

# **BASIC FINANCIAL ACCOUNTING- I**

**Semester: 1<sup>st</sup> Semester IMBA**

**Subject Code: IMPC1001**

**Prepared By**

**Name of the Faculty: MISS SHAHNI SINGH**

**Designation: ASSISTANT PROFESSOR**

**Department: FINANCE**

**Biju Patnaik Institute of IT & Management Studies,  
Bhubaneswar, Odisha.**

## **Syllabus**

**Module-I:** Introduction: Accounting as a business function and language of business; Characteristics, Functions, Objectives, and Basis of Accounting; Users of Accounting information; Limitations of Accounting; Cyclical nature of business and Accounting cycle.

**Module-II:** Fundamentals of Accounting: Accounting Equation; Accounting events and transactions; Classification of Transactions and their effects on Accounting Equation; Statements showing the effect of transactions on assets, liabilities and capital; Accounting concepts and GAAP – as applicable to Balance Sheet and Income Statements; The Rules of Debit and Credit.

**Module-III:** Recording Transactions: The Journal; The ledger postings; Subsidiary Books of Accounts; Capital and Revenue transactions; Fixed Assets and Depreciation policy; Rectification of Errors, Trial Balance

**Module-IV:** Final Accounts of Trading Concerns: Meaning of financial statements, Presentation of final accounts, Trading account, Profit & Loss Account, Balance Sheet, Manufacturing Account, Financial statements with adjustments

## **Course Objectives (CO) & Program Outcomes (PO)**

### **Course Objectives (CO):**

On successful completion of the course, students should be able to

- Identify the accounting concepts, principle and conventions.
- Understand the process of accounting, uses and limitations.
- Solve, and examine the Journal Entries, Ledger, Trial Balance

### **Program Outcomes (PO):**

1. To familiarize the students with accounting principles and accounting mechanisms, process and systems so as to develop their skills of preparing journal, ledger, subsidiary books.
2. Evaluate the financial statements of different companies using financial tools and to analyse and interpret Financial Statement and Balance Sheet of different Companies.
3. To familiarize the students with different basic financial accounting concepts.

## **Introduction**

Accounting is a system meant for measuring business activities, processing of information into reports and making the findings available to decision-makers. The documents, which communicate these findings about the performance of an organisation in monetary terms, are called financial statements. 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 result thereof.

Accounting is often called the language of business because the purpose of accounting is to communicate or report the results of business operations and its various aspects to various users of accounting information. In fact, today, accounting statements or reports are needed by various groups such as shareholders, creditors, potential investors, columnist of financial newspapers, proprietors and others. In view of the utility of accounting reports to various interested parties, it becomes imperative to make this language capable of commonly understood by all. Accounting could become an intelligible and commonly understood language if it is based on generally accepted accounting principles. Hence, you must be familiar with the accounting principles behind financial statements to understand and use them properly. All business transactions, at the first stage, are recorded in the book of original entry i.e. Journal and then posted into the ledger under the double entry system of book-keeping. This procedure is easy and practicable in small business houses where the number of business transactions are less and when a single person can handle the business transactions. The transactions of a business enterprise for the accounting period are first recorded in the books of original entry, then posted therefrom into the ledger and lastly tested as to their arithmetical accuracy with the help of trial balance. After the preparation of the trial balance, every businessman is interested in knowing about two more facts. They are: (i) Whether he has earned a profit or suffered a loss during the period covered by the trial balance, and (ii) Where does he stand now? In other words, what is his financial position?

The businessman prepares financial statements for his business i.e. he prepares the Trading and Profit and Loss Account and Balance Sheet at the end of the accounting period. These financial statements are popularly known as final accounts. The preparation of financial statements depends upon whether the business concern is a trading concern or manufacturing concern. If the business concern is a trading concern, it has to prepare the following accounts along with the Balance Sheet: (i) Trading Account; and (ii) Profit and Loss Account. But, if the business concern is a manufacturing concern, it has to prepare the following accounts along with the Balance Sheet: (i) Manufacturing Account; (ii) Trading Account; and (iii) Profit and Loss Account.

## Module I

Business is an economic activity undertaken with the motive of earning profits and to maximize the wealth for the owners. Business cannot run in isolation. Largely, the business activity is carried out by people coming together with a purpose to serve a common cause. This team is often referred to as an organization, which could be in different forms such as sole proprietorship, partnership, body corporate etc. The rules of business are based on general principles of trade, social values, and statutory framework encompassing national or international boundaries. While these variables could be different for different businesses, different countries etc., the basic purpose is to add value to a product or service to satisfy customer demand. The business activities require resources (which are limited & have multiple uses) primarily in terms of material, labour, machineries, factories and other services. The success of business depends on how efficiently and effectively these resources are managed. Therefore, there is a need to ensure the businessman tracks the use of these resources. The resources are not free and thus one must be careful to keep an eye on cost of acquiring them as well. As the basic purpose of business is to make profit, one must keep an ongoing track of the activities undertaken in course of business. Two basic questions would have to be answered: (a) What is the result of business operations? This will be answered by finding out whether it has made profit or loss. (b) What is the position of the resources acquired and used for business purpose? How are these resources financed? Where the funds come from? The answers to these questions are to be found continuously and the best way to find them is to record all the business activities. Recording of business activities has to be done in a scientific manner so that they reveal correct outcome. The science of book-keeping and accounting provides an effective solution. It is a branch of social science. This study material aims at giving a platform to the students to understand basic principles and concepts, which can be applied to accurately measure performance of business.

### Definition of Accounting

Definition by the American Institute of Certified Public Accountants (Year 1961): —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 result thereof. Definition by the American Accounting Association (Year 1966):



Estd. 1999

—The process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of accounting.

### **Objectives of Accounting**

(i) **Providing Information to the Users for Rational Decision-making** The primary objective of accounting is to provide useful information for decision-making to stakeholders such as owners, management, creditors, investors, etc. Various outcomes of business activities such as costs, prices, sales volume, value under ownership, return of investment, etc. are measured in the accounting process. All these accounting measurements are used by stakeholders (owners, investors, creditors/bankers, etc.) in course of business operation. Hence, accounting is identified as language of business.

(ii) **Systematic Recording of Transactions** To ensure reliability and precision for the accounting measurements, it is necessary to keep a systematic record of all financial transactions of a business enterprise which is ensured by bookkeeping. These financial records are classified, summarized and reposted in the form of accounting measurements to the users of accounting information i.e., stakeholder.

(iii) **Ascertainment of Results of above Transactions** Profit/loss is a core accounting measurement. It is measured by preparing profit and loss account for a particular period. Various other accounting measurements such as different types of revenue expenses and revenue incomes are considered for preparing this profit and loss account. Difference between these revenue incomes and revenue expenses is known as result of business transactions identified as profit/loss. As this measure is used very frequently by stockholders for rational decision making, it has become the objective of accounting. For example, Income Tax Act requires that every business should have an accounting system that can measure taxable income of business and also explain nature and source of every item reported in Income Tax Return.

(iv) **Ascertain the Financial Position of Business**-Financial position is another core accounting measurement. Financial position is identified by preparing a statement of ownership i.e., Assets and Owings i.e., liabilities of the business as on a certain date. This statement is popularly known as balance sheet. Various other accounting measurements such as different types of assets and different types of liabilities as existed at a particular date are considered for preparing the



Estd. 1999

balance sheet. This statement may be used by various stakeholders for financing and investment decision.

(v) To Know the Solvency Position- Balance sheet and profit and loss account prepared as above give useful information to stockholders regarding concerns potential to meet its obligations in the short run as well as in the long run.

- To Know the Solvency Position
- Ascertain the Financial Position of Business
- Ascertainment of Results of above Transactions
- Systematic Recording of Transactions
- Providing Information to the Users for Ratio

### **Accounting – Classification**

(a) Financial Accounting It is commonly termed as Accounting. The American Institute of Certified Public Accountants defines Accounting as —an art of recoding, 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.

(b) Cost Accounting According to the Chartered Institute of Management Accountants (CIMA), Cost Accountancy is defined as —application of costing and cost accounting principles, methods and techniques to the science, art and practice of cost control and the ascertainment of profitability as well as the presentation of information for the purpose of managerial decision-making.

(c) Management Accounting Management Accounting is concerned with the use of Financial and Cost Accounting information to managers within organizations, to provide them with the basis in making informed business decisions that would allow them to be better equipped in their management and control functions.



Estd. 1999

<b>BASIS</b>	<b>FINANCIAL ACCOUNTING</b>	<b>MANAGEMENT ACCOUNTING</b>
Meaning	Financial Accounting is an accounting system that focuses on the preparation of a financial statement of an organization to provide financial information to the interested parties.	The accounting system which provides relevant information to the managers to make policies, plans and strategies for running the business effectively is known as Management Accounting.
Orientation	Historical	Future
Users	Both internal and external users	Only internal users
Nature of statements prepared	General-purpose financial statements	Special purpose financial statements
Rules	Rules of GAAP are followed	No fixed rules for the preparation of reports
Reports	Only financial aspects	Both financial and non-financial aspects
Time Span	Financial statements are prepared for a fixed period, i.e. one year.	Management Reports are prepared whenever needed.
Objective	To create periodical reports	To assist internal management in planning and decision-making process by providing detailed information on various matters.





Estd. 1999

Publishing and auditing	Required to be published and audited by statutory auditors	It is not meant to be published or audited. It is for internal use only.
Format	Specified	Not Specified

<b>BASIS</b>	<b>COST ACCOUNTING</b>	<b>FINANCIAL ACCOUNTING</b>
Meaning	Cost Accounting is an accounting system, through which an organization keeps the track of various costs incurred in the business in production activities.	Financial Accounting is an accounting system that captures the records of financial information about the business to show the correct financial position of the company at a particular date.
Information type	Records the information related to material, labor and overhead, which are used in the production process.	Records the information which are in monetary terms.
Which type of cost is used for recording?	Both historical and pre-determined cost	Only historical cost.
Users	Information provided by the cost accounting is used only by the internal management of the organization like employees, directors, managers, supervisors etc.	Users of information provided by the financial accounting are internal and external parties like creditors, shareholders, customers etc.



Estd. 1999

Valuation of Stock	At cost	Cost or Net Realizable Value, whichever is less.
Mandatory	No, except for manufacturing firms it is mandatory.	Yes for all firms.
Time of Reporting	Details provided by cost accounting are frequently prepared and reported to the management.	Financial statements are reported at the end of the accounting period, which is normally 1 year.
Profit Analysis	Generally, the profit is analyzed for a particular product, job, batch or process.	Income, expenditure and profit are analyzed together for a particular period of the whole entity.
Purpose	Reducing and controlling costs.	Keeping complete record of the financial transactions.
Forecasting	Forecasting is possible through budgeting techniques.	Forecasting is not at all possible.

## Users of Accounting

### Internal users

Internal users are the primary users of accounting.

**Owners-**Owners need to assess how well their business is performing. Financial statements provide information to owners about the profitability of the overall business as well as individual products and geographic segments. Owners are also interested in knowing how risky their business is. Accounting information helps owners in assessing the level of stability in business over the years and to what extent have changes in economic factors affected the bottom line of the business. Such information helps owners to decide if they should invest any further in the



Estd. 1999

business or if they should use their financial resources elsewhere in more promising business ventures.

**Managers-**Managers need accounting information to plan, monitor and make business decisions. Managers need to allocate the financial, human and capital resources towards competing needs of the business through the budgeting process. Preparing and monitoring budgets effectively requires reliable accounting data relating to the various activities, processes, products, services, segments and departments of the business. Management requires accounting information to monitor the performance of business by comparison against past performance, competitor analysis, key performance indicators and industry benchmarks. Managers rely on accounting data to form their business decisions such as investment, financing and pricing decisions. In case of investment decisions for example, managers would require the return on investment calculation of a proposed project supported by reliable estimates of the costs and revenues.

**Employees-**For the employees operating in the finance department, using accounting information is usually part of their job description. This includes for example preparing and reviewing various financial reports such as financial statements. Employees are interested in knowing how well a company is performing as it could have implications for their job security and income. Many employees review accounting information in the annual report just to get a better understanding of the company's business. In recent years, the increase in number of shares and share options schemes for employees particularly in startups has fostered a greater level of interest in accounting information by employees. Moreover, potential employees are also interested to learn about the financial health of the organization they aspire to join in the future.

### **External Users of Accounting**

**Investors-**Investors need to know how well their investment is performing. Investors primarily rely on the financial statements published by companies to assess the profitability, valuation and risk of their investment. Investors use accounting information to determine whether an investment is a good fit for their portfolio and whether they should hold, increase or decrease their investment.

**Lenders-** Lenders use accounting information of borrowers to assess their credit worthiness, i.e. their ability to pay back any loan. Lenders offer loans and other credit facilities on terms that are based on the assessment of financial health of borrowers. Good financial health is indicated by the borrower's ability to pay its liabilities on time, high profitability, substantial securable assets and liquidity. Poor liquidity, low profitability, lack of assets that can be secured and an inability to pay liabilities on time demonstrate poor financial health of borrowers. On a lighter note, borrowers can only get a loan from lenders if they can prove that they don't need the money.

**Suppliers-** Just like lenders, suppliers need accounting information to assess the credit-worthiness of its customers before offering goods and services on credit. Some suppliers only have a handful of customers. These customers could be very large businesses themselves. Suppliers need accounting information of its key customers to assess whether their business is in good health which is necessary for sustainable business growth.



Estd. 1999

**Customers-**Most consumers don't care about the financial information of its suppliers. Industrial consumers however need accounting information about its suppliers in order to assess whether they have the required resources that are necessary for a steady supply of goods or services in the future. Continuity in supply of quality inputs is essential for any business.

**Tax Authorities-** Occasionally, tax authorities conduct audits of the tax returns filed by businesses in order to verify the information with the underlying accounting records. Tax authorities also cross reference accounting information of suppliers and consumers in order to identify potential tax evaders.

Tax authorities determine whether a business declared the correct amount of tax in its tax returns.

**Government-** Government ensures that a company's disclosure of accounting information is in accordance with the regulations that are in place to protect the interest of various stakeholders who rely on such information in forming their decisions. Government defines and monitors accounting thresholds such as sales revenue and net profit to determine the size of each business for the purpose of ensuring that it complies with the relevant employee, consumer and safety regulations.

**Auditors-** External auditors examine the financial statements and the underlying accounting record of businesses in order to form an audit opinion. Investors and other stakeholders rely on the independent opinion of external auditors on the accuracy of financial statements.

**Public-** General public may also be interested in accounting information of a company. These could include journalists, analysts, academics, activists and individuals with an interest in economic developments.

Bookkeeping	Accounting
Bookkeeping is a foundation/base of accounting.	Accounting uses the information provided by bookkeeping to prepare financial reports and



Estd. 1999

	statements.
Bookkeeping is one segment of the whole accounting system.	Accounting starts where the bookkeeping ends and has a broader scope than bookkeeping.
The result of the bookkeeping process is providing input for accounting.	The result of accounting is preparing financial statements for making informed decisions and judgments.
The purpose of bookkeeping is to maintain a systematic record of financial activities and transactions chronologically.	The purpose of accounting is to report the financial strength and obtain the results of the operating activity of a business.
The objective of bookkeeping is to summarise the effect of all financial transactions of a business for a given period.	The objective of accounting is to interpret and analyse financial information for informed decisions.
The person responsible for bookkeeping is called a bookkeeper.	The person responsible for accounting is called an accountant.
Bookkeeping is clerical in nature. The bookkeepers do not require any special knowledge or skill.	Accounting requires the skills of an accountant and knowledge of various accounting practices and policies.
The financial statements are not a part of the bookkeeping process.	The financial reports and statements are prepared under the accounting process.
The bookkeeping process is in accordance with the accounting conventions and concepts.	Accounting procedures and methods for interpreting and analysing financial reports can



Estd. 1999

vary from one entity to another.

<b>Single Entry System</b>	<b>Double Entry System</b>
A single-Entry System is a bookkeeping system in which only one part of a transaction is recorded, such as debit or credit.	A double entry system is a method of recording transactions in which both sides of a transaction are recorded.
This sort of bookkeeping is not for tax purposes. To put it another way, it is not accepted by the tax authorities.	This method of bookkeeping is acceptable for tax purposes. To put it another way, this method is accepted by the tax authorities.
If you use a single-entry bookkeeping system, you won't be able to prepare a trial balance.	In the case of a double-entry bookkeeping system, a trial balance can be prepared.
We can't accurately determine the company's financial status using the Single Entry System of Bookkeeping.	We accurately determine the company's financial status using the Double Entry System of Bookkeeping.
The single entry bookkeeping system is an inadequate accounting system since it does not record all financial transactions. Instead, it only tracks personal accounts such as debtors, creditors, and cash.	The double entry bookkeeping system is a full accounting system since it records all financial activities and categorize them into personal, real, and nominal accounts.
While keeping books of account under it, there is a considerable chance of workers committing frauds and errors.	While keeping books of account under it, there is a reduced danger of workers making frauds and errors.
Because it is not maintained to a specific standard, only the business owner can utilize it.	Because all books are kept in standard formats, this system can be used by any involved parties.
This system is only appropriate for small businesses.	It's appropriate for any business.

## **MODULE II**

### **BASIC ACCOUNTING TERMS**

- i) Transaction: It means an event or a business activity which involves exchange of money or money's worth between parties. The event can be measured in terms of money and changes the financial position of a person e.g. purchase of goods would

involve receiving material and making payment or creating an obligation to pay to the supplier at a future date. Transaction could be a cash transaction or credit transaction. When the parties settle the transaction immediately by making payment in cash or by cheque, it is called a cash transaction. In credit transaction, the payment is settled at a future date as per agreement between the parties.

- ii) Goods/Services: These are tangible article or commodity in which a business deals. These articles or commodities are either bought and sold or produced and sold. At times, what may be classified as goods 'to one business firm may not be goods 'to the other firm? E.g. for a machine manufacturing company, the machines are goods' as they are frequently made and sold. But for the buying firm, it is not goods 'as the intention is to use it as a long term resource and not sell it. Services are intangible in nature which is rendered with or without the object of earning profits.
- iii) Profit: The excess of Revenue Income over expense is called profit. It could be calculated for each transaction or for business as a whole.
- iv) Loss: The excess of expense over income is called loss. It could be calculated for each transaction or for business as a whole.
- v) Asset: Asset is a resource owned by the business with the purpose of using it for generating future profits. Assets can be tangible and intangible. Tangible Assets are the Capital assets which have some physical existence. They can, therefore, be seen, touched and felt, e.g. Plant and Machinery, Furniture and Fittings, Land and Buildings, Books, Computers, Vehicles, etc. The capital assets which have no physical existence and whose value is limited by the rights and anticipated benefits that possession confers upon the owner are known as Intangible Assets. They cannot be seen or felt although they help to generate revenue in future, e.g. Goodwill, Patents, Trade-marks, Copyrights, Brand Equity, Designs, Intellectual Property, etc. Assets can also be classified into Current Assets and Non-Current Assets. Current Assets – An asset shall be classified as Current when it satisfies any of the following :
  - (a) It is expected to be realised in, or is intended for sale or consumption in the Company's normal Operating Cycle,
  - (b) It is held primarily for the purpose of being traded



Estd. 1999

(c) It is due to be realised within 12 months after the Reporting Date, or

(d) 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 shall be classified as Non-Current Assets. e.g. Machinery held for long term etc.

(vi) Liability: It is an obligation of financial nature to be settled at a future date. It represents amount of money that the business owes to the other parties. E.g. when goods are bought on credit, the firm will create an obligation to pay to the supplier the price of goods on an agreed future date or when a loan is taken from bank, an obligation to pay interest and principal amount is created. Depending upon the period of holding, these obligations could be further classified into Long Term on non-current liabilities and Short Term or current liabilities. Current Liabilities – A liability shall be classified as Current when it satisfies any of the following:

(a) It is expected to be settled in the Company's normal Operating Cycle,

(b) It is held primarily for the purpose of being traded,

(c) It is due to be settled within 12 months after the Reporting Date, or

(d) 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 could, at the option of the counterparty, result in its settlement by the issue of Equity Instruments do not affect its classification)

Non-Current Liabilities – All other Liabilities shall be classified as Non-Current Liabilities. E.g. Loan taken for 5 years, Debentures issued etc

(vii) Internal Liability : These represent proprietor's equity, i.e. all those amount which are entitled to the proprietor, e.g., Capital, Reserves, Undistributed Profits, etc.

(viii) Working Capital : In order to maintain flows of revenue from operation, every firm needs certain amount of current assets. For example, cash is required either to pay for expenses or to meet obligation for service received or goods purchased, etc. by a firm. On identical reason, inventories are required to provide the link between production and sale.





Estd. 1999

Similarly, Accounts Receivable generate when goods are sold on credit. Cash, Bank, Debtors, Bills Receivable, Closing Stock, Prepayments etc. represent current assets of firm. The whole of these current assets form the working capital of a firm which is termed as Gross Working Capital.  $\text{Gross Working capital} = \text{Total Current Assets} - \text{Long term internal liabilities} - \text{long term debts}$  plus the current liabilities minus the amount blocked in the fixed assets. There is another concept of working capital. Working capital is the excess of current assets over current liabilities. That is the amount of current assets that remain in a firm if all its current liabilities are paid. This concept of working capital is known as Net Working Capital which is amore realistic concept.  $\text{Working Capital (Net)} = \text{Current Assets} - \text{Currents Liabilities}$ .

(ix) Contingent Liability : It represents a potential obligation that could be created depending on the outcome of an event. E.g. if supplier of the business files a legal suit, it will not be treated as a liability because no obligation is created immediately. If the 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 of account, but disclosed by way of a note to the financial statements.

(x) Capital : It is amount invested in the business by its owners. It may be in the form of cash, goods, or any other asset which the proprietor or partners of business invest in the business activity. From business point of view, capital of owners is a liability which is to be settled only in the event of closure or transfer of the business. Hence, it is not classified as a normal liability. For corporate bodies, capital is normally represented as share capital.

(xi) Drawings : It represents an amount of cash, goods or any other assets which the owner withdraws from business for his or her personal use. e.g. if the life insurance premium of proprietor or a partner of business is paid from the business cash, it is called drawings. Drawing will result in reduction in the owners capital. The concept of drawing is not applicable to the corporate bodies like limited companies.

(xii) Net worth: It represents excess of total assets over total liabilities of the business. Technically, this amount is available to be distributed to owners in the event of closure of the business after payment of all liabilities. That is why it is also termed as Owner's equity. A



Estd. 1999

profit making business will result in increase in the owner's equity whereas losses will reduce it.

(xiii) Non-current Investments: Non-current Investments are investments which are held beyond the current period as to sale or disposal. e. g. Fixed Deposit for 5 years.

(xiv) Current Investments: Current investments are investments that are by their nature readily realizable and are intended to be held for not more than one year from the date on which such investment is made. e. g. 11 months Commercial Paper.

(xv) Debtor : The sum total or aggregate of the amounts which the customer owe to the business

for purchasing goods on credit or services rendered or in respect of other contractual obligations, is known as Sundry Debtors or Trade Debtors, or Trade Payable, or Book-Debts or Debtors. In other words, Debtors are those persons from whom a business has to recover money on account of goods sold or service rendered on credit. These debtors may again be classified as under:

- (i) Good debts: The debts which are sure to be realized are called good debts.
- (ii) Doubtful Debts: The debts which may or may not be realized are called doubtful debts.
- (iii) Bad debts: The debts which cannot be realized at all are called bad debts. It must be remembered that while ascertaining the debtors balance at the end of the period certain adjustments may have to be made e.g. Bad Debts, Discount Allowed, Returns Inwards, etc.

(xvi) Creditor: A creditor is a person to whom the business owes money or money's worth. e.g. money payable to supplier of goods or provider of service. Creditors are generally classified as Current Liabilities.

(xvii) Capital Expenditure: This represents expenditure incurred for the purpose of acquiring a fixed asset which is intended to be used over long term for earning profits there from. e. g. amount paid to buy a computer for office use is a capital expenditure. At times expenditure



Estd. 1999

may be incurred for enhancing the production capacity of the machine. This also will be a capital expenditure. Capital expenditure forms part of the Balance Sheet.

(xviii) Revenue expenditure: This represents expenditure incurred to earn revenue of the current period. The benefits of revenue expenses get exhausted in the year of the incurrence. e.g repairs, insurance, salary & wages to employees, travel etc. The revenue expenditure results in reduction in profit or surplus. It forms part of the Income statement.

(xix) Balance Sheet: It is the statement of financial position of the business entity on a particular date. It lists all assets, liabilities and capital. It is important to note that this statement exhibits the state of affairs of the business as on a particular date only. It describes what the business owns and what the business owes to outsiders (this denotes liabilities) and to the owners (this denotes capital). It is prepared after incorporating the resulting profit/losses of Income statement.

(xx) Profit and Loss Account or Income Statement: This account shows the revenue earned by the business and the expenses incurred by the business to earn that revenue. This is prepared usually for a particular accounting period, which could be a month, quarter, a half year or a year. The net result of the Profit and Loss Account will show profit earned or loss suffered by the business entity.

(xxi) Trade Discount: It is the discount usually allowed by the wholesaler to the retailer computed on the list price or invoice price. e.g. the list price of a TV set could be ₹ 15000. The wholesaler may allow 20% discount thereof to the retailer. This means the retailer will get it for ₹ 12000 and is expected to sale it to final customer at the list price. Thus the trade discount enables the retailer to make profit by selling at the list price. Trade discount is not recorded in the books of accounts. The transactions are recorded at net values only. In above example, the transaction will be recorded at ₹ 12000 only.

(xxii) Cash Discount: This is allowed to encourage prompt payment by the debtor. This has to be recorded in the books of accounts. This is calculated after deducting the trade discount. e.g. if list price is 15000 on which a trade discount of 20% and cash discount of 2% apply, then first trade discount of 3000 (20% of 15000) will be deducted and the cash discount of



Estd. 1999

2% will be calculated on 12000 (15000 – 3000). Hence the cash discount will be 240 (2% of 12000) and net payment will be 11,760 (12,000 - 240)

Introduction to the Accounting Equation From the large, multi-national corporation down to the corner beauty salon, every business transaction will have an effect on a company's financial position. The financial position of a company is measured by the following items:

1. Assets (what it owns)
2. Liabilities (what it owes to others)
3. Owner's Equity (the difference between assets and liabilities)

The accounting equation (or basic accounting equation) offers us a simple way to understand how these three amounts relate to each other. The accounting equation for a sole proprietorship is:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

Assets are a company's resources—things the company owns. Examples of assets include cash, accounts receivable, inventory, prepaid insurance, investments, land, buildings, equipment, and goodwill. From the accounting equation, we see that the amount of assets must equal the combined amount of liabilities plus owner's (or stockholders') equity.

Liabilities are a company's obligations—amounts the company owes. Examples of liabilities include notes or loans payable, accounts payable, salaries and wages payable, interest payable, and income taxes payable (if the company is a regular corporation). Liabilities can be viewed in two ways: (1) as claims by creditors against the company's assets, and (2) a source—along with owner or stockholder equity—of the company's assets.

Owner's equity or stockholders' equity- is the amount left over after liabilities are deducted from assets:  $\text{Assets} - \text{Liabilities} = \text{Owner's (or Stockholders') Equity}$ . Owner's or stockholders' equity also reports the amounts invested into the company by the owners plus



Estd. 1999

the cumulative net income of the company that has not been withdrawn or distributed to the owners. If a company keeps accurate records, the accounting equation will always be in balance, meaning the left side should always equal the right side. The balance is maintained because every business transaction affects at least two of a company's accounts. For example, when a company borrows money from a bank, the company's assets will increase and its liabilities will increase by the same amount. When a company purchases inventory for cash, one asset will increase and one asset will decrease. Because there are two or more accounts affected by every transaction, the accounting system is referred to as double-entry accounting. A company keeps track of all of its transactions by recording them in accounts in the company's general ledger. Each account in the general ledger is designated as to its type: asset, liability, owner's equity, revenue, expense, gain, or loss account.

#### Rules of Accounting Equation

1. **Regarding assets-** increase in assets are debits and decrease in assets are credits.
2. **Regarding liabilities-** increase in liabilities are credits and decrease in liabilities are debits.
3. **Regarding capital-** increase in capital are credits and decrease in capital are debits.
4. **Regarding expenses-** increase in expenses are debits and decrease in expenses are credits.
5. **Regarding incomes or profits-** increases in incomes or profits are credits and decrease in expenses are credits.

#### Accounting Cycle

Accounting cycle is a step-by-step process of recording, classification and summarization of economic transactions of a business. It generates useful financial information in the form of financial statements including income statement, balance sheet, cash flow statement and statement of changes in equity. The time period principle requires that a business should prepare its financial statements on periodic basis. Therefore accounting cycle is followed once during each accounting period. Accounting Cycle starts from the recording of

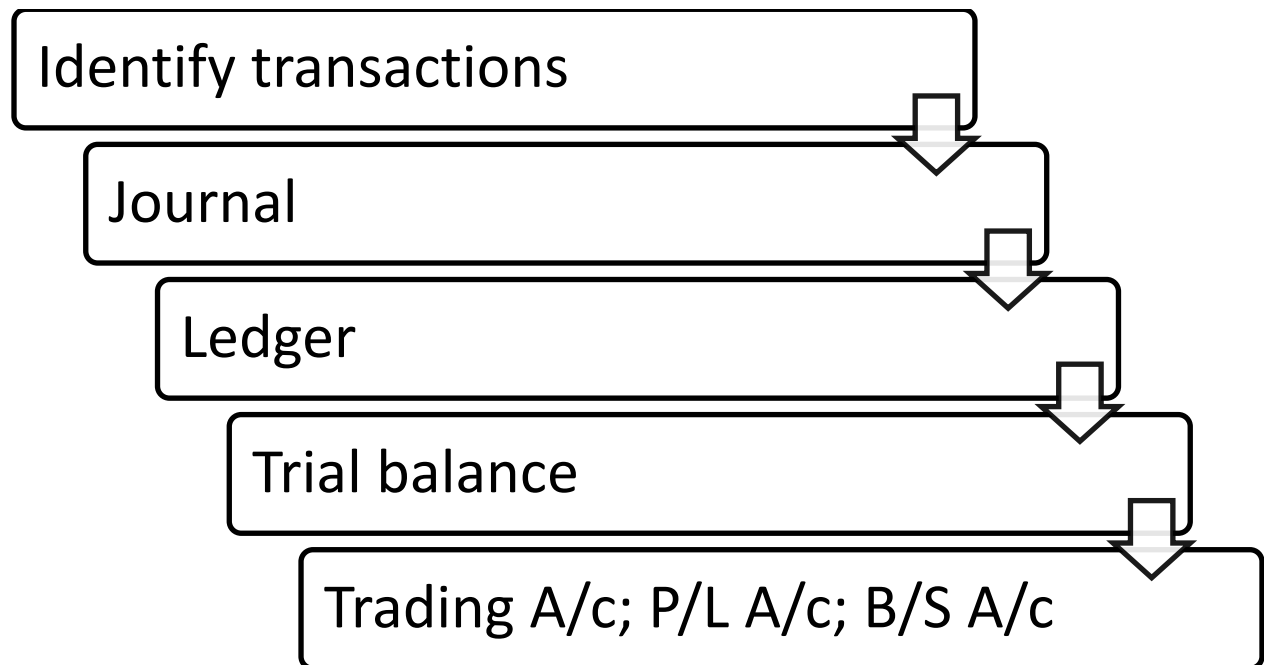


Estd. 1999

individual transactions and ends on the preparation of financial statements and closing entries.

Major Steps in Accounting Cycle Following are the major steps involved in the accounting cycle.

- Analyzing and recording transactions via journal entries
- Posting journal entries to ledger accounts
- Preparing unadjusted trial balance
- Preparing adjusting entries at the end of the period
- Preparing adjusted trial balance
- Preparing financial statements
- Closing temporary accounts via closing entries
- Preparing post-closing trial balance





Estd. 1999

- **Journal-** journal means daily record. It is a book of original record where every transaction is recorded in the first instance and then it is posted to the ledger. The form in which it is recorded is called journal entry and recording or entering a transaction in the journal is known as journalising.
- **Ledger-** a ledger account may be defined as a summary statement of all the transactions relating to a person, asset, expense or income which have taken place during a given period of time and shows their net effect.
- **Trial balance-** a bookkeeping worksheet in which the balance of all ledger are compiled into debit and credit account column totals that are equal. A company prepares a trial balance periodically, usually at the end of every reporting period. The general purpose of producing a trial balance is to ensure the entries in a company's bookkeeping system are mathematically correct.
- **Profit & loss-** The term profit and loss (P&L) statement refers to a financial statement that summarizes the revenues, costs, and expenses incurred during a specified period, usually a quarter or fiscal year. These records provide information about a company's ability or inability to generate profit by increasing revenue, reducing costs, or both. These statements are often presented on a cash or accrual basis.
- **Balance sheet-** The term balance sheet refers to a financial statement that reports a company's assets, liabilities, and shareholder equity at a specific point in time. Balance sheets provide the basis for computing rates of return for investors and evaluating a company's capital structure.

## GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

A widely accepted set of rules, conventions, standards, and procedures for reporting financial information, as established by the Financial Accounting Standards Board are called Generally Accepted Accounting Principles (GAAP). These are the common set of accounting principles, standards and procedures that companies use to compile their financial statements. GAAP are a combination of standards (set by policy boards) and simply the commonly accepted ways of recording and reporting accounting information. GAAP is to be followed by companies so that



Estd. 1999

investors have a optimum level of consistency in the financial statements they use when analyzing companies for investment purposes. GAAP cover such aspects like revenue recognition, balance sheet item classification and outstanding share measurements.

**Accounting Standards** –Its Meaning, Significance & Need Preparation and presentation of corporate financial statement are governed by the companies act,1956 and accounting standards. In India the institute of chartered accountants of India had established in 1977 an Accounting Standard Board (ASB).

**Meaning of Accounting Standards** In this respect main purpose of standards is to provide information to the users as to the basis on which the accounts have been prepared. The objective of setting standards is to bring about uniformity in financial reporting and to ensure consistency in the data published by enterprises. For accounting standards, to be useful tool to enhance the corporate governance and responsibility, two criteria must be satisfied, i.e.

- (i) A standard must provide a generally understood and accepted measure of the phenomena of concern.
- (ii) A standard should significantly reduce the amount of manipulation of the reported numbers and is likely to occur in the absence of the standards.

#### Significance of Accounting Standards

Accounting standards facilities uniform preparation and reporting of general purpose financial statements published annually for the benefit of shareholders, creditors, employee and public at large. They are very useful to the investors and other external groups in assessing the progress and prospects of alternative investments in different companies in different countries.

#### Need for Accounting Standards

Accounting standards can be seen as providing an important mechanism to help in the resolution of potential financial conflicts of interest between the various important groups in society. It is essential that accounting standards should command the greatest possible credibility among shareholders, creditors, employee and public at large. Indian Accounting Standards The accounting standards board of the Institute of Chartered Accountants of India has issued the following Accounting Standards:





Estd. 1999

- AS 1 Disclosure of Accounting Policies
- AS 2 Valuation of Inventories
- AS 3 Cash Flow Statements
- AS 4 Contingencies and Events Occuring after the Balance Sheet Date
- AS 5 Net Profit or Loss for the period, Prior Period Items and Changes in Accounting Policies
- AS 6 Depreciation Accounting
- AS 7 Construction Contracts (revised 2002)
- AS 9 Revenue Recognition
- AS 10 Accounting for Fixed Assets
- AS 11 The Effects of Changes in Foreign Exchange Rates (revised 2003),
- AS 12 Accounting for Government Grants
- AS 13 Accounting for Investments
- AS 14 Accounting for Amalgamations
- AS 15 Employee Benefits (revised 2005)
- AS 16 Borrowing Costs
- AS 17 Segment Reporting
- AS 18 Related Party Disclosures
- AS 19 Leases
- AS 20 Earnings Per Share
- S 21 Consolidated Financial Statements



Estd. 1999

- AS 22 Accounting for Taxes on Income.
- AS 23 Accounting for Investments in Associates in Consolidated Financial Statements
- AS 24 Discontinuing Operations
- AS 25 Interim Financial Reporting
- AS 26 Intangible Assets
- AS 27 Financial Reporting of Interests in Joint Ventures
- AS 28 Impairment of Assets
- AS 29 Provisions, Contingent` Liabilities and Contingent Assets

### Accounting Concepts

**Business entity concept-** This concept assumes that, for accounting purposes, the business enterprise and its owners are two separate independent entities. Thus, the business and personal transactions of its owner are separate. For example, when the owner invests money in the business, it is recorded as liability of the business to the owner. Similarly, when the owner takes away from the business cash/goods for his/her personal use, it is not treated as business expense. Let us take an example. Suppose Mr. Sahoo started business investing Rs100000. He purchased goods for Rs40000, Furniture for Rs20000 and plant and machinery of Rs30000. Rs10000 remains in hand. These are the assets of the business and not of the owner. According to the business entity concept Rs100000 will be treated by business as capital i.e. a liability of business towards the owner of the business. Now suppose, he takes away Rs5000 cash or goods worth Rs5000 for his domestic purposes. This withdrawal of cash/goods by the owner from the business is his private expense and not an expense of the business. It is termed as Drawings. Thus, the business entity concept states that business and the owner are two separate/distinct persons. Accordingly, any expenses incurred by owner for himself or his family from business will be considered as expenses and it will be shown as drawings.



Estd. 1999  
Significance

- This concept helps in ascertaining the profit of the business as only the business expenses and revenues are recorded and all the private and personal expenses are ignored.
- These concept restraints accountants from recording of owner's private/personal transactions.
- It also facilitates the recording and reporting of business transactions from the business point of view
- It is the very basis of accounting concepts, conventions and principles

**Money Measurement Concept-** This concept assumes that all business transactions must be in terms of money, that is in the currency of a country. In our country such transactions are in terms of rupees. Thus, as per the money measurement concept, transactions which can be expressed in terms of money are recorded in the books of accounts. This concept assumes that all business transactions must be in terms of money that is in the currency of a country. In our country such transactions are in terms of rupees. Thus, as per the money measurement concept, transactions which can be expressed in terms of money are recorded in the books of accounts. For example, sale of goods worth Rs.200000, Rent Paid Rs.10000 etc. are expressed in terms of money, and so they are recorded in the books of accounts. But the transactions which cannot be expressed in monetary terms are not recorded in the books of accounts. For example, sincerity, loyalty are not recorded in books of accounts because these cannot be measured in terms of money although they do affect the profits and losses of the business concern.

Another aspect of this concept is that the records of the transactions are to be kept not in the physical units but in the monetary unit. For example, at the end of the year 2006, an organisation may have a factory on a piece of land measuring 10 acres, office building containing 50 rooms, 50 personal computers, 50 office chairs and tables, 100 kg of raw materials etc. These are expressed in different units. But for accounting purposes they are to be recorded in money terms i.e. in rupees. In this case, the cost of factory land may be say Rs.12 crore, office building of Rs.10 crore, computers Rs.10 lakhs, office chairs and tables Rs.2 lakhs, raw material Rs.30 lakhs. Thus, the total assets of the organisation are valued at Rs.22 crore and Rs.42 lakhs.



Estd. 1999

Therefore, the transactions which can be expressed in terms of money is recorded in the accounts books, that too in terms of money and not in terms of the quantity.

### Significance

- This concept guides accountants what to record and what not to record.
- It helps in recording business transactions uniformly.
- If all the business transactions are expressed in monetary terms, it will be easy to understand the accounts prepared by the business enterprise.
- It facilitates comparison of business performance of two different periods of the same firm or of the two different firms for the same period.

**Going concern concept** -This concept states that a business firm will continue to carry on its activities for an indefinite period of time. Simply stated, it means that every business entity has continuity of life. Thus, it will not be dissolved in the near future. This is an important assumption of accounting, as it provides a basis for showing the value of assets in the balance sheet.

According to this concept every year some amount will be shown as expenses and the balance amount as an asset. Thus, if an amount is spent on an item which will be used in business for many years, it will not be proper to charge the amount from the revenues of the year in which the item is acquired. Only a part of the value is shown as expense in the year of purchase and the remaining balance is shown as an asset.

### Significance

- This concept facilitates preparation of financial statements.
- On the basis of this concept, depreciation is charged on the fixed asset.
- It is of great help to the investors, because, it assures them that they will continue to get income on their investments.



Estd. 1999

- In the absence of this concept, the cost of a fixed asset will be treated as an expense in the year of its purchase.
- A business is judged for its capacity to earn profits in future.

**Accounting period concept** - All the transactions are recorded in the books of accounts on the assumption that profits on these transactions are to be ascertained for a specified period. This is known as accounting period concept. Thus, this concept requires that a balance sheet and profit and loss account should be prepared at regular intervals. This is necessary for different purposes like, calculation of profit, ascertaining financial position, tax computation etc. Further, this concept assumes that, indefinite life of business is divided into parts. These parts are known as Accounting Period. It may be of one year, six months, three months, one month, etc. But usually one year is taken as one accounting period which may be a calendar year or a financial year. Year that begins from 1st of January and ends on 31st of December, is known as Calendar Year. The year that begins from 1st of April and ends on 31st of March of the following year, is known as financial year. As per accounting period concept, all the transactions are recorded in the books of accounts for a specified period of time. Hence, goods purchased and sold during the period, rent, salaries etc. paid for the period are accounted for and against that period only.

#### Significance

- It helps in predicting the future prospects of the business.
- It helps in calculating tax on business income calculated for a particular time period.
- It also helps banks, financial institutions, creditors, etc to assess and analyze the performance of business for a particular period.
- It also helps the business firms to distribute their income at regular intervals as dividends.

**Accounting cost concept-** It states that all assets are recorded in the books of accounts at their purchase price, which includes cost of acquisition, transportation and installation and not at its market price. It means that fixed assets like building, plant and machinery, furniture, etc are recorded in the books of accounts at a price paid for them. For example, a machine was purchased by XYZ Limited for Rs.500000, for manufacturing shoes. An amount of Rs.1, 000



Estd. 1999

were spent on transporting the machine to the factory site. In addition, Rs.2000 were spent on its installation. The total amount at which the machine will be recorded in the books of accounts would be the sum of all these items i.e. Rs.503000. This cost is also known as historical cost. Suppose the market price of the same is now Rs 90000 it will not be shown at this value. Further, it may be clarified that cost means original or acquisition cost only for new assets and for the used ones, cost means original cost less depreciation. The cost concept is also known as historical cost concept. The effect of cost concept is that if the business entity does not pay anything for acquiring an asset this item would not appear in the books of accounts. Thus, goodwill appears in the accounts only if the entity has purchased this intangible asset for a price.

### Significance

- This concept requires asset to be shown at the price it has been acquired, which can be verified from the supporting documents.
- It helps in calculating depreciation on fixed assets.
- The effect of cost concept is that if the business entity does not pay anything for an asset, this item will not be shown in the books of accounts.

**Dual aspect concept** -Dual aspect is the foundation or basic principle of accounting. It provides the very basis of recording business transactions in the books of accounts. This concept assumes that every transaction has a dual effect, i.e. it affects two accounts in their respective opposite sides. Therefore, the transaction should be recorded at two places. It means, both the aspects of the transaction must be recorded in the books of accounts. Thus, the duality concept is commonly expressed in terms of fundamental accounting equation :  $\text{Assets} = \text{Liabilities} + \text{Capital}$

For example, goods purchased for cash has two aspects which are (i) Giving of cash (ii) Receiving of goods. These two aspects are to be recorded. Thus, the duality concept is commonly expressed in terms of fundamental accounting equation :  $\text{Assets} = \text{Liabilities} + \text{Capital}$  The above accounting equation states that the assets of a business are always equal to the claims of owner/owners and the outsiders. This claim is also termed as capital or owners equity and that of outsiders, as liabilities or creditors' equity. The knowledge of dual aspect helps in



Estd. 1999

identifying the two aspects of a transaction which helps in applying the rules of recording the transactions in books of accounts. The implication of dual aspect concept is that every transaction has an equal impact on assets and liabilities in such a way that total assets are always equal to total liabilities.

#### Significance

- This concept helps accountant in detecting error.
- It encourages the accountant to post each entry in opposite sides of two affected accounts

**Matching concept** -The matching concept states that the revenue and the expenses incurred to earn the revenues must belong to the same accounting period. So once the revenue is realised, the next step is to allocate it to the relevant accounting period. This can be done with the help of accrual concept. If the revenue is more than the expenses, it is called profit. If the expenses are more than revenue it is called loss. This is what exactly has been done by applying the matching concept. Therefore, the matching concept implies that all revenues earned during an accounting year, whether received/not received during that year and all cost incurred, whether paid/not paid during the year should be taken into account while ascertaining profit or loss for that year.

#### Significance

- It guides how the expenses should be matched with revenue for determining exact profit or loss for a particular period.
- It is very helpful for the investors/shareholders to know the exact amount of profit or loss of the business

**Realisation concept** - this concept states that revenue from any business transaction should be included in the accounting records only when it is realised. The term realisation means creation of legal right to receive money. Selling goods is realisation, receiving order is not. In other words, it can be said that : Revenue is said to have been realised when cash has been received or right to receive cash on the sale of goods or services or both has been created. ∪ The concept of



Estd. 1999

realisation states that revenue is realized at the time when goods or services are actually delivered.

### Significance

- It helps in making the accounting information more objective.
- It provides that the transactions should be recorded only when goods are delivered to the buyer

**Accrual concept-** The meaning of accrual is something that becomes due especially an amount of money that is yet to be paid or received at the end of the accounting period. It means that revenues are recognised when they become receivable. Though cash is received or not received and the expenses are recognised when they become payable though cash is paid or not paid. Both transactions will be recorded in the accounting period to which they relate. Therefore, the accrual concept makes a distinction between the accrual receipt of cash and the right to receive cash as regards revenue and actual payment of cash and obligation to pay cash as regards expenses. The accrual concept under accounting assumes that revenue is realised at the time of sale of goods or services irrespective of the fact when the cash is received.

The accrual concept under accounting assumes that revenue is realized at the time of sale of goods or services irrespective of the fact when the cash is received. For example, a firm sells goods for Rs 55000 on 25th March 2005 and the payment is not received until 10th April 2005, the amount is due and payable to the firm on the date of sale i.e. 25th March 2005. It must be included in the revenue for the year ending 31st March 2005. Similarly, expenses are recognized at the time services provided, irrespective of the fact when actual payment for these services are made. For example, if the firm received goods costing Rs.20000 on 29th March 2005 but the payment is made on 2nd April 2005 the accrual concept requires that expenses must be recorded for the year ending 31st March 2005 although no payment has been made until 31st March 2005 though the service has been received and the person to whom the payment should have been made is shown as creditor. In brief, accrual concept requires that revenue is recognized when realized and expenses are recognized when they become due and payable without regard to the time of cash receipt or cash payment.





Estd. 1999  
Significance

- It helps in knowing actual expenses and actual income during a particular time period.
- It helps in calculating the net profit of the business.

## **ACCOUNTING CONVENTION**

An accounting convention refers to common practices which are universally followed in recording and presenting accounting information of the business entity. Conventions denote customs or traditions or usages which are in use since long. To be clear, these are nothing but unwritten laws. The accountants have to adopt the usage or customs, which are used as a guide in the preparation of accounting reports and statements. These conventions are also known as doctrine.

### **Objectivity/Verifiable concept**

- Objectivity concept in accounting is referred to as the principle which states that financial statements should be objective in nature. In other words, the financial information should be unbiased and free from any kind of internal and external influence.
- Financial information presented in financial statements should be based on solid evidence and not just recorded based on some kind of opinion.
- The purpose served by this principle is that it does not let the opinions of management and accountants impact the preparation of financial statements at any given point of time.

### **Revenue Recognition/Realisation concept**

- The revenue recognition principle, a feature of accrual accounting, requires that revenues are recognized on the income statement in the period when realized and earned—not necessarily when cash is received. Realizable means that goods or services have been received by the customer, but payment for the good or service is expected later.

### **Full disclosure**

- Full disclosure principle refers to the concept that suggests that a business should report all the necessary information in their financial statements, so that the users who are able to read the financial information are in a better position to make important decisions regarding the company.



Estd. 1999

- The business provides financial information to all interested parties like investors, lenders, creditors, shareholders etc. The shareholder would like to know profitability of the firm while the creditor would like to know the solvency of the business. In the same way, other parties would be interested in the financial information according to their requirements. This is possible if financial statement discloses all relevant information in full, fair and adequate manner.

### **Materiality**

- Materiality concept in accounting refers to the concept that all the material items should be reported properly in the financial statements. Material items are considered as those items whose inclusion or exclusion results in significant changes in the decision making for the users of business information.

### **Consistency**

- The consistency principle states that business should maintain the same accounting methods or principles throughout the accounting periods, so that users of the financial statements or information are able to make meaningful conclusions from the data.
- Consistency principle is useful for measuring trends in the business which is spread across many accounting periods. If the business keeps on changing accounting methods, it will create confusion and the financial statements will not be comparable across accounting periods.

### **Conservatism/Prudence**

- The conservatism concept is a concept in accounting which refers to the idea that expenses and liabilities should be recognised as soon as possible in a situation where there is uncertainty about the possible outcome and in contrast record assets and revenues only when they are assured to be received
- In other words, the principle of conservatism states that, if an accountant has two possible outcomes for any accounting issue, then the accountant must choose that outcome which is most conservative or has the least possible chance of profit.
- Thus, this convention clearly states that profit should not be recorded until it is realised. But if the business anticipates any loss in the near future provision should be made in the books of accounts for the same. . For example, valuing closing stock at cost or market price whichever is lower, creating provision for doubtful debts, discount on debtors,



Estd. 1999

writing off intangible assets like goodwill, patent, etc. The convention of conservatism is a very useful tool in situation of uncertainty and doubts.

### **Limitations of Accounting**

Financial accounting is significant for management as it helps them to control the firm activities and in determining appropriate managerial policies in different areas production, sales, administration, finance etc. However, financial accounting does not provide adequate and useful information. Most of limitations are mainly due to the cumulative effect of recorded facts, accounting conventions and personal judgments on financial statements. Financial accounting suffers from the following limitations which have been responsible for the emergence of Cost and Management Accounting:

1. Transactions of non-monetary nature do not find place in accounting. Accounting is limited to monetary transactions only. It excludes qualitative elements like management reputation, employee morale, labour strike etc.
2. Cost concept is found in accounting. Price changes are not considered. Money value is bound to change often from time to time. This is a strong limitation of accounting.
3. Acceptable alternatives are so broad based that comparisons are likely to be confusing or misleading. For instance, inventory cost may be ascertained by LIFO or FIFO; or stock may be evaluated at cost price or market price.
4. Accounting policies are framed by the Accountant. The figures of balance sheet are largely resulted by personal judgment of accountant hence it is the subjective factor that prevails in accounting and objective factor is ignored.
5. Recording and accounting for wages and labour is not carried out for different jobs, processes, products or departments. This creates problems in analyzing the cost associated with different activities.
6. It is difficult to know the behavior of costs in financial accounting as expenses are not assigned to the product at each stage of production. Expenses are not classified into direct and indirect and therefore, cannot be classified as controllable and uncontrollable. Control of cost which is the most important objective of all business enterprise, cannot be achieved with the aid of financial accounting alone.
7. Financial accounting does not provide information to analyze the losses due to various factors—idle plant and equipment, seasonal fluctuations in volume of business etc. It does not help management in taking important decisions about expansion of business, dropping a product, alternative methods of production, improvement in products etc.



Estd. 1999

8. Financial accounting does not set up a proper system of controlling materials and supplies. Undoubtedly, if materials and supplies are not controlled in a manufacturing concern, they will lead to losses on account of misappropriation, misutilization, scrap, defectives etc.

### **"Ethical Issue" in Financial Accounting**

Ethics in accounting are concerned with how to make good and moral choices in regard to the preparation, presentation and disclosure of financial information. During the 1990s and 2000s, a series of financial reporting scandals brought this issue into the forefront. Knowing some of the issues presented in accounting ethics can help you ensure that you are considering some of the implications for the actions that you take with your own business.

**Fraudulent Financial Reporting-** Most accounting scandals over the last two decades have centered on fraudulent financial reporting. Fraudulent financial reporting is the misstatement of the financial statements by company management. Usually, this is carried out with the intent of misleading investors and maintaining the company's share price. While the effects of misleading financial reporting may boost the company's stock price in the short-term, there are almost always ill effects in the long run. This short-term focus on company finances is sometimes known as "myopic management."

**Misappropriation of Assets-** On an individual employee level, the most common ethical issue in accounting is the misappropriation of assets. Misappropriation of assets is the use of company assets for any other purpose than company interests. Otherwise known as stealing or embezzlement, misappropriation of assets can occur at nearly any level of the company and to nearly any degree. For example, a senior level executive may charge a family dinner to the company as a business expense. At the same time, a line-level production employee may take home office supplies for personal use. In both cases, misappropriation of assets has occurred.

**Disclosure-** As a subtopic of fraudulent financial reporting, disclosure violations are errors of ethical omission. While intentionally recording transactions in a manner that is not in accordance with generally accepted accounting principles is considered fraudulent financial reporting, the failure to disclose information to investors that could change their decisions about investing in the company could be considered fraudulent financial reporting, as well. Company executives must walk a fine line; it is important for management to protect the company's proprietary information. However, if this information relates to a significant event, it may not be ethical to keep this information from the investors.

**Penalties-** Penalties for violations of accounting ethics laws have increased greatly since the passage of the Sarbanes-Oxley Act of 2002. This legislation allows for harsh penalties for manipulating financial records, destroying information, interfering with an investigation and provides legal protection for whistle-blowers. In addition, chief executives can be held criminally liable for the misreporting of their company. If accounting ethics wasn't an important



Estd. 1999

consideration before, the higher stakes provided by the Sarbanes-Oxley Act have definitely upped the ante

### Rules of debit and credit

	1. Real Accounts	2. Personal Accounts	3. Nominal Accounts
Debit :-	What comes in	The Receiver	All Expense and Loss
Credit :-	What goes out	The Giver	All Income and Profit
Applicable to :-	<p>This rule is applicable to all assets of the business</p> <p>Like:-</p> <ul style="list-style-type: none"><li>• Cash</li><li>• Land and Building</li><li>• Plant and Machine</li><li>• Furniture and Fixture</li><li>• Trade marks.</li><li>• Etc.</li></ul>	<p>This rule is applicable to Persons, artificial persons and representative persons</p> <p>Like:-</p> <ul style="list-style-type: none"><li>• Aman</li><li>• Ram And Sons .</li><li>• HAPSS Store.</li><li>• Bank A/c (SBI)</li><li>• Outstanding Salary</li><li>• Prepaid Expenses</li><li>• Etc.</li></ul>	<p>This rule is applicable to all Expenses, Income and Losses/Profits</p> <p>Like:-</p> <ul style="list-style-type: none"><li>• Salary</li><li>• Wages</li><li>• Purchases</li><li>• Sales</li><li>• Commission Received</li><li>• Etc.</li></ul>

### **Module III**

#### **Classification of accounts**

**Personal Accounts:** The accounts related to a person or group of persons, business organizations, educational institutions, clubs, banks etc. is called personal account. Again it can be divided as natural personal account (Ram, Rahim), artificial personal account (TELCO, SBI, ISBM), and representative personal account (outstanding rent, prepaid insurance, accrued commission, unexpired insurance).

**Real accounts:** The accounts related to assets of the business are called real accounts. It can be divided as tangible real accounts (land & building, plant & machinery, stock, cash) and intangible real accounts (patent, copyrights, goodwill, and trademark).

**Nominal Accounts:** The accounts related to all expenses & losses or incomes & gains are called nominal accounts.(rent, salary, commission, interest).

**Double Entry System-**Each business transaction used to record in minimum of two accounts, so that the accounting is always in balance. In the double entry system every transaction must be recorded with equals debits and credits. As a result, the total of all debits must equals to total of all credits.



Estd. 1999

## Meaning of Debit & Credit

**Debit:** It means to enter an amount of transaction on the left-hand side of an account.

**Credit:** It means to enter an amount of transaction on the right-hand side of an account.

### Rules of debit and credit

#### Traditional (Golden Rules)

**Personal Accounts:** Debit the receiver Credit the giver.

**Real Accounts:** Debit what comes in Credit what goes out

**Nominal Accounts:** Debit all expenses & losses Credit all incomes & gains

#### Modern

Assets Accounts Increases are debits and Decreases are credits

Liabilities Accounts Increases are credits and Decreases are Debits

Capital Accounts Increases are credits Decreases are Debits

Expenses Accounts Increases are debits Decreases are credits

Revenues Accounts Increases are credits Decreases are Debits

#### Journal

A journal is a detailed account that records all the financial transactions of a business, to be used for the future reconciling of accounts and the transfer of information to other official accounting records, such as the general ledger. A journal states the date of a transaction, which accounts were affected, and the amounts, usually in a double-entry bookkeeping method.

L.F.- It refers to ledger folio. At the time of journal this column shall keep blank. At the time of posting from journal to ledger the page number of ledger on which it is transferred to be mentioned.

#### Features of Journal Entries



Estd. 1999

- i. Chronological: The journal entries are to be recorded in a date-wise sequence or order in which the transactions happen.
- ii. Double Entry System: It is a dual entry system where every transaction is equally entered on both debit and credit sides. That is, one account is debited, and the other is credited for the same value.
- iii. Daybook: The journal is a daybook which records everyday transactions.
- iv. Compound Entry Possible: In journal entries, more than one related transactions occurring on the same day or the ones involving more than two accounts can be compiled together to form a single entry in a journal.
- v. Assistant to Ledger: Journal entries serve as the base for all the other books of account like ledger since it is prepared from the information disclosed in the journals.
- vi. Transaction Identity: It preserves the evidence of each transaction and makes it easy to identify every business activity through its date and other essentials.
- vii. Original Entry: The journal is the first books of account where a transaction is recorded, and therefore, its originality and authenticity can be maintained.
- viii. Includes Brief Explanation: Every transaction is supported by a brief description which is usually called narration and written in brackets (Being\_), to clarify it in a better way.

### **Advantages of Journal**

- i. Journal records all business transactions in one place on the time and date basis.
- ii. All transactions which are recorded are supported with a receipt or bill, so we can check the authenticity of each journal entries with their bills.
- iii. There is a minimum chance to avoid any particular transaction because in a journal we record every transaction on a date basis.
- iv. Accountant writes each journal entry's narration below that journal entry, so another auditor can know what the reason of that journal entry.
- v. In a journal, we record each transaction after deep analysis of two accounts on the basis of double entry system, so there is a minimum chance of mistake in the journal.





Estd. 1999

- vi. Journal is the basis of posting transactions in ledger accounts. Without making of the journal, an accountant can not make ledger accounts.
- vii. If there is a mistake in ledger accounts, we can easily rectify it with the help of journal or rectify journal entry in the journal.
- viii. All opening journal entries, closing journal entries and all other transactions which we cannot record in any other subsidiary books, we record them in the journal proper.
- ix. We also need Journal in every accounting software. This accounting software can make an auto system of posting journal entries to the ledger by their automatic processing, but the accountant must feed journal entries in the journal and other specific vouchers of the journal.
- x. There is one column of ledger folio. It is very helpful for checking reference of each account's posting with its original journal entry.

### **Functions of Journal**

(i) **Analytical Function:** While recording a transaction in the journal each transaction is analyzed into the debit aspect and the credit aspect. This helps to find out how each transaction will financially affect the enterprise.

(ii) **Recording Function:** Accountancy is a business language which helps to keep the record of the transactions based on the principles. Each such recording entry is supported by a brief narration, which explains, every transaction in simple language. Narration means to narrate – i.e. to explain. It starts with a word – Being ...

(iii) **Historical Function:** Journal book contains a chronological record of the transactions for future references.



Estd. 1999

## **Limitations of Journal**

- i. Bulky and voluminous: Journal is a main book of original entry which records all business transactions. Sometimes, it becomes so bulky and voluminous that it cannot be handled easily.
- ii. Information in scattered form: In this book, all information is recorded on daily basis and scattered form; hence it is very difficult to locate a particular transaction unless one remembers the date of occurrence of that transaction.
- iii. Time consuming: Unlike posting from subsidiary books, posting the transactions from journal to ledger accounts take too much time because every time one has to post the transactions in different ledger accounts.
- iv. Lack of internal control: Unlike other books of original entries like subsidiary books and cash book, journal does not facilitate the internal control, because in journal only transactions are recorded in chronological order. However, subsidiary books and cash book gives a clear picture of special type of transactions recorded therein.

## **Types of Journal**

There are many primary books (i.e., Journal Books). The transactions are categorized as per their nature and, for each type of transaction, a separate journal is used for recording the transaction. Since transactions are recorded in journal chronologically as these occur, journal books are generally called day books. There are eight types of journal books:

Purchases Day Book: It records credit purchase of raw materials, and traded goods

Sales Day Book: It records credit sale of goods.

Return Outward (also called Purchases Return) Book: It records goods returned to the supplier (s) of raw materials and traded goods

Return Inward (also called Sales Return) Book: It records goods returned by customers.

Bills Receivable Book: It records bills (of exchange) accepted by customers.

Bills Payable Book: It records bills (of exchange) raised by suppliers.

Cash Book: It records all cash (and bank) transactions: receipts and payments.

Journal Proper: It records all residual transactions i.e., transactions which do not find place in any of the other journal books.

## **GOLDEN RULES/ RULES OF JOURNALISING**



Estd. 1999

❖ **Personal account** – Debit the receiver

Credit the giver

❖ **Real account** – Debit what comes in

Credit what goes out

❖ **Nominal account** – Debit all expenses and losses

Credit all incomes and gains

### Meaning of goods

Goods are those things which are purchased for resale. In other words, goods are the commodities in which the business deals. For example- if a cloth merchant purchases cloth, the cloth will be termed as 'purchases'. But if the same cloth merchant purchases furniture, say chairs and sofa set for the seating of customers, the furniture so purchased will not be termed as purchases, but will be an asset of his business and in this case 'Furniture A/C' will be debited instead of 'Purchase A/C'. It means that purchases of asset are not termed as purchases in accounting terminology because these assets are not meant for sale. Goods account is classified into five accounts for the purpose of passing the journal entries:-

- I. **Purchases A/C**- when goods are purchased, instead of debiting Goods A/C 'Purchase A/C' is debited. Purchase A/C is a nominal account and while passing a Journal entry 'Purchase A/C' should always be debited because of the rule of "debit all expenses and losses."
- II. **Sales A/C**- when goods are sold, instead of crediting Goods A/C 'Sales A/C' is credited. Sales A/C is a nominal account and while passing a Journal entry 'Sales A/C' should always be credited because of the rule of "credit all incomes and gains."
- III. **Purchase return A/C**- this account is also named as '**return outward**'. It is a nominal account and should always be credited because purchases i.e, expenses are reduced. A purchase return occurs is when the buyer of merchandise, inventory, fixed assets, or other items sends these goods back to the seller.
- IV. **Sales return A/C**- this account is also named as '**return inward**'. It is a nominal account and should always be debited because sales i.e, incomes are reduced. A sales return is an adjustment to sales that arises from actual return by a customer of merchandise he/she previously bought from the business.
- V. **Stock A/C**- in the transactions relating to the purchase and sale of goods, it has to be decided whether a transaction is for cash or for credit, because the entry is passed accordingly. If, in the transactions relating to purchase and sale of goods the word 'cash' is stated clearly, only then will it will be a cash transaction otherwise it will be taken as a credit transaction.



Estd. 1999

### Pass Journal entries

#### 1. Credit balances

RS

Capital A/C	30000
Bills payable A/C	5000
Creditors A/C	10000

#### Debit balances

RS

Furniture A/C	13000
Machinery A/C	20000
Debtors A/C	12000

2.

Assets	(Rs)	Liabilities	(Rs)
Cash	8000	Creditors (Chaman 7000; Om Lal 13000)	20000
Bank balance	20000	Capital	200000
Stock	54000		
Debtors (Ashok 12000; Pawan 15000; Vivek 20000)	47000		

#### 3. Enter the following transactions in the journal of Siya Ram:-

2011 April		Rs
1	Siya Ram started business with cash	50,000
2	Purchased goods for cash	20,000
4	Purchased goods from Subash	12000
5	Purchased furniture for cash	6000
7	Sold goods for cash	13000
9	Sold goods to Manish	15000
10	Paid cash to Subash	8000
12	Received cash from Manish	10000
16	Received goods from Ravi for cash	7500
17	Purchased goods from Ravi	5000
18	Sold goods to Suresh for cash	12600
19	Sold goods to Suresh	7000
20	Bought machinery for cash	8000
24	Withdrew cash from office for personal use	2500
27	Paid rent	400
29	Paid wages	450



Estd. 1999

30	Paid salary to Gopal	1200
30	Received commission	200

SOLUTION:- IN THE BOOKS OF SIYA RAM

### JOURNAL

DR CR

DATE 2011	PARTICULARS	L/F	AMT (RS)	AMT (RS)
APRIL 1	Cash A/C Dr To Capital A/C (Being cash brought into the business by Siya Ram as capital)		50000	50000
APRIL 2	Purchase A/c Dr To Cash A/c (Being goods purchased for cash)		20000	20000
APRIL 4	Purchase A/c Dr To Subhash A/c ( Being goods purchased from Subhash on credit)		12000	12000
APRIL 5	Furniture A/c Dr To Cash A/c ( Being furniture purchased for cash)		6000	6000
APRIL 7	Cash A/c Dr To Sales A/c ( Being goods sold for cash)		13000	13000
APRIL 9	Mahesh A/c Dr To Sales A/c ( Being goods sold to Mahesh on credit)		15000	15000
APRIL 10	Subash A /C Dr To Cash A/C (Being cash paid to Subash)		8000	8000
APRIL 12	Cash A/C Dr To Mahesh A/C (Being cash received from Mahesh)		10000	10000
APRIL 16	Purchase A/C Dr To Cash A/C (Being goods purchased for cash)		7500	7500
APRIL 17	Purchase A/C Dr To Ravi A/C (Being goods purchased from Ravi on credit)		5000	5000
APRIL 18	Cash A/C Dr To Sales A/C		12600	12600



Estd. 1999

	(Being goods sold for cash)			
APRIL 19	Suresh A/C Dr To Sales A/C (Being goods sold to Suresh on credit)		7000	7000
APRIL 20	Machinery A/C Dr To Cash A/C (Being machinery purchased for cash)		8000	8000
APRIL 24	Drawings A/C Dr To Cash A/C (Being cash withdrew for personal use)		2500	2500
APRIL 27	Rent A/c Dr To Cash A/c (Being rent paid)		400	400
APRIL 29	Wages A/C Dr To Cash A/C (Being wages paid)		450	450
APRIL 30	Salary A/C Dr To Cash A/C (Being salary paid)		1200	1200
APRIL 30	Cash A/C Dr To Commission A/C (Being commission received)		200	200

#### 4. Pass journal entries in the books of Computer Point:-

1997 Jan	
1	Peter started business as a computer merchant, trading under the name of 'Computer Point' with a capital of Rs 400000 brought in cash
3	He buys on credit from Hindustan Computers Ltd 10 computers @ 300000 each
15	He receives an invoice from Janata Transport Corporation for Rs 5000 in respect of carriage of computers from Bangalore
20	He opens a bank account by depositing Rs 350000
25	He sells 6 computers on credit to ABC Computers @rs35000 each
29	He Pays by cheque the amount for carriage
31	He receives cash Rs 200000 from ABC Computers
31	He issues a cheque to Hindustan Computers Ltd for Rs 300000

SOLUTION:-

IN THE BOOKS OF COMPUTER POINT

JOURNAL

DR

CR



Estd. 1999

DATE 1997	PARTICULARS	L/F	AMT (RS)	AMT (RS)
JAN 1	Cash A/C Dr To Capital A/C (Being business started with capital brought in cash)		400000	400000
JAN 3	PurchaseA/c Dr To Hindustan Computers Lts A/c (Being the purchase of 10 computers@Rs30000 each on credit)		300000	300000
JAN 15	Carriage Inward A/c Dr To Janata Transport Corporation A/c ( Being carriage charges payable)		5000	5000
JAN 20	Bank A/c Dr To Cash A/c ( Being the opening of bank account)		350000	350000
JAN 25	ABC computers A/c Dr To Sales A/c ( Being the sale of 6 computers @ Rs 35000 each on credit)		210000	210000
JAN 29	Janata Transport corporation A/c Dr To Sales A/c ( Being paid by cheque)		5000	5000
JAN 31	Cash A /C Dr To ABC computers A/C (Being cash received from ABC computers)		200000	200000
JAN 31	Hindustan Computers A/C Dr To Bank A/C (Being paid by cheque)		300000	300000
	Total		130600	130600

## 5. Pass journal entries

RS

Started business with cash	45000
Paid into bank	25000
Goods purchased for cash	15000
Purchase of furniture and paid by cheque	5000
Sold goods for cash	8500
Sold goods to Arvid	4000
Goods purchased from Amrit	7000
Paid rent	1000



Estd. 1999

**6. Record the following transactions in the journal of Vishal:-**

2011		Rs
May 1	Commenced business with cash	500000
May 2	Goods purchased from Mohan for cash	50000
May 4	Goods purchased from Ajay	120000
May 5	Goods returned to Ajay	5000
May 8	Goods sold to Rajiv	40000
May 9	Rajiv returned 10% of goods	4000

**SOLUTION:-** IN THE BOOKS OF Vishal

**JOURNAL**

**DR**

**CR**

DATE 2011	PARTICULARS	L/ F	AMT (RS)	AMT (RS)
May 1	Cash A/C Dr To Capital A/C (Being amount brought in by Vishal as capital)		500000	500000
May 2	Purchase A/C Dr To Cash A/C (Being goods purchased from Mohan for cash)		50000	50000
May 4	Purchase A/C Dr To Ajay A/C (Being goods purchased from Ajay)		120000	120000
May 5	Ajay A/C Dr To Purchase Return A/C (Being goods returned to Ajay)		5000	5000
May 8	Rajiv A/C Dr To Sales A/C (Being goods sold to Rajiv)		40000	40000
May 9	Sales Return A/C Dr To Rajiv A/C (Being 10 % of goods sold to Rajiv returned by him)		4000	4000

**Debtors-** represent those persons or firms to whom goods have been sold or services rendered on credit and payment has not been received from them. Eg sold goods of Rs 10000 to R on credit.





Estd. 1999

**Creditors-** represent those persons or firms from whom goods have been purchased or services procured on credit and payment has not been made to them. Eg goods worth Rs 1000 purchased on credit.

**Purchase return-**when purchased goods are returned to the suppliers these are known as purchase returns. It is a nominal account and should always be credited because purchases i.e, expenses are reduced.

**Sales return-**some customers might return the goods sold to them. These are termed as sales return or return inwards. It is a nominal account and should always be debited because sales i.e, incomes are reduced.

Basis of Comparison	Trade Discount	Cash Discount
Meaning	It is the type of discount that is offered by the seller to the buyer as a reduction in the price of the product	This discount is offered by the seller to the buyer on the invoice amount at the time of making payment within the stipulated time
Purpose of offering discount	To ensure bulk sales of the product	To ensure prompt payment for the items purchased
Accounting treatment	Not shown in any books of accounting, reduction adjusted with final price and the discounted price is added to record books	It is properly recorded in the books of both buyer and seller. Recorded in profit and loss statement as an expense
When discount is allowed	At the time the purchase is made	It is allowed at the time of payment
Allowed on transactions	Both cash and credit transactions	Only transactions involving cash payment are allowed.

For eg- if a trader sells goods of the list price of Rs 20000 at 10% trade discount and 2 % cash discount, the net amount will be calculated as ;-



Estd. 1999

MRP/ List Price	Rs 20000
Less: trade discount @ 10% 2000	Rs 2000
	Rs 18000
Less: Cash discount @ 2 % (18000* 2%)	Rs 360
	Rs 17640

It means that RS 17640 will be paid if the payment is made in cash.

1. Purchased goods from X Rs 10000
2. Purchased goods from X Rs 10000 @ 10% TD
3. Purchased goods from X Rs 10000 @ 10% CD

Journal

1. Purchase A/C	dr	10000	
To X A/C			10000
2. Purchase A/C	dr	9000	
To X A/C			9000
3. Purchase A/C	dr	10000	
To cashA/C			9000
To discount received A/C			1000

1. Sold goods to Y 10000
2. Sold goods to Y 10000 @ 10% TD
3. Sold goods to Y 10000 @ 10% CD

Journal

1. Y A/C	dr	10000	
To sales A/C			10000
2. Y A/C	dr	9000	
To Sales A/C			9000
3. Y A/C	dr	9000	
Discount allowed A/c	dr	1000	
To sales A/C			10000

**Bad debts-** when the goods are sold to a customer on credit, and if the amount becomes irrecoverable due to his insolvency or for some other reason, the amount not recovered is called bad debt. For recording it, bad debts account is debited and the customer account is credited.



Estd. 1999

For example- Ravi who owed us Rs 10000 is declared insolvent and 30% in a rupee is received from his estate. The journal entry will be

Cash A/c	dr	3000	
Bad debts A/c	dr	7000	
To Ravi A/c			10000

(Being 30% in the rupee received from Ravi on his insolvency)

Eg- On 1.4.2016, Pioneer Ltd sold goods to RAX Ltd for 40,000; On 15.4.2016 Rax Ltd paid 30,000 to Pioneer Ltd. On 8.8.2016 Rax Ltd became insolvent and outstanding was not realized. Pioneer Ltd treated it has bad debts.

The Pioneer Ltd will record the following entries to give effect to bad debts in its books of accounts:

Date	Particulars	L.F	Debit (	Credit
01.04.2016	Rax Ltd A/c. DR. Sales A/c [ Being goods sold on credit ]		40,000	40,000
15.04.2016	Bank A/c. DR. Rax Ltd A/c [Being cash realized from debtors ]		30,000	30,000
08.08.2016	Bad debts A/c. DR. Rax Ltd A/c [ Being for actual amount of bad debts as Rax Ltd was declared insolvent] [ 40,000 - 30,000]		10,000	10,000
08.08.2016	Profit and Loss A/c DR. Bad debts A/c [ Being transfer of bad debts of Rax Ltd to profit and loss A/c]		10,000	10,000

**Bad debts recovered-** sometimes, it so happens that the bad debts previously written off are subsequently recovered. In such cases, the following entry is passed



Estd. 1999  
Cash A/c

Dr

To bad debts recovered A/c

Eg- R was declared insolvent last year and an amount of 70,000 was shown as bad debts in the books of ABC corp, this year R decided to pay cash 70,000 against the same debt.

Cash A/C                                      Dr                      70000

To bad debts recovered A/C                                      70000

(Cash received from R previously written off as bad debt)

### Some Special entries

- 1. Outstanding expenses-** it is quite common for a business enterprise to be left with some expenses which are yet to be paid at end of the accounting year due to one reason or the other. Such expenses are termed as outstanding expenses. These are the expenses which should have been paid during the current year but which have not been paid. For eg- if an employee is paid salary @ RS 1000 per month, and if during the year only 11 months salary amounting to Rs 11000 has been paid to him, Rs 1000 for one month will be outstanding salary. Outstanding salary is a liability. It has been credited because it is a representative personal account, representing the employees to whom salaries are to be paid.

Salary A/C                                      dr                      1000

To outstanding Salary A/C                                      1000

During the usual course of a business, there are expenses that will be incurred during the current accounting period and are not paid or in other words, there are certain expenses that take place during the current accounting period but payment for the same are not made, such expenses are called outstanding expenses. The outstanding expense is a personal account with a credit balance and is treated as a liability for the business. It is recorded on the liability side of the balance sheet of a business. For accounting accuracy, these expenses need to be realised whether they are paid or not. Like the other expenses incurred by a business, it is also charged against the profit that is obtained for the current year.

Expense A/c Dr.

To Outstanding Expense A/c

(For recording the expense of the current year outstanding)

- 2. Prepaid expenses-** there are certain expenses which are related to the next year but have been paid during the current year in advance. These are called prepaid expenses. The



53



Estd. 1999

The journal entry

Interest on Capital A/c	Dr	10,000	
	To Rahul's Capital A/c		10,000

**4. Interest on drawings-**if the firm allows interest on capital, it should also charge interest on drawings made by the proprietor. Such an interest is an expense for the proprietor and a gain to the business. Hence an entry is made by debiting the drawings account and crediting interest account.

**5. Depreciation-** it is the permanent and continuing decrease in the value of an asset on account of wear and tear and passage of time. It is a business expense though it is not paid in cash. Depreciation is a nominal account since it represents a loss and hence is debited. Asset account will be credited as its value is reduced due to depreciation.

Depreciation A/C	dr
	To asset A/C

**6. Expenditure on the installation of machinery and on the erection of building-** machinery and building are the assets of the business. As such, any expenditure incurred on the carriage and installation of machinery such as freight, transit expenses, installation expenses, wages paid for the installation etc is treated as capital expenditure and is debited to the machinery account. Similarly, any expenditure incurred for the construction of a building such as the purchase of materials and the payment of wages are treated as capital expenditure and as such debited to the building account. However, repair charges incurred on an asset which is already appearing in the books are debited to repairs account.

### Some transactions relating to goods

**1. Drawings in goods-** sometimes the proprietor withdraws goods from the business for his personal use. The entry for recording this transactions will be-

Drawings A/c	dr
	To Purchase A/C

(Being goods for personal use)

Purchase account is credited because as a result of the transaction the net amount of purchases of the business is reduced. Sales account should not be credited since the sale has not taken place. Also when the goods go out of business at cost price, purchase account should be credited and not sales account.

**2. Goods given away as charity-** charity is an expense of the business, as such charity account will be debited. Goods are going out of the business at cost price, hence purchases are reduced to that extent and as such, purchase account will be credited. The entry will be

Charity A/C	dr
	To purchase A/C



3. **Goods distributed as free sample-** sometimes the goods are distributed as free samples to the potential buyers in order to promote sales. As such, free samples can be treated as expenses on advertisement. The entry will be

(Being goods distributed as free samples)

To purchase A/C

In case goods were insured:

To loss by theft or loss by fire

To insurance company A/C

To insurance company A/C

Accounting is indeed a tedious task. For this the companies who have an abundant financial transaction in a year to journalize them all is really bothersome. Hence, the companies prepare the subsidiary books, where the recording of the transactions of a similar nature is done in a chronological manner. The Subsidiary books are known as the books of original entry. In daily business transactions, a majority of the transactions are either related to sales, or to purchases or to cash. Thus, we record the transactions of the same or similar nature in one place, that place is a subsidiary book. We record the transactions chronologically to facilitate the accountant.

1. Cash book
2. Purchases book
3. Sales book
4. Purchases return or return outwards book



Estd. 1999

5. Sales return or return inwards book
6. Bills receivable book
7. Bills payable book
8. Journal proper

**Cash Book-** It records all the cash and bank receipts and payments. It is a book of original entry as we record transactions in it for the first time from the source documents such as vouchers, invoices, etc. A cash book has a debit and a credit side both. Thus, it is similar to a ledger account. Hence, it acts as a subsidiary book as well as a ledger account. An organization can maintain a single column, double column or triple column cash book as per its requirements. A single column cash book consists of only cash column. A double column cash book consists of cash and bank column. While the triple column cash book consists of cash, bank, and discount column. Usually, the firms use triple column cash book. Some organizations also maintain a petty cash book which records the petty or small cash expenses of the firm.

**Purchases book-** A firm records all its credit purchases of goods in Purchase Book or Purchase Day Book. While it records all the cash purchases of goods in the Cash Book. We do not record Purchases of assets in Purchase Book. Thus, they are recorded in the Journal Proper.

**Sales Book-** A firm records all credit sales of goods in the Sales Book or Sales Day Book. It records cash sales of goods in the Cash Book. We do not record the sale of assets in the Sales Book. Thus, we shall record them in the Journal Proper. In this case, also we record entries from the source documents. Also, we record entries with the net amount of the invoice.

**Purchase Return or Return Outward Book-** We record the return of goods purchased in the Purchase Return Book. A Debit Note is prepared for every return of goods in duplicate. It contains the name of the supplier, details of goods returned and reason thereof. It needs to be dated and serially numbered.

**Sales Return or Return Inwards Book-** We record the return of goods sold in the Sales Return Book. A Credit Note is prepared for every return of goods in duplicate. The Credit Note contains the name of the customer, details of goods returned and reason thereof. It also needs to be dated and serially numbered.

**Bills Receivable Book-** We record all the acceptance of the bills in our favor in the Bills receivable book. We need to post the total of bills receivable book to the Bills receivable A/c. Also, we need to post the individual accounts of the customers.

**Bills Payable Book-** We record all the acceptance of the bills that we issue in favour of others in the Bills payable book. We need to post the total of bills payable book to the Bills payable A/c. Also, we need to post the individual accounts of the suppliers.





Estd. 1999

**Journal Proper-** It includes transactions relating to credit purchase and sale of assets, depreciation, outstanding and pre-paid expenses, accrued and unearned income, opening and closing entries, adjustment entries and rectification entries.

## **LEDGER**

A ledger is a book containing accounts in which the classified and summarized information from the journals is posted as debits and credits. It is also called the second book of entry. The ledger contains the information that is required to prepare financial statements. It includes accounts for assets, liabilities, owners' equity, revenues and expenses. This complete list of accounts is known as the chart of accounts. The ledger represents every active account on the list.

### **Features of Ledger**

- i. Each account in Ledger will have separate headings.
- ii. Account transactions are recorded in a specific table.
- iii. Transactions are recorded on the account by date.
- iv. Each ledger has a column of two amounts. The amount of the transaction in both columns is written by debit and credit.
- v. There is a column to write the ref number on both sides of the account.
- vi. The balance of the account is calculated at the end of the period.
- vii. After completion of the calculation, the Debit and Credit Column is closed by drawing two parallel lines below the sum of both sides.

### **Importance of ledger**

- i. The transactions are recorded in the ledger on a permanent basis. As a result, any accounting-related information is readily available from the Ledger.
- ii. With the help of the Ledger, the mathematical accuracy of calculations can be easily verified.
- iii. With the help of the Ledger, the total amount owed to the individual and the organization can easily be known.
- iv. It is easy to calculate the income, expenditure, and profit & loss of a business organization.



Estd. 1999

- v. Ledger plays an important role in the prevention of fraud and falsehood.
- vi. With the help of Ledger, it is possible to maintain a complete account of the organization according to the Double-Entry Accounting System.
- vii. The financial statement shall be prepared with information from Ledger.
- viii. It helps to make any decision of the business organization since all information about Ledger is available in a systematic way.

### **Advantages**

- i. Easy Trial Balance Creation- A trial balance requires a ledger account balance in order to be easily prepared. Due to this, it is almost impossible to create a trial balance without the help of a ledger.
- ii. Final Account Presentation- Final Accounts is the last step of the accounting process where various ledgers maintained in the trial balance of the business are presented to check the profitability and financial position of a company.
- iii. Application of Double Entry System - The double-entry system's application process can be completed only if the journals are posted to separate ledger accounts.
- iv. Classified Accounts Management- The details of the classified accounts, i.e., real account, nominal account and personal account, can be displayed after properly recording them in the ledger accounts.
- v. Presentation of Statistical Information - Balances of the ledger accounts act as a source of the statistical information used by the management in making decisions. The financial data supplied by the ledger accounts is summarised, analysed and interpreted to get the various accounting information of a company.



Estd. 1999

- vi. Minimise the Chances of Accounting Errors and Omissions- Since the transactions are initially recorded in a journal before the ledger, it reduces the chances of accounting errors and omissions.
- vii. Analyse the Total Income and Expenses of a Business - Different types of income and expenses of a business are recorded in separate ledgers. So, it becomes possible to analyze the amount of income and expenditure under each head over a particular period.
- viii. For Storing and Collecting Information- Ledger offers a great way for storing various types of transaction information. The transactional information can be organised within a ledger in terms of assets, liabilities, revenue, and expenses. Once each ledger is closed, the trial balance is prepared, which is required to produce income statements, balance sheets and other essential financial reports.
- ix. For Understanding a Business's Present Financial Position - The present financial position of an enterprise after creating the final account can easily be recognized with proper maintenance of a ledger account.

### **Disadvantages**

- i. Maintaining a ledger is a time-consuming task. Ledger is not entirely safe since anyone can easily access the book or file from the system.
- ii. These are sensitive financial documents and call for extra security.
- iii. It is dependent upon the transactions recorded in the journal. If there's any mistake in transaction records in the journal, the results of the transaction posting inside the ledger will also be unreliable.
- iv. Maintaining a ledger is a time-consuming task.

### **Rules for posting of entries in the ledger**

- i. A separate account is opened for each account and entries from the journal are posted in respective ledger account accordingly.



Estd. 1999

- ii. The words like 'To' and 'By' are used while posting the entries in the ledger accounts. 'To' is used when accounts are posted in the debit side column of a particular account. 'By' is used when accounts are posted in the credit side column of a particular account. These words may not have meaning but are used to represent the debit and credit accounts.
- iii. The account which is debited in the journal should also be debited in the ledger book but the reference should be of respective credit account.

### **Steps for Balancing Ledger Account**

- i. First of all, calculate the totals of debit and credit columns separately on a rough sheet to avoid mistakes. Find out the difference between the heavier total and lighter total by subtracting the lower from higher. The difference is called a Balance amount.
- ii. If the total of the debit side is heavier than that of the credit side, the balance is called as "Debit Balance" and is written on the credit side (the side with lower amount) of that particular account as "By Balance c/d" or "By Balance c/d". Here, c/d means carried down and c/d means carried forward.
- iii. Similarly, if the total of the credit side is more than that of debit side total, the balance is called "Credit Balance". The difference amount is written on the debit side of the account as "To balance c/d" or "To balance c/d"
- iv. Once we get the heavier total it should be written in both the columns' total. Draw double lines across the total below the amounts which indicates the account is closed and balanced.
- v. Last year's closing balance is the opening balance of the current year. So, if there is debit it should be shown on the debit side of a particular account as "To Balance b/d" or "To Balance b/d". Here, b/d means brought down and b/d means brought forward.

Note: Nominal accounts are not balanced; the balances are transferred to profit and loss account.

- On 1<sup>st</sup> April 2020, sold goods for cash Rs 2000. Pass journal entry and post it into ledger



Estd. 1999

Date	Particulars	L/F	Amount (Rs)	Amount (Rs)
1/04/2020	Cash A/c <span style="float: right;">dr</span>  To sales A/C		2000	2000

Cash account

Date	Particulars	J/F	Amount (Rs)	Date	Particulars	J/F	Amount (Rs)
1/04/2020	To sales A/c		2000				

Sales account

Date	Particulars	J/F	Amount (Rs)	Date	Particulars	J/F	Amount (Rs)
				1/04/2020	By cash A/c		2000

- On 1<sup>st</sup> April 2020, purchased goods for cash Rs 2000. Pass journal entry and post it into ledger

Date	Particulars	L/F	Amount (Rs)	Amount (Rs)



Estd. 1999

1/04/2020	Purchase A/c	dr		2000	2000
	To cash A/C				

Purchase account

Date	Particulars	J/F	Amount (Rs)	Date	Particulars	J/F	Amount (Rs)
1/04/2020	To cash A/c		2000				

Cash account

Date	Particulars	J/F	Amount (Rs)	Date	Particulars	J/F	Amount (Rs)
				1/04/2020	By purchase A/c		2000

- On 10<sup>th</sup> April 2021, cash received from Gopal & Co is Rs 14800 and discount allowed to them is Rs 200.

Cash account

Date	Particulars	J/F	Amount (Rs)	Date	Particulars	J/F	Amount (Rs)
10/04/2021	To Gopal & Co		14800				



Estd. 1999

	A/c						
--	-----	--	--	--	--	--	--

#### Discount allowed account

Date	Particulars	J/F	Amount (Rs)	Date	Particulars	J/F	Amount (Rs)
10/04/2021	To Goapl & Co A/c		200				

#### Gopal & Co account

Date	Particulars	J/F	Amount (Rs)	Date	Particulars	J/F	Amount (Rs)
				10/04/2021	By cash A/c		14800
					By discount allowed a/c		200

### Balancing of accounts

The word Balance means the difference between the total amounts of two sides of an account. Periodically, the businessman is interested to know the cumulative effect of the entries in the accounts or to know the net position of the accounts. For this purpose they total the two sides of an account separately and find out the difference of the two sides which is called the net balance of the account. Balancing of an account is the process of finding out the difference between totals of two sides of an account and recording it on the shorter side of the account. The balance ascertained is put on the shorter side of the account with a reference —Balance c/d. The c/d (carried down) is written to indicate that the balance has been carried down to tally both sides.



Estd. 1999

## Cash Book

Cash book is a subsidiary book which records all cash and bank transactions. It records all receipts and payments made in the form of cash, cheques, and bank drafts. Types of cash Book

**Simple/Single Column Cash Book:** It is a cash book which has one column on each side for recording the amounts. Single column cash book will always show either a debit balance or zero balance. It cannot show a credit balance.

Dr.		Cash Book.				Cr.	
Date	Receipts	LF	Amount	Date	Payments	LF	
Amount							

**Double Column Cash Book** It is a cash book with two columns on each side, one for recording cash and the other for discount. Offering and accepting cash discounting is closely related to receipt and payment of cash. So discount allowed and received should be simultaneously recorded along with cash in order to get full picture.

Dr.		Double column cash Book				Cr.			
Date	Receipts	LF	Discount	Cash	Date	Payments	LF	Discount	Cash

Note: The discount column in the cash book is not balanced.





Estd. 1999

**Triple Column Cash Book** It is a cash book with three columns on each side for recording amounts. These columns are: • Cash Column: to record cash receipts and cash payments. • Bank Column: to record all receipts and payments through bank. • Discount Column: to record all cash discount received and allowed.

**Cash Book (Triple column)**

Date	Particulars	LF	Discount	Cash	Bank	Date	particulars	LF	Discount	Cash	bank

**Contra entries:** The word contra is a Latin word which means opposite side. Contra entry is an entry on one side of the cash book against which another entry appears on the opposite side. It means two entries, one appearing on the debit side and the other on the credit side of the cash book. Contra entries are denoted by the letter C in the LF column on both sides of the cash book. There are three contra entries:

Cash deposited or paid into the bank.

Cash withdrawn from bank for office use.

Cheque deposited into the bank on a latter date

**Petty Cash Book** The word petty is a French word which means small. In every business house, payments involving very small or petty amounts are made daily. But recording of all these small payments in the main cash book will make it unnecessarily heavy. Hence, it is better to record all these small payments in a separate cash book. Such a cash book is known as petty cash book. The person in charge of this book is called petty cashier. There are two types of petty cash book like: a. Simple Petty Cash Book b. Analytical petty cash Book



Estd. 1999

## **Other subsidiary Books**

**Purchase book:** Only the credit purchase of goods, meant for resale will take place on the purchase book.

**Sales book :** Only the credit sales of goods, meant for resale will take place on the sales book

**Purchase return book (Return outwards book):** Goods, which are purchased, may be returned to the supplier for any reason are recorded in this book.

**Sales Return book (Return inwards book):** Goods, which are sold for credit or cash may be returned to company, if they are defective are recorded in this book.

**Bills receivable book:** Goods are sold for credit to customers with an agreement written by company and counter signed by customer called bills receivable book.

**Bills Payable book:** Goods are purchased for credit from Suppliers with an agreement written by suppliers and counter signed by company called bills payable book.

**Journal Proper:** There are certain transaction which cannot be entered in through any subsidiary books and such transaction entered in the form of journal, called journal proper. Like opening entries, closing entries and adjusting entries

### **Trial balance**

In the words of J.R Batliboi, "A trial balance is a statement, prepared with the debit and credit balances of the ledger accounts to test the arithmetical accuracy of the books." A trial balance gets prepared just before preparing final accounts, which includes a balance sheet, Profit and loss statement, Cash flow, and notes to Accounts. In layman's terms, we can assume that it is the basic structure behind preparing the final accounts. It is the third step in the road map to prepare final accounts after the entries are passed in journal-register followed by classification and



Estd. 1999

grouping of transactions to their respective ledgers. These ledgers, i.e. the principal book containing all sets of accounts, are then accumulated in a single place to constitute a Trial balance.

### Features

- i. Trial balance in accounting lists down all the ledgers, including the cash book.
- ii. It does not form a part of the Double-entry System of Accounting. It serves only as a reference.
- iii. A trial balance can be prepared any time- weekly, monthly, quarterly, and year-end.
- iv. It serves as a vital tool to verify the arithmetical accuracy of the books.
- v. It forms a connecting point between the Profit and Loss Account and Balance sheet.
- vi. It does not provide conclusive proof of the absence of error. Errors such as errors of principal may still exist.

### Objectives

- i. To test the arithmetical accuracy: No doubt a Trial Balance provides the arithmetical accuracy of transactions. That is why, if the Trial Balance agrees, it may be assumed that the posting of various accounts and casting and balancing are correct. But if it does not agree, there must be some errors (which should be located/detected) for which the Trial Balance does not agree. After careful scrutiny the accountant locates the errors which are known as 'Errors disclosed by a Trial Balance' or 'Errors which affect the agreement of Trial Balance.'
- ii. To help in locating/detecting errors: It has been pointed out in an earlier paragraph that if the Trial Balance does not agree, the accountant must locate such errors. The accountant must give equal emphasis or weight-age to both small and wide differences found in a Trial Balance. Because, there may be a number of errors which have practically compensated the effect of one another producing a small difference.



Estd. 1999

- iii. To summarise information about ledger accounts: Since a Trial Balance contains all the ledgers accounts' balances, summarised information about the ledgers, i.e., whether a particular account shows a debit balance or a credit balance, can easily be seen at a glance.
- iv. To help in preparing final accounts: It is practically impossible to prepare the final accounts of a firm in the absence of Trial Balance. The various ledger accounts that we get from a Trial Balance are transformed to Trading and Profit and Loss Account and also to the Balance Sheet in order to know the result of the operation and also the financial position—as a whole.

### **Limitations**

- i. It may hide errors of omission. Some transactions are not journalised at all. Even a correctly balanced Trial Balance cannot reveal this mistake.
- ii. If a journal entry with an incorrect amount gets recorded in both accounts, the Trial Balance will not detect that error.
- iii. A journal entry may have the right amount, but the accountant may have entered it under the wrong accounting heads. The Trial Balance cannot identify such mistakes.
- iv. If a journal entry is missing in the ledger, it will not reflect in the Trial Balance.

### **Methods of Preparation of Trial Balance**

1. Balance Method: In this method, it is the net amount of a ledger that gets displayed in a trial balance. It can either be debit or credit balance. Under this method, the trial balance can be prepared only after all the accounts get balanced. This is one of the accurate methods for the preparation of final accounts.

2. Totals Method: In this method, the total of each side of the account (debit and credit) gets posted in the trial balance. This method provides higher mathematical accuracy. However, the preparation of final accounts is not usually conducted using this method because of the scope of duplication, resulting in errors.



Estd. 1999

The balances of all accounts relating to the following items are placed in the debit column of the trial balance:

Assets

Expenses & Losses

Drawings

Purchases

Sales Return/Return Inward

Debtors

Bills Receivable

Opening stock

The balances of all accounts relating to the following items are placed in the credit column of the trial balance:

Liabilities

Capital

Incomes & Gains

Sales

Purchase Return/ Return Outward



Estd. 1999

Creditors

Bills Payable

Provision for doubtful Debtors

Reserve fund/ General reserve

**Note- Closing Stock is excluded from Trial balance at the time of preparation of trial balance.**

Balance method	Total method
A trial balance prepared by this method shows the balances of all the ledger accounts	A trial balance prepared by this method shows the total amounts of debit items and credit items in each ledger account instead of their balances
A trial balance prepared by this method considers only those accounts which shows no balance, i.e the debit and credit totals equal, the account is not included in trial balance.	A trial balance prepared by this method considers all the accounts in the ledger



Estd. 1999

It can be prepared only when all the ledger accounts have been balanced.	It can be prepared immediately after the completion of posting to the ledger
--	--

### **Steps to prepare Trial Balance**

**Step 1:** Understanding the Golden Rule of accounting: Understanding the golden rules of accounting is vital. It helps in understanding which account needs to be debited and which needs to be credited. As per the golden rule, debit comes under Expenses and assets and credit under incomes, gains, and liabilities. Therefore, credit is payables, whereas debit is receivables.

**Step 2:** Pass the journal entries: After making sure which account is debited or credited, a necessary journal entry is passed. If you are using Tally ERP 9, the entries get passed automatically when the amount is input.

**Step 3:** Once the journal entries get passed, post the entries into their respective ledgers. In the case of Tally ERP 9, this posting takes place automatically at the back end. If you are maintaining manual accounts, then post them manually into the respective accounts.

**Step 4:** In this step, all the ledgers get routed to the trial balance. If there is no arithmetical mistake, the debit and credit sides will match up. In case of any difference, record the same in the suspense account.

### **Errors that cause a mismatch in Trial Balance**

Both the sides of a trial balance must tally. But if that does not happen, it may be on account of the following reasons.

1. When only one transaction is posted: Suppose goods are purchased on credit. The Purchase account gets debited, but the Creditor's account was not credited.



Estd. 1999

2. Lack of accurate balancing: The Closing balances of the previous year have not been accurately balanced in the current year.

3. Amounts mismatched: Suppose the sales ledger has a credit balance of Rs 10000, but while posting it in the trial balance, Rs 1000 gets posted. As a result, there will be a mismatch of Rs 9000 in the trial balance.

4. Mismatch issue: Suppose that the prepaid rent is paid. Instead of debiting the prepaid rent account, the Vendor's account gets debited. This will cause a mismatch in the trial balance.

### **Errors Not Reflected by Trial Balance**

1. Omission: In this case, if a transaction gets missed in its entirety; the same will not get detected by the trial balance.

2. Error of Principle: The trial balance will still match if a transaction gets recorded against the generally accepted accounting principle. The error of principle includes recording the Capital transaction as a revenue transaction in the books of accounts.

3. Error of Commission: Suppose Rs 5000 gets recorded as Rs 500 in both the debit and credit sides of the trial balance. The trial balance will fail to point out this error.

4. Compensating Error: In compensating error, one error compensates for another. For example, you did not debit the purchase account of Rs 1000 in one account but by mistake debited Rs 1000 in another account.

### **Important Principle used in the Preparation of Trial Balance**

- i. All the nominal, personal, and real accounts are to be considered in preparing the Trial balance.
- ii. If a ledger shows a NIL balance, it is not considered in the preparation of the trial balance.
- iii. The purchase or consumption ledger always carries a debit balance and appears on the debit side of the trial balance.





Estd. 1999

- iv. The revenue account always carries a credit balance and appears on the credit side of the balance sheet.
- v. Sales return and purchase return can appear as separate line items in the trial balance or be shown as reduced from the main purchase and sales ledger, respectively.
- vi. Opening stock figure comes from the Profit and loss account since it is not available as a closing balance of stock in the previous year's trial balance.
- vii. All the expenses generally carry a debit balance. Accordingly, they will appear with a debit balance in the trial balance.
- viii. All the incomes and gains generally carry a Credit balance. Accordingly, they will appear with a credit balance in the trial balance.
- ix. The asset and liability must tally at the end.

I. Prepare a trial balance from the following balances of Sh. Keshav Chand Gopal Chand as on 31<sup>st</sup> March, 2021

Name of accounts	Rs	Name of accounts	Rs
Opening stock	20000	Furniture	6000
Purchase	85000	Machinery	62000
Purchase return	5000	Debtors	36000
Sales	160000	Creditors	12750
Sales return	6200	Bills receivable	4600
Rent	1200	Bills payable	2500
Salaries	5700	Cash in hand	5220



Estd. 1999

Advertisement	880	Bank overdraft	10000
Commission received	1440	Interest on overdraft	1800
Discount (cr)	710	Capital	50000
		drawings	7800

Name of the account	L.F	Balance (dr)	Balance (cr)
Opening stock		20000	
Purchase		85000	
Purchase return			5000
Sales			160000
Sales return		6200	
Rent		1200	
Salaries		5700	
Advertisement		880	
Commission received			1440
Discount (cr)			710
Furniture		6000	
Machinery		62000	
Debtors		36000	
Creditors			12750
Bills receivable		4600	
Bills payable			2500
Cash in hand		5220	
Bank overdraft			10000
Interest on overdraft		1800	
Capital			50000

drawings		7800	
<b>Total</b>		242400	242400

### Treatment of closing stock in trial balance

- Generally, closing stock does not appear in the trial balance because, in most cases, it is brought into accounts at the time of preparing the trading account.
- However, in the following cases, closing stock will appear in trial balance
- If, before preparing the trial balance, closing stock is brought into accounts by adjusting it against purchases by the entry
- Closing stock A/c                      dr

To purchases A/c

In case a trial balance is prepared after preparing the trading account

In case a trial balance is prepared after passing adjustment entries.

- Cost of goods sold- the term cost of goods sold, in short, indicates purchases+ opening stock- closing stock
- Hence, when cost of goods sold is stated in the question it indicates that opening stock has already been added to purchases and the closing stock has already been deducted from purchases. In such case, opening stock will not appear in the trial balance.
- But, the closing stock will appear in the trial balance because it has been brought into accounts by a deduction from purchases. It is no longer an item relating to adjustments.

The following trial balance is prepared by an inexperienced accountant, redraft it in a correct form and give necessary notes

Name of accounts	Dr	Cr
Sundry debtors	12200	



Estd. 1999

Sundry creditors		9200
Opening stock	15600	
Purchases	53500	
Purchase returns	2100	
Cash in hand	11000	
Machinery	40200	
Goodwill		10000
Sales		86200
Sales return		7800
Loan from Ram	20000	
Interest on Ram'	3000	
BR		6400
Capital		57000
Life insurance premium	5000	
Carriage	600	
Advertisement	2500	
Discount received	1500	



Estd. 1999

Investments	8000	
Interests on investments	800	

Name of the account	L.F	Balance (dr)	Balance (cr)
Sundry debtors		12200	
Sundry creditors			9200
Opening stock		15600	
Purchases		53500	
Purchase returns			2100
Cash in hand		11000	
Machinery		40200	
Goodwill		10000	
Sales			86200
Sales return		7800	
Loan from Ram			20000
Interest on Ram's		3000	
BR		6400	
Capital			570000
Carriage		600	
Advertisement		2500	
Discount received			1500

Investments		8000	
Interests on investments			800
Suspense a/c		1000	
TOTAL			

### Marshalling of assets and liabilities

Marshalling of assets and liabilities refers to the process of arranging the items of a balance sheet (assets and liabilities) in a specific order. In other words, it is a process of arranging the various assets and liabilities appearing in a balance sheet as per a specific order.

There are two methods by which assets and liabilities can be marshalled and these are:

1. In order of liquidity
2. In order of permanence

**In order of liquidity:** Liquidity refers to the quality of an asset by which it can easily get converted to cash. We can say that an asset is highly liquid if that asset can be converted into cash fast.

Therefore, if we marshall the assets and liabilities of a balance sheet in the order of liquidity, the assets and liabilities are placed in a specific order, based on their decreasing liquidity.

Asset that is most liquid is placed first in the asset column and the asset which is having the least liquidity is placed last.

As per this method, cash will be placed at the top of the list as it is the most liquid asset while goodwill will be placed at the bottom, as it is the least liquid asset and can only be realised when the company is dissolved.

In the case of liabilities, cash is needed to pay off the liabilities, short term liabilities require that they should be cleared first. Hence assets that can be easily converted to cash will be used for clearing the short term liabilities.

Therefore, as per this method, the liabilities that are required to be paid off at the earliest are placed first matching with the highly liquid assets. Similarly, liabilities that are paid out at the last are placed with the asset that is having the least liquidity.

As per this rule, the bank overdraft is an example of a liability that is paid off at the earliest while capital is the liability that is paid out at the last, only if the organisation is dissolved.

**Order of Permanence:** Order of permanence is based on the theory of permanence. In other words, permanence means the tendency of the asset for staying within the organisation or the extent of life of the asset within the organisation.



Estd. 1999

An asset is said to be having a higher degree of permanence when an asset is staying longer with the organisation.

Therefore, in this method assets and liabilities are placed in order of their decreasing permanence.

Asset to be placed first is the one having the highest permanence, while the asset that has the least permanence is the one to be placed last. As per this rule, goodwill is regarded as the asset that will have the highest permanence as it is the last asset that leaves the organisation, while cash is regarded as the asset with the least permanence as it is the fastest to leave the organisation.

Similarly, the liability that has the highest permanence is placed first while the liability having the least permanence is placed last in order. As per this rule, capital is regarded as the liability having the highest permanence while bank overdraft is regarded as the liability with the least permanence.

## **Errors and Rectification**

When the trial balance tallies it provides us only with the proof of the arithmetical accuracy of the ledger accounts. However, there may still be some errors present. Some errors affect the trial balance while some do not. When the trial balance does not tally, it is a clear indication of the presence of errors. We need to identify and locate these errors. Thus, after locating them Rectification of Errors is also necessary. Rectification of errors is a procedure of revising mistakes in the entries. These errors can be of two types, i.e, the errors committed on both sides in an entry that does not influence the trial balance and can be rectified by making a journal entry. And another one is the errors that occur on one side of the trial balance and disturbs the trial balance are known as single-sided errors, which cannot be corrected by only passing journal entry, however, gets corrected by opening a suspense account.

### **Rectification of Errors**

On the basis of rectification of errors, we can classify the errors into the following two broad categories:

1. Errors not affecting the Trial Balance
2. Errors affecting the Trial Balance

The errors need to be categorized in these categories because we can usually rectify the errors not affecting the trial balance by passing a rectification journal entry. While the errors affecting the trial balance affect only one account and for these, we cannot pass a journal entry. However, we can pass a journal entry only by opening a Suspense A/c.

### **Rectification of Errors not affecting the Trial Balance**



Estd. 1999

- ❖ These errors affect two or more accounts simultaneously. Thus, these are two-sided errors. We can rectify these by passing a journal entry giving the correct debit and credit to the accounts. In order to rectify an error, we need to cancel the effect of wrong debit or credit by reversing it and restore the effect of correct debit or credit.
- ❖ When there is short debit or excess credit in an account we need to debit the concerned account. Whereas, when there is short credit or excess debit in an account we need to credit the concerned account.
- ❖ Complete omission to record an entry in the journal or the subsidiary books, incorrect recording of transactions in the books, complete omission of posting and errors of principle are the examples of these errors.

### **Rectification of Errors affecting the Trial Balance**

These errors affect only one account. Thus, these are one-sided errors. We can rectify these errors by giving an explanatory note in the account or by passing a journal entry with the help of Suspense A/c. When we detect an error before posting to the ledger, we can correct it by simply crossing the wrong amount, writing the correct amount above it and initializing it. Similarly, we can also correct an error in the ledger account. Errors of casting, errors of carrying forward the balances, errors of balancing the accounts, errors of posting the wrong amount in the correct account, error of posting in the correct account on the wrong side, omitting to show an account in the trial balance, posting in wrong side with wrong amount are the examples of errors affecting the Trial Balance.

### **Suspense Account**

When the trial balance does not tally due to the one-sided errors in the books, an accountant puts the difference between the debit and credit side of the trial balance on the shorter side as the Suspense A/c. As and when we locate and rectify the errors, the balance in the Suspense A/c reduces and consequently becomes zero. Thus, we cannot categorize the Suspense A/c. It is a temporary account and can have debit or credit balance depending upon the situation. While using the Suspense A/c to rectify the one-sided errors, the accountant needs to follow the following steps:

1. Identification of the account with the error.
2. Ascertainment of the excess debit or credit or short debit or credit in the above account.
3. In case of short debit or excess credit in an account, we need to debit the concerned account. Whereas, in case of short credit or excess debit in an account we need to credit the concerned account.
4. Pass the necessary journal entry by debiting or crediting the Suspense A/c





Estd. 1999

## Rectification of Errors in the Next Accounting Year

When we cannot locate and rectify the errors before the final accounts, we need to carry forward the balance of the Suspense A/c to the next financial year. When we rectify the errors of the previous accounting year, we need to route them through the Profit and Loss Adjustment A/c for the items of expenses, losses, incomes and gains. This avoids their impact on the current income statement.

### Kinds of Errors

Errors of Omission	Errors of Commission
<b>Definition</b>	
Errors of omission are defined as those errors that result from a partial or complete omission of a transaction from the account books.	Errors of commission are defined as those errors that occur due to incorrect recording of transactions in the account books.
<b>Occurs due to</b>	
Errors of omission occur due to mistakes on the part of the accountant in recording the transaction.	Errors of commission occur due to negligence, carelessness or a lack of knowledge of the accountant involved in recording of transactions.
<b>Ways to rectify the mistake</b>	
Errors can be rectified in errors of omission by simply rewriting the entry.	Errors can be rectified in errors of commission by either debiting or crediting the incorrect account and posting to the correct account.
<b>Agreement of Trial Balance</b>	
In errors of omission, complete omission will result in trial balance agreement, while partial omission will not result in agreement of trial balance.	In errors of commission, the trial balance may or may not agree.

### Capital and Revenue Expenditures and Receipts

The main functions of accounting include the ascertainment of profit/loss for an accounting period and financial position as at the end of that period. The distinction between capital and revenue items is important both from the Income Statement (Profit and Loss Account) as well as the Position Statement (Balance Sheet) point of view. For example, if a depreciable asset is purchased, the depreciation on that asset is charged to the Profit and Loss Account, and the written down value of the asset (or original cost of the asset less accumulated depreciation) is shown in the Balance Sheet. If the purchase



Estd. 1999

of a depreciable asset, which is a capital expenditure, is treated as revenue expenditure it will understate the profit of the current year and overstate the profits of the subsequent years. Similarly, the Balance Sheet will not give a true and fair view of the assets and equity of the enterprise till the useful life of the asset is over assuming that the asset is not sold earlier.

### **Capital and revenue item is divided into**

1. Capital and revenue expenditure;
2. Capital and revenue receipts.

### **Capital and Revenue Expenditure**

According to Guidance Note on terms used in financial statements issued by ICAI, “Expenditure is incurring a liability, disbursement of cash or transfer of property for the purpose of obtaining assets, goods or services”. Thus expenditure may or may not involve outflow of cash. It includes the purchase of capital or long-lived asset, goods for the purpose of sale or for getting services. Expenditures are divided into three categories

1. capital expenditure
2. revenue expenditure, and
3. deferred revenue expenditure

### **Capital Expenditure**

Expenditure that acquires a capital asset is capital expenditure. If it acquires stock-in-trade, then it is revenue expenditure. A capital asset is one that is used in or for the purposes of the business and not meant for sale in the ordinary course of business of the enterprise. Purchase of stock-in-trade is not capital expenditure as it is sold in the ordinary course of business. Expenditure on the purchase and installation of machinery is a capital expenditure. Further when an expenditure is made with a view to bringing into existence an asset or advantage for the enduring benefit of trade is a capital expenditure in the absence of special circumstances leading to the opposite conclusion.

Asset or advantage of enduring nature means that it must not be fully consumed or used up in the accounting period in which it is incurred. Capital expenditure increases the earning capacity or reduces the operating expenses of a business.



Estd. 1999

According to Kohler the term capital expenditure is “generally restricted to expenditures that add fixed asset units or that have the effect of increasing the capacity, efficiency, life span, or economy of operation of an existing fixed asset.”

The following are the examples of capital expenditure:

1. Expenditure incurred for acquisition of fixed tangible assets such as land, building, machinery, furniture, motor vehicle etc.
2. Expenditure incurred for improvement or extension of fixed assets such as increasing the seating capacity of a theatre.
3. Expenditure incurred to bring the fixed assets to the place of their use and expenditure incurred on their installation or erection such as freight on fixed assets, wages paid for installation.
4. Expenditure incurred for the purchase of intangible assets such as goodwill, patent rights, and trademarks, copyright, etc.
5. Expenditure incurred for reconditioning of old fixed assets such as expenditure incurred on repairing or overhauling of secondhand machinery.
6. Major repairs and replacement of plant which increase the efficiency of the plant.
7. The cost of shifting a plant to another place is a capital expenditure [Sultanpur Sugar Works Ltd. vs. CIT (1963) 49 ITR 160 SC]
- Treatment of Capital Expenditure. Capital expenditure is capitalised. It is written off over the estimated useful life of the asset. For example, when machinery is purchased, Machinery Account is debited at the price paid for it and later shown in the Balance Sheet as an asset after deducting depreciation. Similarly, wages paid for the installation of machinery is capitalised by debiting the Machinery Account.

### **Rules for Determining Capital Expenditure**

An expenditure is capital expenditure, if it is incurred for acquiring a long term asset (having a useful life of more than one year) for use in the business to earn revenue and not meant for sale.

1. An expenditure is capital expenditure, if it is incurred to put an asset into working condition. For example, the transportation and installation charges are added to

the cost of machine. Similarly, the legal charges like registration and stamp duty is added to the cost of land and building. Again, architect fee paid for supervising construction of building is capitalised.

2. An expenditure incurred for putting an old asset into working condition is treated as capital expenditure and added to the cost of the asset.
3. An expenditure incurred to increase the earning capacity of a business is treated as capital expenditure. For example, expenditure incurred for shifting the factory to convenient site is a capital expenditure.
4. Borrowing costs (e., interest and other costs incurred by an enterprise in connection with the borrowing of funds) that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset till the asset is ready for its intended use or sale as per AS-16 : Borrowing costs.

### **Revenue Expenditure**

If an expenditure is made not for the purpose of bringing into existence any capital asset or advantage of enduring nature but for running the business or working it with a view to produce the profits is revenue expenditure. Such expenditure benefits the current period only. It is incurred to maintain the existing earning capacity of the business. For example, the amount spent on purchase of stock-in-trade is of revenue nature. Administrative expenses and selling and distribution expenses are other examples of revenue expenditure.

1. **Rules for Determining Revenue Expenditure.** An expenditure incurred for the purpose of acquiring goods purchased for resale, consumable items, etc. is a revenue expenditure. For example, purchase of raw material in the case of manufacturing unit and purchase of merchandise meant for the purpose of resale. At the end of the year, closing stock and opening stock of these items adjusted to match cost with revenue for calculating profit.
2. Expenditures incurred on other direct expenses, e., expenses on production and purchase of goods such as wages, power, freight etc. are revenue expenditure.
3. Expenditure incurred for maintaining fixed assets in working order is revenue expenditure. For example, amount spent on repairs and renewals is revenue expenditure.

4. Depreciation on fixed assets is revenue expenditure.
5. Expenditures incurred on office and administrative and selling and distribution departments (not covered above) in the normal course of business are revenue expenditures. These include salaries, rent, telephone expenses, electricity, postage, advertisement, travelling expenses, commission to salesmen.
6. Expenditures incurred on non-operating expenses and losses are revenue expenditures. For example, interest on loan taken after commencement of commercial production, loss on sale of a long term asset, loss by theft, loss by fire are revenue expenditures.
7. Expenditure incurred by an enterprise to discharge itself from recurring liability is of revenue nature. For example, a lump sum amount paid to a pensioner by the employer is revenue expenditure.
8. Expenditure incurred for protecting the business is a revenue expenditure. For example, the amount spent on propaganda campaign to oppose the threatened nationalisation of industry is of revenue nature.
9. Expenditure incurred to maintain the existing efficiency or the earning capacity is of revenue type.

**Distinction Between Capital Expenditure and Revenue Expenditure:** The following are the points of distinction between capital expenditure and revenue expenditure

1. Enduring benefit: Capital expenditure is meant for enduring benefit, e., for more than one accounting period. Revenue expenditure benefits one accounting period only.
2. Nature of asset: Capital expenditure relates to the acquisition of fixed asset and revenue expenditure relates to the acquisition of stock-in-trade.
3. Effect on net profit: Capital expenditure is capitalised while revenue expenditure is transferred to the Trading or Profit and Loss Account. Unexpired portion of the capital expenditure is shown as an asset in the Balance Sheet. Revenue expenditure is expired cost.
4. Nature of liability discharged: Expenditure incurred by an assessee to free himself from a capital liability, for instance, disadvantageous lease is a capital

expenditure, while the amount spent in discharging himself from a recurring liability is of revenue nature.

5. Periodicity of occurrence: Capital expenditure is usually of non-recurring nature while revenue expenditure is usually of recurring nature.
6. Earning capacity: Capital expenditure helps to increase the earning capacity of the business or to reduce the operating cost. Revenue expenditure is incurred to maintain the existing earning capacity of the business.
7. Matching: Capital expenditure are not matched against capital receipts. Revenue expenditures are matched against revenue receipts for income determination.
8. Commencement of business: Capital expenditures may be incurred even before the commencement of business. Revenue expenditures are incurred only after the commencement of business.

### **Deferred Revenue Expenditure**

Deferred revenue expenditure is a revenue expenditure by nature but it is not treated as revenue expenditure on the ground that its benefit is not fully exhausted in the accounting period in which it is incurred. The Guidance Note on 'Terms used in Financial Statement', issued by the Institute of Chartered Accountant of India, states that "Deferred revenue expenditure is that expenditure for which payment has been made or a liability incurred but which is carried forward on the presumption that it will benefit over a subsequent period or periods."

Deferred revenue expenditure is, for the time being, deferred from being charged against revenue. The unwritten off portion of the deferred revenue expenditure is shown on the asset side of the Balance Sheet. A portion of the total deferred revenue expenditure is charged as revenue expenditure. Deferred revenue expenditure should be written off over a certain number of years.

- AS-26 "**Intangible Assets**" has diluted the concept of deferred revenue expenditure. According to it, if expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired that can be recognised, then expenditure should be recognised when it is incurred. For example, preliminary expenses in establishing a legal entity, expenditure on training activities and expenditure on relocating or reorganising an enterprise, expenditure on launching of



Estd. 1999

new products, expenditure on advertising and promotional activities should be recognised as expenses in the year in which these are incurred. However, share issue expenses and discount on issue of shares/debentures can be written off over a certain number of years.

Deferred revenue expenditure should be distinguished from prepaid expenses. In case of deferred revenue expenditure the benefits available cannot be precisely estimated but in case of prepaid expenses, like payment of insurance in advance, benefits available can be precisely estimated. In case of prepaid insurance, insurance protection will be available for a definite period after close of the financial year.

### **Illustration 1.**

Classify the following into capital or revenue expenditure:

- (a) Overhaul expenses of ` 10,000 spent on second hand machinery purchased.
- (b) Carriage of ` 1,000 spent on machinery purchased.
- (c) Legal fees of ` 5,000 paid to acquire property.
- (d) ` 1,500 paid for servicing the company's car including ` 500 paid for change of oil.
- (e) ` 1,000 paid for replacement of a worn out part of a machine.
- (f) ` 18,000 spent for construction of temporary huts, which were necessary for construction of the cinema house and were demolished when the cinema house was ready.

### **Solution:**

- (a) Overhaul expenses spent on second hand machinery purchased is a capital expenditure.
- (b) Carriage paid on machinery is a capital expenditure.
- (c) Legal fees paid to acquire property is a capital expenditure.
- (d) Amount spent on servicing entity's car is a revenue expenditure.
- (e) Amount spent on replacement of worn part of a machine is a revenue expenditure.
- (f) Amount spent on construction of temporary huts is a capital expenditure.

### **Illustration 2.**



Estd. 1999

Classify the following into capital or revenue expenditure:

- (a) ` 5,000 spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land.
- (b) ` 1,50,000 spent on the repairs and white-washing for the first time on purchase of an old building.
- (c) ` 15,000 spent in connection with obtaining a licence for starting a factory.
- (d) ` 6,000 paid as compensation to two employees who were retrenched.
- (e) ` 8,000 custom duty paid on import of machinery for modernisation of factory production.

**Solution:**

- (a) Lawyer's fee to defend the impugned suit is a revenue expenditure.
- (b) Amount spent on repairs and white-washing for the first time on purchase of old building is a capital expenditure.
- (c) Amount spent in connection with obtaining licence for starting a factory is a capital expenditure.
- (d) Amount paid as compensation to the employees is a revenue expenditure.
- (e) Custom duty paid on import of machinery for modernisation of factory is a capital expenditure.

**Illustration 3.**

State with reasons whether the following are capital or revenue expenditure :

- (a) Freight and cartage on the new machine ` 150, and erection charges ` 500.
- (b) Fixtures of the book value of ` 2,500 sold off at ` 1,600 and new fixtures of the value of ` 4,000 were acquired, cartage on purchase ` 5.
- (c) A sum of ` 400 was spent on painting the factory.
- (d) ` 8,200 spent on repairs before using a second hand car purchased recently, to put it in usable condition.

**Solution:**





Estd. 1999

- (a) Freight and cartage on the new machine and erection charges ₹ 500 are capitalised because they will benefit the business for more than one accounting period.
- (b) Loss on sale of fixtures ₹ 900 (₹ 2,500 – 1,600) is a revenue expenditure although it is of non-operating nature. Amount spent on new fixtures ₹ 4,000 and on cartage ₹ 5 are capital expenditures as they will benefit future periods also.
- (c) ₹ 400 spent on painting the factory is a revenue expenditure as it was incurred to maintain the factory building.
- (d) Overhaul expenses (or repairs) ₹ 8,200 incurred to put a second hand car in working condition is a capital expenditure. It will benefit in future also.

#### **Illustration 4.**

Classify the following into capital or revenue or deferred revenue expenditure:

- (a) Heavy advertising cost of ₹ 10,00,000 spent on the launching of a company's new product.
- (b) Advertisement expense ₹ 50,000 incurred during peak festive season on regular basis.
- (c) ₹ 2,000 paid for hiring of computer time for the preparation of the accounts of the business.
- (d) Interest paid ₹ 40,000 on loan taken for construction of building and purchase of plant and machinery before the asset is ready for intended use.

#### **Solution:**

- (a) Heavy advertising cost of ₹ 10,00,000 spent on the launching of a company's new product is a revenue expenditure as per AS-26. According to AS-26 (Para 56) "Intangible Assets", expenditure incurred on "launching new products or process" and "expenditure on advertising and promotional activities" are recognised as expenses when these are incurred. Earlier, it used to be treated as deferred revenue expenditure.
- (b) Advertisement expense ₹ 50,000 incurred during peak festive season on regular basis is a revenue expenditure.
- (c) ₹ 2,000 paid for hiring of computer time for the preparation of the accounts of the business is a revenue expenditure.



Estd. 1999

(d) Interest paid ₹ 40,000 on loan taken for construction of building and purchase of plant and machinery before the asset is ready for intended use is a capital expenditure.

### **Distinction between Expenses and Expenditure**

- **Expenditure:** According to the Guidance Note on Terms used in financial statements issued by ICAI, expenditure is incurring a liability, disbursement of cash or transfer of property for the purpose of obtaining assets, goods or services. It does not necessarily involve actual delivery or parting with money or property. Incurring a liability is also expenditure. Expenditure may be capital expenditure, revenue expenditure or deferred revenue expenditure.
- **Expense:** According to the Guidance Note on Terms used in financial statements issued by ICAI, expense is a cost relating to the operations of an accounting period or to the revenue earned during the period or the benefits of which do not extend beyond that period. Expense is expired cost. It decreases owners equity, other than those relating to distribution of dividend to shareholders in case of a company or withdrawal etc. made by the owner (s) in case of non-corporate entities. Expenses give benefit during the accounting period only in which they are incurred. An expense is incurred when goods or services are used in the process of earning revenue.

### **Capital and Revenue Receipts**

The distinction between capital receipt and revenue receipt is important because capital receipt is taken to the Balance Sheet and revenue receipt is taken to the Trading and Profit and Loss Account.

Capital receipts are the receipts which are not obtained in course of normal business activities of the enterprise. The examples of capital receipts are :

1. capital contributed by the owner(s),
2. secured or unsecured loans taken,
3. receipts from sale of fixed assets and non-current investments.

In case of not for profit organisation, legacy and life membership are capital receipts.



Estd. 1999

Revenue receipts are the receipts which are obtained in course of normal business activities. They include proceeds from sale of goods, fee received from the services rendered in the ordinary course of business, receipts.

The nature of receipt is decided from the point of view of the person receiving it.

- The following broad principles may be laid down as guide for determining whether a particular receipt is of capital nature or of revenue nature:
  1. A receipt on account of fixed assets is a capital receipt whereas a receipt on account of current assets or circulating capital is a revenue receipt. For example, sale proceeds from sale of fixed assets is a capital receipt while proceeds from sale of stock-in-trade is a revenue receipt. Capital profit from sale of fixed asset is to be shown in Profit and Loss Accounts.
  2. A receipt in substitution of source of income is a capital receipt whereas a receipt in substitution of income alone is a revenue receipt. For example, compensation for loss of employment or agency is a capital receipt (though taxable) whereas damages for breach of business contract is a revenue receipt.
  3. An amount received for surrender of certain right under an agreement is a capital receipt whereas amount received by way of compensation of loss of future profits is a revenue receipt. For example, pension is a revenue receipt whereas lump sum received in commutation of pension is a capital receipt (though taxable).
  4. The nature of a receipt is determined exclusively by its character in the hands of the receiver.
  5. Where an asset is held as an investment, the sale proceeds of such asset is a capital receipt. But where an asset is held as stock-in-trade, the sale proceeds of such asset is a revenue receipt. For example, profit on sale of shares to a dealer in shares is a revenue receipt.

### **Distinction between Capital Receipts and Revenue Receipts**

1. Capital receipts are not obtained in the course of normal business activities of the enterprise whereas revenue receipts are obtained in the course of normal business activities.
2. Capital receipts are usually obtained in case of a company from issue of shares, debentures, borrowings and sale of fixed assets or investments. Revenue receipts

are usually obtained from sale of goods, rendering of services or use of enterprise resources yielding interest, royalties and dividend.

3. Capital receipts are usually of non-recurring nature and revenue receipts are usually of recurring nature.
4. Capital receipts from financing activities such as issue of shares, debentures and borrowings are shown on the liabilities side of the balance sheet as these receipts create liabilities payable at a future date whereas interest on borrowings is shown as a charge in the Profit and Loss Account and dividends to shareholders are shown as appropriation of profit in the appropriation section of Profit and Loss Account. Interest accrued/outstanding will also be shown as a liability.

### **Illustration 5.**

State with reasons whether the following are capital or revenue receipts :

- (a) Introduction of capital by the owner ` 10,00,000.
- (b) Amount realised from sale of old machinery ` 50,000 (book value ` 48,000).
- (c) Sale of goods for cash ` 10,000.
- (d) Cash received from debtors ` 20,000.
- (e) Sale of investments for ` 40,000 (book value ` 44,000).
- (f) Interest received on investments ` 3,000.

### **Solution:**

- (a) Introduction of capital by the owner ` 10,00,000 is a capital receipt as it creates a claim on the business to repay it.
- (b) Amount realised from sale of old machinery: ` 50,000 is a capital receipt. Capital profit on sale of ` 2,000 is to be shown in Profit and Loss Account.
- (c) Sale proceeds from sale of goods ` 10,000 is a revenue receipt as it is a receipt in the course of normal business activities of the enterprise.
- (d) Cash received from debtors ` 20,000 is a revenue receipt as this is in the course of normal business activities of the enterprise.
- (e) Sale proceeds from investments ` 40,000 is a capital receipt and capital loss of ` 4,000 is to be charged in the Profit and Loss Account.



Estd. 1999

(f) Interest on investments ` 3,000 is a revenue receipt as use of enterprise resources yielding interest is revenue.

## **DEPRECIATION**

Depreciation may be described as a permanent, continuing and gradual shrinkage in the book value of fixed assets. It is based on the cost of assets consumed in a business and not on its market value. According to Institute of Cost and Management Accounting, London (ICMA) terminology “The depreciation is the diminution in intrinsic value of the asset due to use and/or lapse of time.” Accounting Standard-6 issued by The Institute of Chartered Accountants of India (ICAI) defines depreciation as “a measure of the wearing out, consumption or other loss of value of depreciable asset arising from use, effluxion of time or obsolescence through technology and market-change. Depreciation is allocated so as to charge fair proportion of depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is pre-determined”.

Depreciation has a significant effect in determining and presenting the financial position and results of operations of an enterprise. Depreciation is charged in each accounting period by reference to the extent of the depreciable amount. It should be noted that the subject matter of depreciation, or its base, are ‘depreciable’ assets which: • “are expected to be used during more than one accounting period; • have a limited useful life; and • are held by an enterprise for use in production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.”

Examples of depreciable assets are machines, plants, furnitures, buildings, computers, trucks, vans, equipments, etc. Moreover, depreciation is the allocation of ‘depreciable amount’, which is the “historical cost”, or other amount substituted for historical cost less estimated salvage value. Another point in the allocation of depreciable amount is the ‘expected useful life’ of an asset. It has been described as “either (i) the period over which a depreciable asset is expected to be used by the enterprise, or (ii) the number of production of similar units expected to be obtained from the use of the asset by the enterprise.”



Estd. 1999

## Features of Depreciation

1. It is decline in the book value of fixed assets.
2. It includes loss of value due to effluxion of time, usage or obsolescence. For example, a business firm buys a machine for ₹ 1,00,000 on April 01, 2017. In the year 2017, a new version of the machine arrives in the market. As a result, the machine bought by the business firm becomes outdated. The resultant decline in the value of old machine is caused by obsolescence.
3. It is a continuing process.
4. It is an expired cost and hence must be deducted before calculating taxable profits. For example, if profit before depreciation and tax is ₹ 50,000, and depreciation is ₹ 10,000; profit before tax will be: (₹) Profit before depreciation & tax 50,000 (-) Depreciation (10,000) Profit before tax 40,000
5. It is a non-cash expense. It does not involve any cash outflow. It is the process of writing-off the capital expenditure already incurred.

## Depreciation and other Similar Terms

There are some terms like 'depletion' and 'amortisation', which are also used in connection with depreciation. This has been due to the similar treatment given to them in accounting on the basis of similarity of their outcome, as they represent the expiry of the usefulness of different assets.

**Depletion** The term depletion is used in the context of extraction of natural resources like mines, quarries, etc. that reduces the availability of the quantity of the material or asset. For example, if a business enterprise is into mining business and purchases a coal mine for ₹ 10,00,000. Then the value of coal mine declines with the extraction of coal out of the mine. This decline in the value of mine is termed as depletion. The main difference between depletion and depreciation is that the former is concerned with the exhaustion of economic resources, but the latter relates to the



Estd. 1999

usage of an asset. In spite of this, the result is erosion in the volume of natural resources and expiry of the service potential. Therefore, depletion and depreciation are given similar accounting treatment.

**Amortisation-** Amortisation refers to writing-off the cost of intangible assets like patents, copyright, trade marks, franchises, goodwill which have utility for a specified period of time. The procedure for amortisation or periodic write-off of a portion of the cost of intangible assets is the same as that for the depreciation of fixed assets. For example, if a business firm buys a patent for ₹ 10,00,000 and estimates that its useful life will be 10 years then the business firm must writeoff ₹ 10,00,000 over 10 years. The amount so written- off is technically referred to as amortisation.

### Causes of Depreciation

**Wear and Tear due to Use or Passage of Time-**Wear and tear means deterioration, and the consequent diminution in an assets value, arising from its use in business operations for earning revenue. It reduces the asset's technical capacities to serve the purpose for, which it has been meant. Another aspect of wear and tear is the physical deterioration. An asset deteriorates simply with the passage of time, even though they are not being put to any use. This happens especially when the assets are exposed to the rigours of nature like weather, winds, rains, etc.

**Expiration of Legal Rights-** Certain categories of assets lose their value after the agreement governing their use in business comes to an end after the expiry of pre-determined period. Examples of such assets are patents, copyrights, leases, etc. whose utility to business is extinguished immediately upon the removal of legal backing to them.

**Obsolescence-** Obsolescence is another factor leading to depreciation of fixed assets. In ordinary language, obsolescence means the fact of being “out-of-date”. Obsolescence implies to an existing asset becoming out-of-date on account of the availability of better type of asset. It arises from such factors as: • Technological changes; • Improvements in production methods; • Change in market demand for the product or service output of the asset; • Legal or other description.



Estd. 1999

**Abnormal Factors-** Decline in the usefulness of the asset may be caused by abnormal factors such as accidents due to fire, earthquake, floods, etc. Accidental loss is permanent but not continuing or gradual. For example, a car which has been repaired after an accident will not fetch the same price in the market even if it has not been used.

### **Need for Depreciation**

The need for providing depreciation in accounting records arises from conceptual, legal, and practical business consideration. These considerations provide depreciation a particular significance as a business expense.

**Matching of Costs and Revenue** The rationale of the acquisition of fixed assets in business operations is that these are used in the earning of revenue. Every asset is bound to undergo some wear and tear, and hence lose value, once it is put to use in business. Therefore, depreciation is as much the cost as any other expense incurred in the normal course of business like salary, carriage, postage and stationary, etc. It is a charge against the revenue of the corresponding period and must be deducted before arriving at net profit according to 'Generally Accepted Accounting Principles'.

**Consideration of Tax Depreciation-** is a deductible cost for tax purposes. However, tax rules for the calculation of depreciation amount need not necessarily be similar to current business practices,

**True and Fair Financial Position-** If depreciation on assets is not provided for, then the assets will be over valued and the balance sheet will not depict the correct financial position of the business. Also, this is not permitted either by established accounting practices or by specific provisions of law.





Estd. 1999

Compliance with Law-Apart from tax regulations, there are certain specific legislations that indirectly compel some business organisations like corporate enterprises to provide depreciation on fixed assets.

### Factors Affecting the Amount of Depreciation

The determination of depreciation depends on three parameters, viz. cost, estimated useful life and probable salvage value.

**Cost of Asset** Cost (also known as original cost or historical cost) of an asset includes invoice price and other costs, which are necessary to put the asset in use or working condition. Besides the purchase price, it includes freight and transportation cost, transit insurance, installation cost, registration cost, commission paid on purchase of asset and items such as software, etc. In case of purchase of a second hand asset it includes initial repair cost to put the asset in workable condition. According to Accounting Standard-6 of ICAI, cost of a fixed asset is “the total cost spent in connection with its acquisition, installation and commissioning as well as for addition or improvement of the depreciable asset”. For example, a photocopy machine is purchased for ₹ 50,000 and ₹ 5,000 is spent on its transportation and installation. In this case the original cost of the machine is ₹ 55,000 (i.e. ₹ 50,000 + ₹ 5,000 ) which will be written-off as depreciation over the useful life of the machine.

**Estimated Net Residual Value** Net Residual value (also known as scrap value or salvage value for accounting purpose) is the estimated net realisable value (or sale value) of the asset at the end of its useful life. The net residual value is calculated after deducting the expenses necessary for the disposal of the asset. For example, a machine is purchased for ₹ 50,000 and is expected to have a useful life of 10 years. At the end of 10th year it is expected to have a sale value of ₹ 6,000 but expenses related to its disposal are estimated at ₹ 1,000. Then its net residual value shall be ₹ 5,000 (i.e. ₹ 6,000 – ₹ 1,000).

**Depreciable Cost** Depreciable cost of an asset is equal to its cost (as calculated in point 7.5.1 above) less net residual value (as calculated in point 7.5.2.) Hence, in the above example, the



Estd. 1999

depreciable cost of machine is ₹ 45,000 (i.e., ₹ 50,000 – ₹ 5,000.) It is the depreciable cost, which is distributed and charged as depreciation expense over the estimated useful life of the asset. In the above example, ₹ 45,000 shall be charged as depreciation over a period of 10 years. It is important to mention here that total amount of depreciation charged over the useful life of the asset must be equal to the depreciable cost. If total amount of depreciation charged is less than the depreciable cost then the capital expenditure is under recovered. It violates the principle of proper matching of revenue and expense.

#### 7.5.4 Estimated Useful Life

Useful life of an asset is the estimated economic or commercial life of the asset. Physical life is not important for this purpose because an asset may still exist physically but may not be capable of commercially viable production. For example, a machine is purchased and it is estimated that it can be used in production process for 5 years. After 5 years the machine may still be in good physical condition but can't be used for production profitably, i.e., if it is still used the cost of production may be very high. Therefore, the useful life of the machine is considered as 5 years irrespective of its physical life. Estimation of useful life of an asset is difficult as it depends upon several factors such as usage level of asset, maintenance of the asset, technological changes, market changes, etc. As per Accounting Standard – 6 useful life of an asset is normally the “period over which it is expected to be used by the enterprise”. Normally, useful life is shorter than the physical life. The useful life of an asset is expressed in number of years but it can also be expressed in other units, e.g., number of units of output (as in case of mines) or number of working hours. Useful life depends upon the following factors :

- Pre-determined by legal or contractual limits, e.g., in case of leasehold asset, the useful life is the period of lease.
- The number of shifts for which asset is to be used.
- Repair and maintenance policy of the business organisation.
- Technological obsolescence.
- Innovation/improvement in production method.
- Legal or other restrictions.

### Methods of Calculating Depreciation Amount

The depreciation amount to be charged for during an accounting year depends upon depreciable amount and the method of allocation. For this, two methods are mandated by law and enforced by professional accounting practice in India. These methods are straight line method and written down value method. Besides these two main methods there are other methods such as – annuity method, depreciation fund method, insurance policy method, sum of years digit method, double



Estd. 1999

declining method, etc. which may be used for determining the amount of depreciation. The selection of an appropriate method depends upon the following : • Type of the asset; • Nature of the use of such asset; • Circumstances prevailing in the business; As per Accounting Standard-6, the selected depreciation method should be applied consistently from period to period. Change in depreciation method may be allowed only under specific circumstances.

**Straight Line Method** This is the earliest and one of the widely used methods of providing depreciation. This method is based on the assumption of equal usage of the asset over its entire useful life. It is called straight line for a reason that if the amount of depreciation and corresponding time period is plotted on a graph, it will result in a straight line. It is also called fixed installment method because the amount of depreciation remains constant from year to year over the useful life of the asset. According to this method, a fixed and an equal amount is charged as depreciation in every accounting period during the lifetime of an asset. The amount annually charged as depreciation is such that it reduces the original cost of the asset to its scrap value, at the end of its useful life. This method is also known as fixed percentage on original cost method because same percentage of the original cost (infact depreciable cost) is written off as depreciation from year to year.

#### Advantages of Straight Line Method

- It is very simple, easy to understand and apply. Simplicity makes it a popular method in practice;
- Asset can be depreciated upto the net scrap value or zero value. Therefore, this method makes it possible to distribute full depreciable cost over useful life of the asset;
- Every year, same amount is charged as depreciation in profit and loss account. This makes comparison of profits for different years easy;



Estd. 1999

- This method is suitable for those assets whose useful life can be estimated accurately and where the use of the asset is consistent from year to year such as leasehold buildings.

#### Limitations of Straight Line Method

- This method is based on the faulty assumption of same amount of the utility of an asset in different accounting years;
- With the passage of time, work efficiency of the asset decreases and repair and maintenance expense increases. Hence, under this method, the total amount charged against profit on account of depreciation and repair taken together, will not be uniform throughout the life of the asset, rather it will keep on increasing from year to year.

**Written Down Value Method** Under this method, depreciation is charged on the book value of the asset. Since book value keeps on reducing by the annual charge of depreciation, it is also known as 'reducing balance method'. This method involves the application of a pre-determined proportion/percentage of the book value of the asset at the beginning of every accounting period, so as to calculate the amount of depreciation. The amount of depreciation reduces year after year.

#### Advantages of Written Down Value Method

- This method is based on a more realistic assumption that the benefits from asset go on diminishing (reducing) with the passage of time. Hence, it calls for proper allocation of cost because higher depreciation is charged in earlier years when asset's utility is higher as compared to later years when it becomes less effective.
- It results into almost equal burden of depreciation and repair expenses taken together every year on profit and loss account;
- Income Tax Act accept this method for tax purposes;



Estd. 1999

- As a large portion of cost is written-off in earlier years, loss due to obsolescence gets reduced;

- This method is suitable for fixed assets which last for long and which require increased repair and maintenance expenses with passage of time. It can also be used where obsolescence rate is high.

#### Limitations of Written Down Value

- As depreciation is calculated at fixed percentage of written down value, depreciable cost of the asset cannot be fully written-off. The value of the asset can never be zero;
- It is difficult to ascertain a suitable rate of depreciation.

BASIS	SLM	WDV
Meaning	A method of depreciation in which the cost of the asset is spread uniformly over the life years by writing off a fixed amount every year.	A method of depreciation in which a fixed rate of depreciation is charged on the book value of the asset, over its useful life.
Calculation of depreciation	On the original cost	On the written down value of the asset.
Annual depreciation charge	Remains fixed during the useful life.	Reduces every year
Value of asset	Completely written off	Not completely written off
Amount of depreciation	Initially lower	Initially higher



Estd. 1999

Impact of repairs and depreciation on P&L A/c	Increasing trend	Remains constant
Appropriate for	Assets with negligible repairs and maintenance like leases, copyright.	Assets whose repairs increase, as they get older like machinery, vehicles etc.

Accounting treatment

- Entry for purchase

Asset A/c                      dr

To bank A/c

Entry for providing depreciation at the end of each year

Depreciation A/c            dr

To asset A/c

Entry for the amount realised on sale of asset

Bank A/c                      dr

To asset A/c

- Entry in case of loss on sale of asset

Profit & loss A/c                      dr

To asset A/c

Entry in case of profit on sale of asset



Estd. 1999

Assets A/c

dr

To profit & loss A/c

## **MODULE IV**

The most important function of an accounting system is to provide information about the profitability of the business. A sole trader furnishes a Trading and Profit and loss Account which depicts the result of the business transactions of the sole trader. Along with the Trading and Profit and Loss Account he also prepares a Balance Sheet which shows the financial position of the business.

### Steps in the Process of Finalization of Accounts

#### A. For Trading Concerns:

1. Trading Account.
2. Profit and Loss Account.
3. Balance Sheet.

#### B. For Manufacturing and Trading Concerns:

1. Manufacturing Account.
2. Trading Account.



Estd. 1999

### 3. Profit and Loss Account.

### 4. Balance Sheet.

## Preparation of Financial Statements

**Profitability Statement** – This statement is related to a complete accounting period. It shows the outcome of business activities during that period in a summarized form. The activities of any business will include purchase, manufacture, and sell.

**Balance Sheet** – Business needs some resources which have longer life (say more than a year). Such resources are, therefore, not related to any particular accounting period, but are to be used over the useful life thereof. The resources do not come free. One requires finance to acquire them. This funding is provided by owners through their investment, bank & other through loans, suppliers by way of credit terms. The Balance Sheet shows the list of resources and the funding of the resources i.e. assets and liabilities (towards owners and outsiders). It is also referred as sources of funds (i.e. liabilities & capital) and application of funds (i.e. assets). Let us discuss these statements in depth. **Trading Account:** It is an account which is prepared by a merchandising concern which purchases goods and sells the same during a particular period. The purpose of it to find out the gross profit or gross loss which is an important indicator of business efficiency.

The following items will appear in the debit side of the Trading Account:

- (i) **Opening Stock:** In case of trading concern, the opening stock means the finished goods only. The amount of opening stock should be taken from Trial Balance.
- (ii) **Purchases:** The amount of purchases made during the year. Purchases include cash as well as credit purchase. The deductions can be made from purchases,



such as, purchase return, goods withdrawn by the proprietor, goods distributed as free sample etc.

- (iii) Direct expenses: it means all those expenses which are incurred from the time of purchases to making the goods in suitable condition. This expenses includes freight inward, octroi, wages etc.
- (iv) Gross profit: If the credit side of trading A/c is greater than debit side of trading A/c gross profit will arise.

The following items will appear in the credit side of Trading Account:

- (i) Sales Revenue: The sales revenue denotes income earned from the main business activity or activities. The income is earned when goods or services are sold to customers. If there is any return, it should be deducted from the sales value. As per the accrual concept, income should be recognized as soon as it is accrued and not necessarily only when the cash is paid for. The Accounting standard 7 (in case of contracting business) and Accounting standard 9 (in other cases) define the guidelines for revenue recognition. The essence of the provisions of both standards is that revenue should be recognized only when significant risks and rewards (vaguely referred to as ownership in goods) are transferred to the customer. For example, if an invoice is made for sale of goods and the term of sale is door delivery; then sale can be recognized only on getting the proof of delivery of goods at the door of customer. If such proof is pending at the end of accounting period, then this transaction cannot be taken as sales, but will be treated as unearned income.
- (ii) Closing Stocks: In case of trading business, there will be closing stocks of finished goods only. According to convention of conservatism, stock is valued at cost or net realizable value whichever is lower.



Estd. 1999

(iii)

Gross Loss: When debit side of trading account is greater than credit side of trading account, gross loss will appear.

### **Closing entries relating to trading account**

- Purchase A/c dr

To purchases A/c

Sales A/c dr

To sales return A/c

Closing entry for those accounts which are transferred to the debit side of trading account

- Trading A/c dr

To opening stock A/c

To purchase A/c

To wages A/c

To direct expenses A/c

To carriage A/c

To gas, fuel & power A/c

To freight, octroi & cartage A/c

To manufacturing expenses A/c

To royalty A/c

Closing entry for those accounts which are to be transferred to the credit side of trading account



To trading A/c



Estd. 1999

- (i) **Revenue Incomes:** These incomes arise in the ordinary course of business, which includes commission received, discount received etc.
  
- (ii) **Other Incomes:** The business will generate incomes other than from its main activity. These are purely incidental. It will include items like interest received, dividend received, etc. The end result of one component of the P & L A/c is transferred over to the next component and the net result will be transferred to the balance sheet as addition in owners' equity. The profits actually belong to owners of business. In case of company organizations, where ownership is widely distributed, the profit figure is separately shown in balance sheet.

**Balance Sheet:** Horizontal format of Balance Sheet is also used by the business other than company

#### A. Liabilities

(a) **Capital:** This indicates the initial amount the owner or owners of the business contributed. This contribution could be at the time of starting business or even at a later stage to satisfy requirements of funds for expansion, diversification etc. As per business entity concept, owners and business are distinct entities, and thus, any contribution by owners by way of capital is liability.

(b) **Reserves and Surplus:** The business is a going concern and will keep making profit or loss year by year. The accumulation of these profit or loss figures (called as surpluses) will keep on increasing or decreasing owners' equity. In case of non-corporate forms of business, the profits or losses are added to the capital A/c and not shown separately in the balance sheet of the business.

(c) **Long Term or Non-Current Liabilities:** These are obligations which are to be settled over a longer period of time say 5-10 years. These funds are raised by way of loans from banks and



Estd. 1999

financial institutions. Such borrowed funds are to be repaid in installments during the tenure of the loan as agreed. Such funds are usually raised to meet financial requirements to procure fixed assets. These funds should not (d) Short Term or Current Liabilities: A liability shall be classified as Current when it satisfies any of the following

- It is expected to be settled in the organisation'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 organization 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 could, at the option of the counterparty, result in its settlement by the issue of Equity Instruments do not affect its classification)

Current liabilities comprise of

- (i) Sundry Creditors - Amounts payable to suppliers against purchase of goods. This is usually settled within 30-180 days.
- (ii) (ii) Advances from customers – At times customer may pay advance i.e. before they get delivery of goods. Till the business supplies goods to them, it has an obligation to pay back the advance in case of failure to supply. Hence, such advances are treated as liability till the time they get converted to sales.
- (iii) Outstanding Expenses: These represent services procured but not paid for. These are usually settled within 30–60 days e.g. phone bill of Sept is normally paid in Oct.

- (iv) Bills Payable: There are times when suppliers do not give clean credit. They supply goods against a promissory note to be signed as a promise to pay after or on a particular date. These are called as bills payable or notes payable.
- (v) Bank Overdrafts: Banks may give fund facilities like overdraft whereby, business is permitted to issue cheques up to a certain limit. The bank will honour these cheques and will recover this money from business. This is a short term obligation.

**B. Assets** In accounting language, all debit balances in personal and real accounts are called as assets. Assets are broadly classified into fixed assets and current assets.

(a) **Fixed Assets:** These represent the facilities or resources owned by the business for a longer period of time. The basic purpose of these resources is not to buy and sell them, but to use for future earnings. The benefit from use of these assets is spread over a very long period. The fixed assets could be in tangible form such as buildings, machinery, vehicles, computers etc, whereas some could be in intangible form viz. patents, trademarks, goodwill etc. The fixed assets are subject to wear and tear which is called as depreciation. In the balance sheet, fixed assets are always shown as “original cost less depreciation”.

(b) **Investments:** These are funds invested outside the business on a temporary basis. At times, when the business has surplus funds, and they are not immediately required for business purpose, it is prudent to invest it outside business e.g. in mutual funds or fixed deposit. The purpose is to earn a reasonable return on this money instead of keeping them idle. These are assets shown separately in balance sheet. Investments can be classified into Current Investments and Non-current Investments. Non-current Investments are investments which are restricted beyond the current period as to sale or disposal. Whereas, current investments are investments that are by their nature readily realizable and is intended to be held for not more than one year from the date on which such investment is made.

(c) **Current Assets:** An asset shall be classified as Current when it satisfies any of the following



Estd. 1999

- It is expected to be realised in, or is intended for sale or consumption in the organisation's normal Operating Cycle,
- It is held primarily for the purpose of being traded,
- It is due to be realised 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.

Current assets comprise of: (i) Stocks: This includes stock of raw material, semi-finished goods or WIP, and finished goods.

Stocks are shown at lesser of the cost or market price. Provision for obsolescence, if any, is also reduced. Generally, stocks are physically counted and compared with book stocks to ensure that there are no discrepancies. In case of discrepancies, the same are adjusted to P & L A/c and stock figures are shown as net of this adjustment.

- (iii) Debtors: They represent customer balances which are not paid. The bad debts or a provision for bad debt is reduced from debtors and net figure is shown in balance sheet.
- (iv) Bills receivables: Credit to customers may be given based on a bill to be signed by them payable to the business at an agreed date in future. At the end of accounting period, the bills accepted but not yet paid are shown as bills receivables.
- (v) Cash in Hand: This represents cash actually held by the business on the balance sheet date. This cash may be held at various offices, locations or sites from where the business activity is carried out. Cash at all locations is physically counted and verified with the book balance. Discrepancies if any are adjusted.



Estd. 1999

- (vi) Cash at Bank: Dealing through banks is quite common. Funds held as balances with bank are also treated as current asset, as it is to be applied for paying to suppliers. The balance at bank as per books of accounts is always reconciled with the balance as per bank statement, the reasons for differences are identified and required entries are passed.
- (vii) Prepaid Expenses: They represent payments made against which services are expected to be received in a very short period.
- (viii) Advances to suppliers: When amounts are paid to suppliers in advance and goods or services are not received till the balance sheet date, they are to be shown as current assets. This is because advances paid are like right to claim the business gets. Please note that both current assets and current liabilities are used in day-to-day business activities. The current assets minus current liabilities are called as working capital or net current assets. The following report is usual horizontal form of balance sheet. Please note that the assets are normally shown in descending order of their liquidity. Also, capital, long term liabilities and short term liabilities are shown in that order.



**TRADING ACCOUNT (Horizontal Format)**  
*for the year ended.....*

<b>Dr.</b>		<b>Cr.</b>	
<b>Particulars</b>	<b>Rs.</b>	<b>Particulars</b>	<b>Rs.</b>
To Opening Stock	xxx	By Sales	xxx
To Purchases xxx		Less: Returns inwards (xxx)	xxx
Less: Returns		By Closing Stock	xxx
outwards (xxx)	xxx	By Gross Loss c/d*	xxx
To Frieght & Carriage	xxx		
To Customs & Insurance	xxx		
To Wages	xxx		
To Gas, Water & <b>Fuel</b>	xxx		
<b>To</b> Factory Expenses	xxx		
To Royalty on Production	xxx		
To Cargo Expenses	xxx		
To Shipping Expenses	xxx		
To Import Duty	xxx		
To Custom Duty			
To Dock Charges			
To Octroi			
To Commission on Purchases			
To Gross Profit c/d*			
	xxx		xxx



Estd. 1999

**PROFIT AND LOSS ACCOUNT (Horizontal Form)**  
for the year ended....

<b>Dr</b>		<b>Cr.</b>	
<b>Particulars</b>	<b>Rs.</b>	<b>Particulars</b>	<b>Rs.</b>
To Gross Loss b/d*	xxx	By Gross Profit b/d*	xxx
<b>Office and Administrative Expenses:</b>		<b>Other Income:</b>	
To Salaries (Administrative)	xxx	By Commission Earned	xxx
To Office Rent, Rates & Taxes	xxx	By Discount Received	xxx
To Lighting	xxx	<b>Non Trading Income:</b>	
To Legal Charges	xxx	By Interest Received	xxx
To Postage	xxx	By Dividend Received	xxx
To Printing	xxx	<b>Abnormal Gains:</b>	
To Insurance	xxx	By Gain on	
To Audit Fees etc.	xxx	Sale of Fixed Assets	xxx
<b>Selling and Distribution Expenses:</b>		By Insurance Claims	xxx
To Carriage Outward	xxx	By Net Loss f	xxx
To Advertisement Expenses	xxx	(Transferred to capital account)	
To Godown Rent	xxx		
To Commission	xxx		
To Brokerage	xxx		
To Bad Debts	xxx		
To Provision for bad debts etc.	xxx		
<b>Financial Expenses:</b>			
To Interest on loans	xxx		
To Bank Charges	xxx		
To Legal Charges for arranging loans	xxx		
To Discounts and Rebate on Bills etc.	xxx		
<b>Maintenance Expenses:</b>			
To Repairs & Renewals	xxx		
To Depreciation	xxx		
<b>Abnormal Losses:</b>			
To Loss on Sale of Fixed Assets	xxx		
To Loss by Fire etc	xxx		
To Net Profit f	xxx		
(Transferred to capital account)	xxx		xxx



Estd. 1999

### Balance Sheet

Liabilities	Amount	Assets	Amount
<u>Current Liability</u>		<u>Current assets</u> Cash	
Sundry Creditors		in hand Cash at	
Bills Payable		Bank Closing	
Bank Overdraft		Stock Bills	
Outstanding Expenses		Receivable	
<u>Long term Liabilities</u>		Short-term Investment	
Share capital Reserves		Sundry Debtors	
and Surplus Debentures		<u>Fixed Assets</u>	
Long term loans		Land & Building	
		Plant & Machinery	
		Furniture	
		Vehicles	
		Goodwill	
		Copyrights	

BASIS FOR COMPARISON	TRADING ACCOUNT	PROFIT & LOSS ACCOUNT
Meaning	Trading account is an account which indicates the result of trading activities, such as purchase and sale of products.	Profit & loss account is an account, representing the actual profit earned or loss sustained by the business during the accounting period.
Preparation	It is prepared to ascertain gross profit for the period.	It is prepared to ascertain net profit for the period.
Transfer of balance	Balance of trading account is transferred to Profit & Loss Account.	Balance of profit & loss account is transferred to Capital Account.
Accounts for	Direct revenue and direct expenses	Operating and non-operating incomes and expenses.

## SELF ASSESSMENT QUESTIONS

1. Define accounting. What purpose is served by accounting?
2. Discuss the role and activities of an accountant.
3. What are the various interested parties which use accounting information? How is such information used?
4. Explain the different types of accounting.
5. Differentiate Financial Accounting and Management Accounting in detail

## SELF ASSESSMENT QUESTIONS

1. State whether the following statements are true or false:
  - a) The 'materiality concept' refers to the state of ignoring small items and values from accounts.
  - b) Accounting principles are rules of action or conduct which are adopted by the accountants universally while recording accounting transactions.
  - c) The 'separate entity concept' of accounting is not applicable to sole trading concerns and partnership concerns.
  - d) The 'dual aspect' concept result in the accounting equation:  $\text{Capital} + \text{Liabilities} = \text{Assets}$ .
  - e) The 'conservatism concept' leads to the exclusion of all unrealised profits.
  - f) The balance sheet based on 'Cost concept' is of no use to a potential investor.
  - g) Accounting standards are statements prescribed by government regulatory bodies.
  - h) Accounting statements are statements prescribed by professional accounting bodies.
  - i) Accounting concepts are broad assumptions.
2. Choose the correct answer from the alternations given:
  - (I) Accounting standards are statements prescribed by a) Law b) Bodies of shareholders c) Professional accounting bodies
  - (II) Accounting Principles are generally based on a) Practicability b) Subjectivity c) Convenience in recording



Estd. 1999

(III) The Policy of 'anticipate no profit and provide for all possible losses' arises due to convention of a) Consistency b) Disclosure c) Conservatism

(IV) Which is the accounting concept that requires the practice of crediting closing stock to the trading account a) Going concern b) Cost c) Matching

(V) The convention of conservatism, when applied to the balance sheet, results in a) understatement of assets liabilities b) understatement of c) understatement of capital.

3. Examine the role of accounting concepts in the preparation of financial statements. Do you find any of the accounting concepts conflicting with each other? Give examples.

4. Discuss briefly the basic concepts and conventions of accounting?

5. Write short notes on a) Going concern concept b) Dual aspect concept c) Business entity concept d) Convention of materiality e) Convention of conservatism.

6. Why accounting practices should be standardised? Explain.

7. What progress has been made in India regarding standardisation of accounting practices?

#### SELF ASSESSMENT QUESTIONS

1. "Recording of transaction is an important step in accounting process" Comment.

2. What is Journal? Distinguish between Journal and Journalising.

3. How you will classify the accounts? State the rules of journalising with respect to each class of accounts.

4. What will be the Journal entry in the following cases:

Loss of goods by theft

Sale and purchase of investments

Goods taken by the proprietor for his private use.

Amount paid/received on behalf of others by the business entity

Satinder, a marketer appointed at a salary of Rs. 3000 p.m.

#### SELF ASSESSMENT QUESTIONS

1. Explain the rules regarding posting of transactions into the Ledger.

2. What is a Trial Balance? Explain its objectives.



Estd. 1999

3. Discuss and differentiate between Journal and Ledger.

### SELF ASSESSMENT QUESTIONS

1. Distinguish between Trading Account and Profit and Loss Account. Give a specimen of Trading and Profit and Loss Account with imaginary figures.
2. What is a Balance Sheet? What do you understand by Marshalling used in the balance Sheet? Illustrate the different forms of marshalling.
3. What are closing entries? Give the closing entries which are passed at the end of the accounting period.
4. What are adjustment entries? Why are these necessary for preparing final account.

### References-

Financial Accounting, S.P.JAIN,K.L.NARANG

D.K,GOEL, Financial Accounting for Management

S. N. Maheswari