, managers at the middle level may not find the detailed information needed by the operations personnel. Similarly, management information is thus more summarized and categorized for the reporting purposes so that the corrective measures are taken well in time. In a same way, external users require quite different information from the internal users of organization.

Users of accounting information and their needs

Internal users of accounting information:

a) **Owners:** Person(s) who contribute capital in the business are called owners. They are ultimately responsible to bear all risks of the business. They are interested to know the profitability and solvency position of the business. This is the reason why owners of business concern are interested to know the financial statements of business in order to ascertain
   i) Whether the resources are utilized in a way that has added to their investment i.e. financial performance of the business?
   ii) Current position of its assets against liabilities etc i.e. financial position of the business?

b) **Management:** Small business enterprises are managed by owners themselves, but medium or large scale enterprises are managed by Board of Directors or Managers. To judge the capacity of business to earn profits in future and to examine the solvency of business enterprise to meet its liabilities i.e. debt obligations on time, various types of accounting information is needed by the management. Financial information is needed by owners and managers to take important decisions regarding business and that information is provided by Accounting.

External users of accounting information:

a. **Investors and Potential Investors**: Investors and potential investors of an enterprise are interested to know the profitability, current financial standing and future prospects of the business. Before investing further capital in the business, the people need information on the risks and return on investment of the business. Such information is obtained from the financial statements of a business concern. Investors and potential investors are the potential sources of finance to the business. More opportunities would be created in the business as with new investments money will flow in the business. To ascertain whether the business can promise a favorable return on their investment and how long investment can stay profitable considering connected factors these users require accounting information.
b. **Lenders and Financial Institutions**: As the name suggests, lenders are the ones who extend given loans to the business. Lenders and financial institutions need information on the creditworthiness of the business enterprise and its ability to repay loans and pay interest i.e. the short term and long term solvency position of the business. To ensure the safety of their trends the investors or the people who are interested to invest in business, need financial information about the business operations whether the risks associated with the lending to the business are addressed appropriately.
c. **Suppliers and Creditors**: Suppliers and creditors need information of the business to ascertain whether amounts owed will be repaid, when due, and also about the continued operations of the business. Accounting information helps suppliers and trade creditors to assess the short-term liquidity of a business. They want to know that whether the business would be able to pay short-term debt, when it falls due. As majority of the business transactions with the suppliers are on credit and business is under obligation to pay them on timely basis to ensure the smooth supply of materials and sources.
d. **Customers:** Customers are interested to get information on the continued existence of the business and continued supply of goods and sources. Customers have a long-term interest in the company's range of products and services. They may even be

dependent on the business for continuous supply of certain products or services in the market. The financial statements helps customer in planning to buy certain goods which are high in terms of price or value.

e. **Competitors:** Those organizations or individuals that are selling similar products or services to similar class of customers are called competitors. . Business organizations examine the financial strength and weaknesses of their competitors through their financial statements. Business organizations also examine and analyze their financial statements to make their own strategies on how to challenge competition. Information is needed on the relative strengths and weaknesses of their competition and for comparative and benchmarking purposes.

f. **Trade Unions**: Employees and trade unions require information about the stability and sustainable profitability of the business. The profits of the business are indication that there are chances of growth of the organization which is good for the betterment of employees. Trade unions are also likely to be interested in pay packages and benefits obtained by them and by the management.

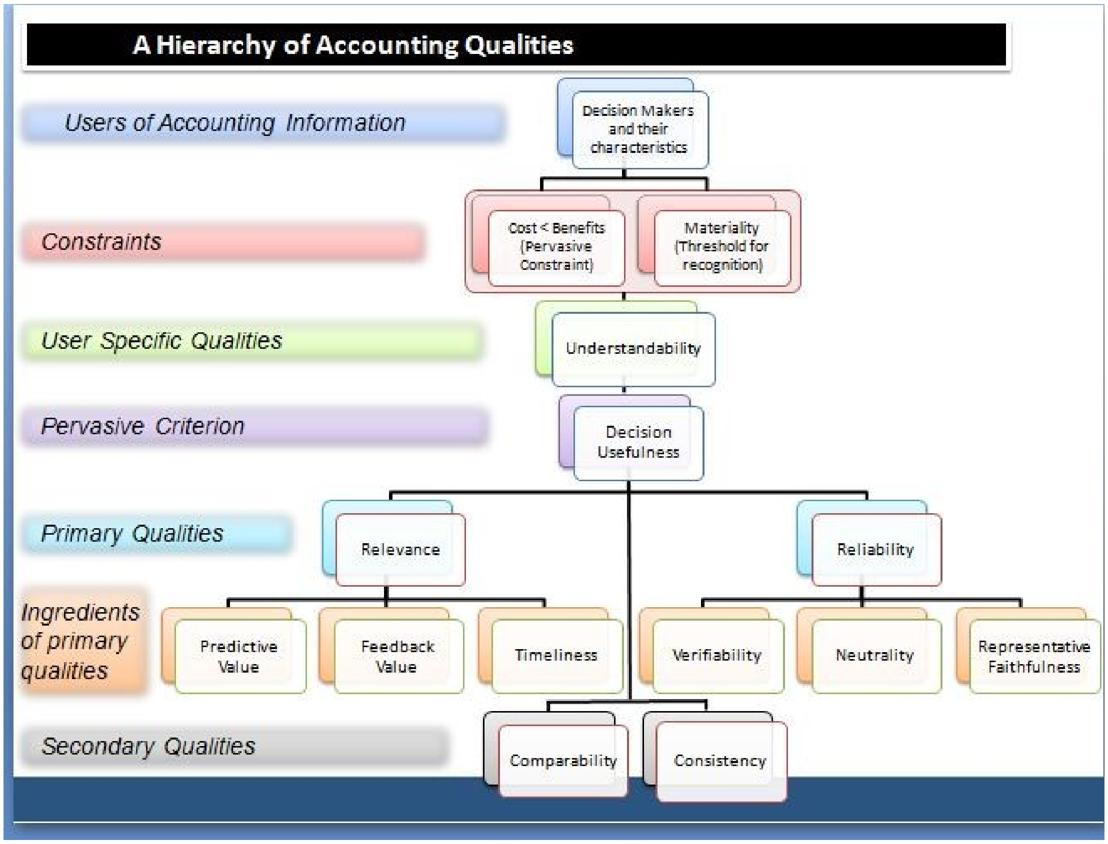
g. **Government and other Regulators**: Government and other regulators require financial statements to gather information on the allocation of resources and the compliance to regulations. Government has to determine the various industries who are important from economic development of the country and if they need financial assistance. Similarly, sometimes Government has to put restrictions on some business enterprises if the Government observes.

h. **Taxation Authorities**: Taxes and excise duties are levied by the Government based upon the analysis of financial statements of a business concern. To ensure that the financial statements are prepared as per the legal provisions, Government has various agencies e.g. Income Tax Department, Sales Tax Department, Customs and Excise etc. Through these agencies, Government also ensures that in the financial statements, various figures relating to sales and income are correctly reported in order to assess the tax liability of the business enterprise. For all these purposes, Government needs Accounting information of the business.

Qualitative Characteristics of Accounting Information

Qualitative characteristics or qualities are the attributes that make the information provided in financial statements useful to internal and external users of information.

Accounting information qualitative characteristics are summarized below**:**



Relevance and reliability are the two primary characteristics that make accounting information useful for decision-making. Ideally, financial reporting should produce information that is both reliable and relevant. **Relevance** is closely and directly related to the qualitative aspect of useful information. Relevance implies that all those items of information should be reported in the financial statements that may enable the users in making decisions and/or predictions. A necessary test of the relevance of reportable data is the ability to predict events of interest to the users. Having said that the accounting information has predictive value does not imply that it is itself is a prediction. The question of relevance arises after identification and recognition of the purpose for which the information will be used. It means that information relevant for one purpose may not be necessarily relevant for other purposes. Information that is not relevant is useless because that will not aid users in making decisions. Hence, Relevance is the dominant criterion in taking decisions regarding information disclosure.

Reliability is that quality which permits users of data to depend upon it with confidence as representative of what it claims to represent. Reliable information facilitates to form judgments about the financial position of any business concern, combined with an assurance for the users that it has that representational quality. It is important to note here that the degrees of reliability must be recognized by the users of information i.e., reliability rests upon the extent to which the accounting description or measurement is verifiable and representational. Neutrality of information also interacts with those two components of reliability to affect the usefulness of the information. The reliability concept does not imply cent-percent accuracy. Any sort of Non-disclosure of information can mislead the users. It is pertinent to note that the most reliable information may not be the most significant information for users in making economic decisions and assessment of an enterprise's earning power. Thus, relevance and reliable qualities of information impinge upon each other for completeness.

Understandability is the quality of information that enables users to recognize its importance. It is essential for information to be presented in a fashion which not only facilitate understanding but also stay away from mistaken interpretation of financial statements. The benefits of information may be increased by making it more understandable. Thus, understandable financial accounting information presents data that can be understood by its users and is expressed in a, form which is meaningful and understandable to the users.

Comparability is normally a quantitative assessment of the common characteristics i.e., similar items may be reported in a same manner. Economic decision requires making choices among possible courses of actions. In making decisions, the decision-maker will make comparisons among alternatives, which is facilitated by financial information.

Consistency in reporting accounting data is a valuable quality that makes financial information decision worthy by facilitating analysis and understanding of comparative accounting data. **Neutrality** is also known as the quality of 'freedom from bias' or objectivity. Therefore, it is important that accounting facts and accounting practices should be impartially determined and reported with no objective of purposeful bias toward any user or user group.

Materiality permeates the entire field of accounting. It implies that only material information should be reported in the annual statements. Immaterial information should be omitted. Information should be disclosed in the annual report which is likely to influence economic decisions of the users. Information that meets this requirement is material.

Timeliness means having information available to decision-makers before it loses its power to influence decisions. Timeliness is an ancillary aspect of relevance. If information is either not available when it is needed or becomes available long after the reported events that it has no value for future action, it lacks relevance and is of little or no use. Timeliness alone cannot make information relevant, but a lack of timeliness can rob information of relevance it might otherwise have had.

Accounting as an Information System

Manual system of accounting has been traditionally the most popular method of keeping the records of financial transactions of an organization. Earlier, the bookkeeper (or accountant) used to maintain book of accounts such as cash book, journal and ledger so as to prepare a summary of transactions and final accounts manually. The technological innovations led to the development of various procedures capable of performing a variety of accounting functions. Accounting as an Information System combines a study and practice of accounting with design, implementation and monitoring of information systems. In other words, accounting information system is a set of formal procedures by which data are collected, processed into information and disseminated to the users of information, both internal and external.

Accounting as a source of information begins with the recognition that information is a business resource. Like other business resources (such as raw material, capital, labour) information generation and dissemination also plays an important role in the survival of the business. In order to remain competitive, organizations depend heavily on information systems. The information system accepts input called *transactions* which are processed to produce information for the users. Transactions are broadly classified as financial and non financial transactions. A financial transaction is an economic event that affects the assets and equities of an organization and is measurable in monetary terms. The non financial transactions are those which can not explicitly be measured in quantitative terms but are considered as the important events of any organization for its effective operating capacity.

Accounting information system is a group of interrelated components or sub systems that serves a common purpose. The sub-systems of AIS are shown in figure 2 and discussed briefly hereunder:

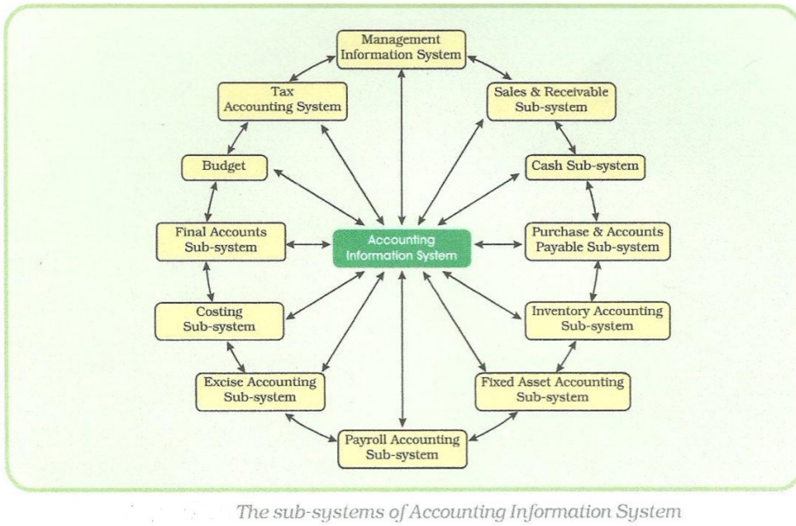


Figure 2: AIS and Sub-Systems

1. **Cash and Bank Sub-system**

It deals with the receipt and payment of cash both physical cash and electronic fund transfer. Electronic fund transfer takes place without having the physical entry or exit of cash using credit cards or electronic banking.

2. **Sales and Accounts Receivable Sub-System**

It deals with recording of sales, maintaining of sales ledger and receivables. It generates periodic reports about sales, collections made, overdue accounts and receivable position i.e., aging schedule of receivables/debtors.

3. **Inventory Sub-System**

It deals with recording of different items purchased and issued specifying the price, quantity and date. It generates the inventory position and valuation report.

4. **Purchase and Accounts Payable Sub-System**

It deals with the purchase and payments to creditors. It provides for ordering of goods, sorting of purchase expenses and payment to the creditors. It also generates periodic reports about the performance of suppliers, payment schedule and position of the creditors.

5. **Payroll Accounting Sub-System**

It deals with payment of wages and salaries. A typical wage report details information about basic pay, dearness allowance and other allowances and deductions from salary and wages on account of provident fund, taxes, loans and advances and other charges. The system generates reports about wage bill, overtime payment and payment on account of leave encashment etc.

6. **Fixed Assets Accounting Sub-System**

It deals with the recording of purchases, additions, deletions, usage of fixed assets such as land and buildings, machinery and equipments etc. It also generates reports about cost, depreciation and book value of different assets.

7. **Expense Accounting Sub-System**

This sub-system records expenses under broad groups such as manufacturing, administrative, financial, selling and distribution etc.

8. **Tax Accounting Sub-System**

This sub system deals with the compliance requirement value added tax (VAT), excise, customs and income tax. This sub-system is used in large size organisations.

9. **Final Accounts Sub-System**

This sub system deals with the preparation of profit and loss account , balance sheet and cash flow statement for reporting purposes.

10. **Costing Sub-System**

It deals with the ascertainment of cost of goods sold. It has linkages with other accounting sub-systems for obtaining the necessary information about cost of material, labour and other expenses. This sub system generates information about changes in the cost that takes place during the period under review.

11. **Budget Sub-System**

It deals with the preparation of budget for the coming financial year as well as comparison with the actual performances.

Management Information System

Management Information system, on the other hand, often requires information that goes beyond the capability of AIS. MIS deals with the generation and processing of reports that are vital for managerial decision making.

As organization grow in size and complexity, specialized functional areas emerge requiring additional information for production, planning and control, sales forecasting, inventory, warehouse etc. Non financial transactions are not processed by AIS but directly affect the processing of financial transactions. For example, change in customer's address is a non financial transaction but is vital for AIS in order to initiate the future sales.

Summary

Users of accounting information: Accounting plays a significant role in society by providing information to management at all levels and to those having a direct financial interest in the enterprise. It is also very useful to the people who are indirectly associated with the business and its economic events. They can be broadly classified as internal users and external users.

Qualitative characteristics of Accounting: To make accounting information decision useful, it should possess the following qualitative characteristics.

- Reliability
- Relevance
- Understandability
- Comparability
- Consistency
- Full disclosure

Accountancy as an information system: every step in the process of accounting generates information. Such information enables the interested parties to take appropriate decisions. Therefore accounting as a source of information dissemination is an essential function of accounting.