PART - A: FINANCIAL ACCOUNTING-I

UNIT – I: THEORETICAL FRAME WORK

CHAPTER-1

INTRODUCTION TO ACCOUNTING



Revision Notes

- > Introduction: Accounting is the language of business which helps in recording the business transactions in chronological order in the books of accounts. It records only financial transactions related to the business.
- > Accounting: According to American Institute of Certified Public Accountants "Accounting is the art of recording, classifying and summarising in a significant manner and in terms of money, transactions and events which are, in part at least of a financial character and interpreting the result thereof.
- ➤ Accounting Process :
 - (i) Recording of financial transactions in the Journal (Journalizing).
 - (ii) Recording in the Ledger (Posting to Ledger).
 - (iii) Summarising the Activities/Transactions.
 - (iv) Analysis and Interpretation.
 - (v) Communicating the results.
- > **Objectives of Accounting :** Following are the important objectives or purposes of Accounting :
 - (i) Maintaining Records.
 - (ii) Estimating Profit or Loss.
 - (iii) Presenting the financial position.
 - (iv) Providing useful information to users.
- > Advantages of Accounting
 - (i) Availability of information.
 - (ii) Identifies strength and weaknesses of business.
 - (iii) Enables comparison between time periods and similar companies.
 - (iv) Evidence in the court of law.
 - (v) Payment of tax.
 - (vi) Helps in realisation of debts.
- ➤ Limitations of Accounting
 - (i) Financial accounting is not absolutely exact.
 - (ii) Financial accounting does not show the exact worth of business.
 - (iii) Problem of window dressing.
 - (iv) Worthless assets are often shown in the balance sheet.
 - (v) No effect of inflationary trends.
 - (vi) Qualitative factors are ignored.
- > Branches of Accounting :
 - (i) Financial accounting
 - (ii) Cost accounting
 - (iii) Management accounting
- > Types of Accounting Information:

Accounting information refers to the financial statements generated through the process of Book Keeping, use of which helps the users to arrive at decisions. The financial statements so generated are the Income Statement, i.e., Profit and Loss Account and the Position Statement, i.e., Balance Sheet. The accounting information can be categorised into three types:

- (i) Information Relating to Profit or Surplus: The Income Statement makes available the accounting information about the profit earned or loss incurred as a result of business operations or otherwise during an accounting period.
- (ii) Information Relating to Financial Position: The Position Statement, i.e., the Balance Sheet provides the information about the financial position of the entity. It provides information about the assets owned by the entity, amounts receivable and the cash and bank balances held by it. These are represented in the liabilities by the amounts owed by the entity towards loans, creditors and amounts payable, and capital.

(iii) Information about Cash Flow: Cash Flow Statement is a statement that shows both inflow and outflow of cash during a specific period. It is of immense use as many decisions such as payment of liabilities, payment of dividend and expansion of business, etc., are based on availability of cash.

> Users of Accounting Information

Users of Accounting Information may be categorized into Internal Users and External Users Internal Users

- (i) Owner: To know about return of their investment, financial health of their business/company.
- (ii) Management: To evaluate the performance to take various decisions.
- (iii) Employees: To know profitability so as to claim higher wages and bonus.

External Users

- (i) Investors: To ensure safety and growth of their investments and future of the business.
- (ii) Creditors: To assess the financial capability i.e., ability of business to pay its debts.
- (iii) Lenders: To assess repaying capacity and credit worthiness of the business.
- (iv) Tax authorities: To assess the taxes due, true and fair disclosure of accounting information.
- (v) Others: Customers, researchers, etc., may seek different information for different reasons.

> Qualitative characteristics of accounting information are explained as:

- (i) Reliability: It means that the user can rely on the accounting information. All accounting information is verifiable and can be verified from the source document (voucher), viz. cash memos, bills, etc.

 Hence, the available information should be free from any errors and unbiased.
- (ii) Relevance: It means that essential and appropriate information should be easily and timely available and any irrelevant information should be avoided. The users of accounting information need relevant information for decision-making, planning and predicting the future conditions.
- (iii) Understandability: Accounting information should be presented in such a way that every user is able to interpret the information without any difficulty in a meaningful and appropriate manner.
- (iv) Comparability: It is the most important quality of accounting information. Comparability means accounting information of a current year can be compared with that of the previous years. Comparability enables intrafirm and inter-firm comparison. This assists in assessing the outcomes of various policies and programmes adopted in different time horizons by the same or different businesses. Further, it helps to ascertain the growth and progress of the business over time and in comparison to other businesses.
- > Role of Accounting in Business: The role of accounting has been changing for centuries with the changes in economic development and increasing societal demands. It describes and analyses a mass of data of an enterprise through measurement, classification and summarisation, and reduces those data into reports and statements, which show the financial condition and results of operations of that enterprise. Hence, it is regarded as a language of business. It also performs the service activity by providing quantitative financial information that helps the users in various ways.
 - Accounting as an information system provides financial information to the stakeholders of the business: management, investors and creditors. Accounting measures and summarizes the activities of the company and communicates the results to management and other interested parties. However, accounting information relates to the past transactions and is quantitative and financial in nature, it does not provide qualitative and non-financial information. These limitations of accounting must be kept in view while making use of the accounting information.

Basic Accounting Terms

- ➤ Entity: Entity means a reality that has a definite individual existence. Business entity means a specifically identifiable business enterprise like Big Bazaar, ITC Limited, Tanishq etc. An accounting system is always devised for a specific business entity (also called accounting entity).
- > Business Transaction: It is an activity that involves exchange of money or money's worth between parties and brings about a change in the financial position like purchase of goods, payment for transport, payment of wages, salaries, sale of goods, collection of money, etc. Transactions can be broadly classified into cash transactions and credit transactions depending on when the payment is made. If the payment is done immediately it is a cash transaction and if the payment is postponed to a future date, it is a credit transaction.
- > Asset: The properties owned by a business and its claims against are collectively called assets. Assets are classified into:
 - (i) Non-current Assets: These assets are meant for long term use with the aim of generating profits/incomes.
 - (ii) Current Assets: Current assets are the assets which keep on circulating from business-to-business, party-to-party. These assets are not held for permanent use. They just come into the possession of the business during normal course of business. More and more assets are added each day from one side and sold out or exchanged from the other side, which makes their balance always fluctuating. These assets can be converted into cash within one accounting year.

Examples: cash, debtors, stock of goods, etc.

- ➤ **Liability**: Liabilities are claims of creditors against the business. They are the claims on the assets or wealth of the business. **For example**, when a company borrows money it gets assets in the form of cash and at the same time it accepts a liability named as loan. Liabilities can be classified into the following categories:
 - (i) Current Liabilities: These are liabilities to be paid off within a short period, usually less than one year. These are usually paid off by current assets. Current portion of long-term liabilities are also considered as current liabilities.
 - Examples: bank overdraft, trade creditors, outstanding expenses, etc.
 - (ii) Non-current Liabilities: As the name indicates, non-current liabilities are paid off after a long period. All liabilities maturing after one year are considered as non-current liabilities. These liabilities can be settled either by payment of cash or by delivery of fixed assets or by conversion of liabilities into equity.

 Examples: mortgage loans and debentures.
 - (iii) Contingent Liabilities: Contingent liabilities are not actual liabilities. They are probable liabilities which are dependent on the happening of a certain contingency. For example, a claim against the business in court is a contingent liability. If the court decides against the business the claim becomes a real liability to pay. Other examples of contingent liabilities are loan guaranteed by the business, bills receivable discounted with the bank, etc.
- > Capital: Capital is normally understood as the owner's investment in a business. The owner's investment does not mean the exact amount he puts in to start the business. The capital of the owner will increase when he makes profit. It will decrease when he incurs a loss. If he takes out money or goods for personal use, we call it drawings. Owner's capital will reduce when he makes drawings. Infact capital is excess of total assets of the business over the liabilities. In other words, capital is the net worth of the business.

On the basis of assets owned by the company, capital can be divided into fixed capital or working capital.

The amount invested in the fixed assets of the business is known as fixed capital.

Working capital is the value of current assets over current liabilities.

Working Capital = Current Assets – Current liabilities

- > Drawings: Drawing is the withdrawal of cash or goods by the owner for personal use. In accounting this is considered as negative capital.
- > Revenue: Revenue is the increase in current assets without a corresponding increase in liability or owner's investment. According to the Financial Accounting Standard Board (FASB) revenue is "inflow or other enhancements of assets to an entity from delivering or producing goods, rendering services or other activities that constitute the entity's ongoing major or central operations."
- ➤ **Goods**: Articles purchased for sale or for use in the manufacturing of other products as raw material are known as 'Goods'. **For example**: furniture will be the goods for the firm dealing in furniture but it will be an asset for the firm dealing in stationery.
- > Stock/Inventories: The term 'stock' includes goods lying unsold on a particular date. The stock may be of two types:
 - (i) Opening stock; and (ii) Closing stock.
 - The term 'Opening stock' means goods lying unsold at the beginning of the accounting period whereas the term 'Closing stock' represents the goods lying unsold at the end of the accounting period. These can be further classified into:
 - (a) Raw materials: Goods that have been purchased and have not yet been put through the manufacturing process.
 - (b) Work-in-progress: Goods that have entered in the manufacturing process, but are not completed.
 - (c) Finished goods: Those that have completed the manufacturing process, but remain unsold.
- ➤ **Purchases**: The term 'Purchases' is used only for the purchases of goods which are purchased with the purpose of resale or to be converted into products dealt with by the firm.
 - Purchases of assets are not purchases in accounting terminology as these are not meant for sale.
- > Sales: The term 'Sales' is used only for the sale of goods which are purchased with the purpose of resale. The term 'sales' includes both cash sales and credit sales.
 - In accounting terminology, sale of assets are not sales. Sales should be of a regular nature.
- ➤ **Debtors**: The term 'Debtors' represents those persons or firms to whom goods have been sold on credit and the payment has not been received from them.
- > Creditors: A person or firm to whom an amount is owed by the business is called a 'Creditor'. For Example Mohan is a creditor of the firm if the goods are purchased from him on credit.
 - Creditors may also be creditors for expenses. It happens when certain expenses such as salaries, rent, wages, interest, etc., remain due during the accounting period.
- > **Profit**: Profits refer to the excess of 'Sales' over 'Cost of Goods Sold'. It arises from continuous business operations.
- ➤ **Income**: The term 'income' is synonymous with the term 'Profit'. It may be defined as excess of total revenues over the total expenses of the business. It is a favourable difference between the revenues and the expenses.

- Fig. Gain: 'Gain' is the term which is used for a monetary benefit, profit or advantage resulting from a business transaction other than its main operation. For example, if a building costing ₹ 4,00,000 is sold for ₹ 7,00,000, ₹ 3,00,000 will be the gain on sale of building.
- ➤ Expense: The term 'Expense' originates from the French word 'Expendre' which means to spend out. It is the amount spent in order to produce and sell the goods and services which helps to generate the revenue. 'Cost of Goods Sold' is an expense which includes all the expenses relating to purchases, transportation and storage of goods. Similarly, salaries, wages, interest, rent, advertisement, depreciation, etc. are also the examples of expense.
- > Expenditure: The amount which is spent for acquiring the fixed assets is called Expenditure. Expenditures are non-recurring in nature. Expenditure increases the profit earning capacity of the business. It may be classified into two categories: (i) Capital Expenditure, (ii) Revenue Expenditure.
 - (i) Capital Expenditure: Expenditure incurred on purchasing a fixed asset, to be used over a long period of time and/or to increase the earning capacity of a business.
 - (ii) Revenue Expenditure: Expenditure incurred to earn revenue for the current period and whose benefit gets exhausted within a years.
- > Loss: A 'loss' is the term which expresses the excess of expenses over the revenues of a business.
 - Sometimes, in addition to the above, losses convey some other meaning *viz.*, losses due to normal circumstances are known as normal losses and losses due to abnormal circumstances are known as abnormal losses. Normal losses are those recurring losses which are bound to occur in the normal course of a business operation, such as losses due to leakage, spoilage, evaporation, etc. Abnormal losses are non-recurring losses which occur due to happening of some extraordinary circumstances such as earthquake, fire, theft, flood, accident, etc.
- ➤ Outstanding Expenses: These are expenses that have been incurred for earning revenue during a period, but remains unpaid at the end of the accounting period.
- > **Prepaid Expenses**: These are expenses that have been paid in the current year, but relate to a future period or remain unexpired.



Key Words

- ➤ Capital: The amount which is invested by the owner for the commencement of business is called Capital. Capital is the excess of total assets of the business over the liabilities. In other words, capital is the net worth of the business.
 - On the basis of assets owned by the company, capital can be divided into fixed capital or working capital.
 - The amount invested in the fixed assets of the business is known as fixed capital.
 - Working capital is the value of current assets over current liabilities.
- ➤ Accounting Cycle: The accounting cycle means the sequence of steps in accounting for a financial transaction entered into by an organisation.
- Types of Business Transactions: (a) Cash Transaction, (b) Credit Transaction.

CHAPTER-2

THEORY BASE OF ACCOUNTING

Topic-1

Accounting Principles, Concepts and Assumptions



Revision Notes

Basic or Fundamental Accounting Assumptions

The financial statements, comprising the Trading A/c, Profit & Loss Account, Balance Sheet and Cash Flow Statement, that are prepared from the accounting information are published for the use by different entities, persons, etc. It is therefore essential that the published information is based on defined principles, concrete concepts and conventions. Accounting principles are the basic guidelines that provide standards for accounting

practices and procedures to be followed, so that uniformity in accounting transactions are maintained. Accounting concepts are the assumptions on the basis of which financial statements are prepared. Accounting conventions emerge out of the accounting practices that have been followed by various organizations, over a period of time. Accounting concepts, convention and principles known as GAAP *i.e.*, Generally Accepted Accounting Principles. Following are the fundamental accounting assumptions:

- Consistency assumption: According to this assumption, accounting practices once selected and adopted, should be applied consistently year after year. This will ensure a meaningful study of the performance of the business for a number of years.
- **2. Going concern assumption :** This concept assumes that an enterprise has an indefinite life or existence. It is assumed that the business has neither intention to liquidate nor to scale down its operations significantly.
- **3. Accrual assumption :** Accrual concept applies equally to revenue and expenses. As per the assumption, all revenue and cost are recognized when they are earned or incurred, not at the time when settlement is done.
- ➤ Accounting Principles/Basic Accounting Concepts:
- 1. Business Entity Principle: According to this assumption, a business unit should be understood as a separate entity apart from the businessman. Transactions of business should not be merged with the personal transactions of businessman. When the owner invests money into the business it should be assumed that the business owes money to the owner. This is known as capital. Capital is the amount which a business owes to its owner. All transactions of the business should be considered from the point of view of the business. For example, when the owner invests money into the business the accountant should consider this transaction as follows:
 - (i) The business received cash in the cash book.
 - (ii) The business owes this amount to the owner.
- 2. Money Measurement Principle: A business deals in various items, with different forms, sizes, shapes and units of measurements. For the purpose of accounting, only relevant factor of measurement is money as a measure of value. A business may own a five storied office building and a single storied factory building. A description such as 'Office buildings worth ₹ 5,50,000 and factory building worth ₹ 2,40,000' is meaningful information from the accounting point of view. When all transactions are converted into a common unit of measurement, they can be added or subtracted together, to find out their combined effect. The disadvantage of this is that money is recorded in terms of absolute value, ignoring the fluctuations due to inflation, exchange rate, etc.

 Money measurement concept restricts the scope of accounting to factors that are measurable in terms of money. It says only the transactions measurable in terms of money are to be recorded. While we can record values of various assets and liabilities, we cannot record the level of satisfaction of our customers and loyalty of our employees. We can say our customers are 'happy' or 'very happy', but we cannot write in our accounts how much our customers are happy, simply because 'happiness' cannot be measured in terms of money.
- 3. Accounting Period Principle: As per the going concern assumption the life of the business is indefinite. To assess the performance of a business, it is illogical to wait for the life of the business to come to an end and then calculate the profit or loss. To overcome this problem and for the purpose of calculation of profits, the life of the business is divided in smaller parts called 'accounting period'. An Accounting period is a segment of one year in the indefinite life of a business. This assumption helps us to: (a) Measure the progress of business accurately and on a consistent basis; (b) Facilitates comparison; (c) Match periodic revenues with expenses for getting correct business results; (d) Calculate income tax and other government dues. In India we practice two types of accounting years:
 - (i) Calendar Year (1 Jan. 31 Dec.).
 - (ii) Fiscal or Financial Year (1 Apr. 31 Mar.).
- **4. Principle of Full Disclosure :** This principle implies that the accounting report should be full and accurate. If there is any material fact which can affect the profitability of the business in future, it must disclose it to the users whether it is legally required or not. There are standard forms for Balance Sheet, Notes to Accounts for Balance Sheet and Profit & Loss Account. It is a legal requirement for joint stock companies to present information in the standardized form.
 - Disclosure of accounting information means that the management should reveal its business position correctly to the users including the facts, matters and policies which are even though not legally required but are material i.e., affect the decision making of the stakeholder.
- 5. Materiality Principle: This is a reception to the full disclosure principle. Financial statements should disclose all items that are material enough to influence decision making. Items are accounted on the basis of significance rather than accurate adherence to principles. We do classify expenses into revenue expenses and capital expenses (assets) on the basis of this principle. Purchase of a pencil is treated as an expense, not as an asset, but purchase of machine is treated as purchase of asset not as expense. So an item is material or not will depend on its nature and/or value of that item.
- 6. Conservatism or Prudence Principle: The principle of conservatism requires a business to be extremely cautious about possible losses. It should guard against any possible losses. If there is an anticipated loss, there should be adequate provision in the account. There need not to be any provision for anticipated revenue or gain. Provision for bad debts is created on the basis of this principle. When a business says they have debtors, our experience reminds us that a part of this can be lost while collecting the money by way of bad debts. We reduce bad debts from debtors to present a conservative estimate of realisable value of debts. The following examples indicate the application of conservatism in accounting:

- (i) Valuation of closing stock at cost price or market price, whichever is less.
- (ii) Creating provision for bad debts and discount on debtors, but not creating provision for discount on creditors.
- (iii) Writing off fictitious assets from the books as early as possible.
- (iv) Treating small capital expenditure as revenue item (principle of materiality is also involved here).
- 7. Cost Concept: All fixed assets should be recorded in the books of accounts at the historical cost. Historical cost is the cost at which an asset is originally acquired. It includes all the acquisition and installation cost, as it is highly objective and free from bias. This is the cost to be considered for accounting purpose.
- 8. Matching Principle of Revenue and Expenses: Matching principle suggests that we must match the revenue of a particular period with expenses of that particular period only to get correct profits. Business is carried out with the intention of making profits. Profit is the excess of revenue over expenditure. It is the net increase in assets due to business activity. To ascertain the profit for a period, a businessman must identify the revenue for a period, and compare it with the expenses related to earn that revenue. When his revenue is more than the expenditure, he has earned profit. This requires adjustments of certain items like prepaid and outstanding expenses, accrued and advance income. A calculator is traditionally an asset, as it has a life of more than one year. However, the cost of it is insignificant and hence, we depreciate it at 100% in the year of purchase. The cost is relatively, to be shown in the Balance Sheet of a company. What is material and immaterial depends not only on the cost of the item, but also on the size of a business. What is most important is that the omission of any information should not affect the decision-making of the user.
- 9. **Dual Aspect Principle :** This principle is the backbone of accounting. Every business transaction affects at least two aspects in a business. When we buy goods, we get goods and pay cash. When we sell goods we give goods and get cash. Accounting is much more than just buying and selling. Dual aspects is involved in every transaction and event which gives rise to the basic accounting equation, Equity + Liabilities = Assets.
- 10. Revenue Recognition Principle: This principle suggests that revenue should be recognized as realised when:
 - (i) Earning process is reasonably complete,
 - (ii) The amount is capable of objective measurement,
 - (iii) It is realised in the form of cash or any other asset or an obligation to realise it in future is established.

Merely getting an order from a customer is not regarded as a sale.

A sale transaction is complete when goods are delivered at an agreed price and the customer has paid the money or accepted his liability to pay the money. A sale can be considered complete even though the buyer has not taken delivery of goods due to his own reasons, if the ownership of the goods is transferred to the buyer and seller got an asset in exchange either as cash or as a debtor.

Revenue from sale should be recognized during the period in which the sale occurred. For example, if goods are sold in December and money received in January, it is considered as the income for December.

Revenue from services should be recognized for the period in which service is rendered. If the workers of a cleaning company worked in the month of March and the company received payment in April, it is the income for March not for April.

Revenue from disposal of assets is recognized at the time of sale.

- 11. Objectivity Concept: According to this principle, a business transaction should be supported by documentary evidence. No entry shall be passed without its supporting documents. Objectivity means the document should contain facts in an unbiased manner. Accounting should be done without favour or prejudice. This concept will thus ensure the dependability, reliability and trust worthiness of the accounting information.
- 12. Going Concern Concept: The concept of going concern assumes that a business firm would continue to carry out its operations indefinitely, i.e. for a fairly long period of time and would not be liquidated in the foreseeable future. This is an important assumption of accounting as it provides the very basis for showing the value of assets at their original cost and they are depreciated in a systematic manner over their expected useful life in the balance sheet.
 - For example, a machine purchased is expected to last 10 years. The cost of the machinery is spread on a suitable basis over the next 10 years for ascertaining the profit or loss for each year. The total cost of the machine is not treated as an expense in the year of purchase itself.
- 13. Consistency Concept: The accounting information provided by the financial statements would be useful in drawing conclusions regarding the working of an enterprise only when it allows comparisons over a period of time as well as with the working of other enterprises. Thus, both inter-firm and inter-period comparisons are required to be made. This can be possible only when accounting policies and practices followed by enterprises are uniform and are consistent over the period of time.

To illustrate, an investor wants to know the financial performance of an enterprise in the current year as compared to that in the previous year. He may compare this year's net profit with that in the last year. But, if the accounting policies adopted, say with respect to depreciation in the two years are different, the profit figures will not be comparable. Because the method adopted for depreciation in the past two years is inconsistent. It is, therefore, important that the concept of consistency is followed in preparation of financial statements so that the results of two accounting periods are comparable. Consistency eliminates personal bias and helps in achieving results that are comparable. However, consistency does not prohibit change in accounting policies. Necessary required changes are fully disclosed by presenting them in the financial statements indicating their probable effects on the financial results of business.



Key Words

- Accounting Concepts: The term concepts refer to the necessary assumptions, rules and basic theoretical ideas which are fundamental to accounting practice.
- **Convention:** The term convention refers to customs or traditions as a guide to the preparation of accounting statements.
- Postulates: Postulates imply basic assumptions which are accepted by all.
- ➤ **Revenue Recognition concept**: It provides a standard for recognising the revenues.

Topic-2 Accounting Standards and GST



Revision Notes

Accounting Standards

> History: Financial results of a business are communicated to the various users through accounting, which is regarded as the language of business. With the increasing diversity, complexity and globalization of business transactions, it became essential for the diverse accounting policies and practices that were being followed to become standardized. A need was felt for the introduction of certain minimum standards of accounting policies and practices to be universally applicable, which ensures transparency, consistency, comparability and reliability of the financial reporting.

The 1st step in the process of developing Accounting Standards was the formation of the International Accounting Standards Committee.

IASC is now renamed as International Financial Reporting Board, in the year 1973. The objective of this Board is to (a) formulate the Accounting Standards and (b) work for its improvement.

- Meaning: Accounting Standards can be understood as a set of guidelines issued by the accounting organization of a country (the Institute of Chartered Accountants of India) to be adopted in the preparation and presentation of financial statements. The idea behind this, is to standardize the diverse accounting practices that exist for the various aspects of accounting.
- Purpose : The Accounting Standards, being mandatory, help in :
 - (i) Comparing financial statements easily, thereby improving their reliability.
 - (ii) Providing a set of standard accounting policies, valuation norms and disclosure requirements.
 - (iii) Reducing the scope of creative accounting i.e., interpreting the accounting policies for a favourable presentation of financial statements to a particular group.

Benefits:

- (i) Eliminates variations in accounting treatment, where alternatives exist.
- (ii) Disclose certain important information, not statutorily required.
- (iii) Helps comparison of financial statements of different organizations within and outside the country.
- (iv)Helps auditors while auditing accounts.
- (v) Gives confidence to the users of accounting information.

➤ Limitations :

- (i) Where alternative accounting treatment exists, choosing one particular treatment, may be difficult to choose and explain.
- (ii) There may be a tendency to rigidly follow the Accounting Standards, thereby moving away from its flexible nature.
- (iii) They cannot override statute and have to abide by the laws prevalent in a country and where there is a conflict between the two, the laws of a country shall prevail.

> Indian Accounting Standards

With the growth in Indian economy during the last few years, the importance of Accounting Standards, as a means of ensuring transparent financial reporting by corporate was increasingly being felt. As cross border capital investments were taking place, the adherence to Generally Accepted Accounting Principles (GAAP) in India, is viewed positively, as falling in line with International and National expectations. The Institute of Chartered Accountants of India is the premier accounting organization in India that took up the task of formulating Accounting Standards and formed the Accounting Standards Board (ASB) in 1977. The primary task of this body was to harmonize the diverse accounting policies and practices followed in India. The process of setting the Accounting Standards are:

- (i) Identify the areas where alternative and diverse practices were being followed.
- (ii) Preparing the preliminary drafts of the proposed standards to bring about a uniformity in practices, within the legal framework, applicable laws, customs and usage, of our country. Also, due consideration is given to the IFRS (International Financial Reporting Standards) and trying to integrate the two to the extent possible.
- (iii) Circulation of the draft among various organizations like SEBI (Securities and Exchange Board of India), Confederation of Indian Industries, Department of Company Affairs, Indian Banks Association, Comptroller and Auditor General of India etc. to ascertain their views on the proposed standards.
- (iv) Finalizing the proposed draft after considering the comments and discussions of the various organizations.
- (v) Issuing the final Accounting Standards under the authority of the Council of Institute of Chartered Accountants of India.
- > GST: Goods and Services Tax is a comprehensive indirect tax levied at the prescribed rate on every supply, *i.e.*, sale of goods and/or services except on petroleum and alcohol for human consumption.

Characteristics of GST :

- It is a comprehensive indirect tax which has replaced all indirect taxes levied earlier except custom duty.
- (ii) It is a value added tax as GST paid is set off against GST collected.
- (iii) GST Paid is not cost to purchases but an asset.
- (iv) GST rate on each category is uniform on goods and services across all states.

Advantages of GST :

- (i) Developing common National Market by having one Indirect Tax.
- (ii) Ease of running the business by registering under one Indirect Tax only.
- (iii) Decrease in cost of goods by removing cascading effect of Indirect Taxes.
- (iv) To simplify indirect tax regime by having one tax and fewer rates of taxes.
- (v) Effective and better Indirect Tax management.
- (vi) To make goods cheaper.
- (vii) Attracting Foreign Direct Investment(FDI).
- (viii) Uplifting Gross Domestic Product(GDP)
- (ix) Eradicating cash economy.



Key Words

- Accounting Standards: It can be understood as a set of guidelines issued by the accounting organization of a country (the Institute of Chartered Accountants of India) to be adopted in the preparation and presentation of financial statements.
- > GDP: Gross Domestic Product.

Topic-3

System and Basis of Accounting



Revision Notes

- Systems of Accounting: Transactions may be recorded in the books of accounts under any of the two systems mentioned below:
- (i) Double Entry System: Every transaction has two aspects one aspect is debit and the other aspect is credit. When both the aspects of a transaction are recorded in the books of accounts, it is said that the accounts are maintained under Double Entry System. One aspect is the debit and the other aspect is the credit for e.g., when goods are purchased for cash, the two aspects are that the goods are received and cash is given out. Following the accounting rules, goods are debited when received and cash is credited by the same amount, when paid out. Thus, the sum total of all the transactions on the debit side must equal to that of the credit side under this system. Since it establishes the arithmetical accuracy of transactions, it is said that the Double Entry system is scientific and complete.

Advantages of Double Entry System :

- (a) Complete record of transactions are maintained.
- (b) It is a scientific method of recording transactions.
- (c) Establishes the arithmetical accuracy of recording transactions.
- (d) Helps in preparing financial statements without delay.
- (e) Helps in tracking/reducing errors and frauds.
- (f) Decision making is facilitated as comparison between two years can be easily done.
- (ii) Single Entry System: Under this system, both the aspects of a transaction may not be recorded or one aspect is recorded and the other is not. Only cash book and Personal accounts are maintained, leading to an incomplete record of transactions. Hence, it is also known as Accounts from Incomplete Records. Transactions recorded under this system are incomplete and hence unreliable. Since the double entry principle is not followed, a Trial Balance cannot be prepared, which makes it impossible to prepare the Final Accounts.
- Basis of Accounting: Transactions may be entered in the books of accounts under either of the following two basis:
- (i) Cash Basis of Accounting: Under cash basis of accounting, transactions are entered when actual cash is received or paid out. This implies that revenue is recognized at the time of actual realisation and not when the right or obligation to receive the money arises. Likewise, expenses are recorded when the actual payment is made and not when the benefit has been received. The total income is the difference between the cash income and cash payment. This system of recording does not take into account outstanding expenses or accrued income for a current year. Likewise, no adjustment is done in the current year for expenses that are prepaid or income received in advance. Cash basis of accounting is mainly followed by 'Non-profit organizations.

> Advantages:

- (a) Accounting under this method is simple as adjustments for outstanding expenses, prepaid expenses are not required.
- (b) It is more objective as use of personal judgments and estimates are minimized.
- (c) Suitable for Non-profit organizations and other organizations that mainly deal in cash transactions.

> Disadvantages:

- (a) Not recognized under the Companies Act.
- (b) Does not give a true and fair view of Profit and Loss and Balance Sheet, as expenses relating to outstanding and prepaid and incomes relating to advance and accrued are not adjusted as required under the Matching Principle.
- (c) Does not distinguish between capital and revenue expenditure, making comparisons between two years inconsistent and impractical.
- (ii) Accrual Basis of Accounting: Under this system, income is recorded when the right to receive the money is established against a service rendered or sale made. It is immaterial whether the amount has been actually received or not. On the other hand, expenses are recorded as soon as they are incurred, irrespective of whether the payment has been made or not. This system of accounting thus takes into account adjustments relating to outstanding and prepaid expenses and also advance and accrued income, thereby following the Matching Concept Principle. The difference between the total income and total expense is the profit or loss for the year.

> Advantages:

- (a) Gives a true and fair view of the Profit & Loss and financial Position, as adjustments relating to outstanding and prepaid expenses and accrued and advance income are taken into account.
- (b) More scientific as compared to cash basis.
- (c) Recognized under the Companies Act and used more widely by business enterprises.
- (d) Distinguishes between capital and revenue expenditure.

> Disadvantages:

- (a) More complex than cash basis as adjustments need to be made.
- (b) Adjustments and estimates may become subjective to the accountants view.
- (c) Since adjustments are to be made, it is not easy to ascertain the Profit & Loss and the Financial Position of a company.

UNIT - II: ACCOUNTING PROCESS

CHAPTER-3

RECORDING OF BUSINESS TRANSACTIONS-I

Topic-1

Source Document and Rules of Debit and Credit



Revision Notes

> Business transactions are exchange of economic consideration between parties and have two-fold effects that are recorded in two or more accounts. Business transactions are usually evidenced by an appropriate document such as Cash memo, Invoice, Sales bill, Pay-in-slip, Cheque, Salary slip, etc. A document which provides evidence of the transactions on the basis of which entries are made in subsidiary books is termed as *Source Document or a Voucher*.

These are also known as supporting documents.

- > Vouchers can be classified into:
- (i) Source / Supporting Vouchers : Some of the common source documents are as under :
- (a) Cash Memo: When goods are sold for cash, the document prepared by the seller to evidence the transactions is known as Cash Memo. This has the details of date of transaction, item sold, quantity sold, rate of each item, total amount received and other terms and conditions of sale. For the purchaser, this serves as an evidence for the goods purchased by him.
- (b) Invoice / Bill: When goods are sold on credit, an Invoice is prepared. This contains details of the party to whom goods are sold, the date of transaction, items sold, quantity sold, total sales value. This is usually prepared in triplicate; the original is given to the purchaser, one copy is sent to the accounts department and the third copy is retained by the sales department.
- (c) Receipt Vouchers: A receipt voucher is prepared to record a receipt by cash or through cheque. This is usually prepared in duplicate, with the original being given to the party giving the payment and the duplicate serving as an office copy for entry into the accounting records. Details of date, amount received, person giving the payment are mentioned on this receipt.
- (d) Pay-in-slip: This is a document used for depositing cash or cheque into the bank and is printed / available with the Bank.
- (e) Cheque: This is a negotiable instrument, payable on demand and drawn upon the bank, to pay a specific amount of money
- (f) Debit note: This is a document prepared when a person's/party's account is to be debited, which is usually done under two circumstances:
 - (a) by a seller, if he has undervalued his goods or
 - (b) by a purchaser, if the goods have been overvalued/he has returned goods/seller has given lower discount.
- **(g) Credit note :** This is a document prepared when a person's/party's account is to be credited, which is usually done under two circumstances :
 - (a) by the seller, if he has overvalued his goods/a customer has returned goods/he offers more discount or
 - (b) by a purchaser, if the goods are undervalued.
- (ii) Accounting vouchers: Based on the supporting vouchers, an accountant, before making these entries in the books of accounts, records the details of the accounts to be debited and/or credited on a document. It is referred to as Accounting Voucher. The types of accounting vouchers are:
- (a) Cash Voucher: This is prepared at the time of receipt or payment of cash. When cash is received, a credit note is prepared as we have to credit the account for which cash is being received. A debit cash voucher is prepared when cash is paid, as we have to debit the account for which payment is being made.
- **(b) Non-cash/Transfer Voucher :** These are prepared for non-cash transactions like credit sale, credit purchases, for rectifying mistakes.

A transaction with one debit and one credit is a simple transaction and the accounting vouchers prepared for such transaction is known as Transaction Voucher.

Transactions with multiple debits and multiple credits are called complex transactions and the accounting voucher prepared for such transaction is known as Complex Voucher/ Journal Voucher.

➤ Accounting Equation: The relationship of assets with liabilities and owner's equity in equation form is known as Accounting Equation. It is a mathematical expression which shows that the assets and liabilities of a firm are equal.

Accounting equation signifies that the assets of a business are always equal to the total of its liabilities and capital (owner's equity). The equation reads as follows:

$$A = L + C$$

where, A = Assets, L = Liabilities, C = Capital

Under Double Entry System, every transaction has a double effect that changes the assets, liabilities and capital in such a way that the accounting equation is complete and equal. This accounting equation holds good under all circumstances and for any number of transactions, except when errors occur in the accounting process. Accounting Equation is also known as Balance Sheet Equation.

> Rules of Debit and Credit

To enter the transactions into the books of entry, the first step is to analyse each transaction and find out which account has to be debited and which is to be credited. To help this process, two approaches exist:

- (i) Traditional Approach: Under this approach, accounts are classified into:
- (a) Personal accounts: These include accounts relating to persons like customers, suppliers, individuals, firms, persons, etc. The proprietor/ partners of a business, being a person, their capital contribution is treated as a personal account. Personal accounts may be classified into:
- (1) Natural Personal Accounts: Dealing with transactions relating to human beings.
- (2) Artificial (Legal) Personal Accounts: Where business entities are treated separate from the owners, they acquire a separate legal entity in the eyes of law. Examples are Government companies, Cooperative societies, Companies (Ltd. or Pvt. Ltd).
- (3) Representative Personal Accounts: These are accounts that represent a group of persons, like outstanding salary (representing the persons to whom salary is owed), prepaid accounts, etc. and are not in the name of any particular person.
- (b) Impersonal Accounts: These are accounts that are not personal like computers, building, salary, rent, etc. and can be further divided into:
- (1) Real accounts: Representing assets (other than debts) of the firm like building, computers, cash in hand, goodwill, patents etc. These include tangible and intangible assets.
- (2) Nominal accounts: Accounts relating to expense, loss, income and gain like rent paid, dividend received, etc., the net effect of which gives us the profit/loss of a firm.
- ➤ Golden Rules of Accounting Based on Traditional Method :
- (i) Personal Account: Debit the Receiver and Credit the Giver.
- (ii) Real Account: Debit what comes in and Credit what goes out.
- (iii) Nominal Account: Debit all Expenses and Losses and Credit all Incomes and Gains.
- (ii) Modern Approach: Accounts are classified into five categories:
- (a) Assets: Include accounts of assets which an organization owns or has the right of property. All assets have debit balances and are shown in the Balance Sheet, *e.g.*, Machinery, cash, debtors, etc.
- **(b) Liabilities :** These are amounts owed to outsiders and have credit balances. They are represented in the Balance Sheet. *e.g.* Creditors, Bank loan, outstanding expenses, etc.
- **(c) Capital:** These are amounts invested by the proprietor/partners in a business. They usually have credit balances and are shown in the Balance Sheet.
- **(d) Revenue**: Accounts of incomes and gains are called Revenue. These have credit balances, and are shown on the credit side of Profit & Loss account/ Income and Expenditure account. *e.g.* Sales, dividend received, etc.
- **(e) Expense :** The accounts relating to amount spent for business or loss incurred are called Expenses. *e.g.* Salary, commission paid, purchases, etc. These have debit balances and are shown on the debit side of Profit & Loss account/ Income and Expenditure account.
- > Two fundamental rules are followed to record the changes in these accounts :
- (i) For recording changes in Assets/Expenses (Losses):
- (a) "Increase in asset is debited, and decrease in asset is credited."
- (b) "Increase in expenses/losses is debited, and decrease in expenses/losses is credited."

- (i) For recording changes in Liabilities and Capital/Revenues (Gains):
- "Increase in liabilities is credited and decrease in liabilities is debited."
- (b) "Increase in capital is credited and decrease in capital is debited."
- (c) "Increase in revenue/gain is credited and decrease in revenue/gain is debited."



Key Words

- Complex voucher/ Journal voucher: Transactions with multiple debits and multiple credits are called complex transactions and the accounting voucher prepared for such transaction is known as Complex Voucher/ Journal Voucher.
- **Vouchers**: (a) Supporting Vouchers, (b) Accounting Vouchers.
- Supporting Vouchers: (a) External Supporting Vouchers, (b) Internal Supporting Vouchers.
- ➤ Accounting Vouchers : (a) Cash Vouchers, (b) Non-Cash Vouchers.
- Cash Vouchers: (a) Debit Vouchers, (b) Pay in slip, (c) Credit Vouchers.
- Non-cash Vouchers: (a) Invoice or Bill, (b) Debit Note, (c) Credit Note.

Topic-2 Journal



Revision Notes

- > Journal: Business transactions are first recorded in the books of Prime Entry or Original Entry called 'Journal'. Here, transactions are recorded in chronological order i.e., as and when they occur. The process of recording transactions in a journal is called 'Journalising' and the entry made in this book is called 'Journal Entry'. Journal entries can be of two types:
- (i) Simple Journal entry: A transaction that has only one debit and credit of the same amount, is referred to as a Simple Journal entry.
- (ii) Compound Journal entry: A transaction that has one debit and two or more credits or vice- versa, is referred to as a Compound Journal entry.
- > Functions of a Journal:
- (i) Transactions are analysed according to the debit and credit aspect, thereby finding out how each transaction will financially affect the business.
- (ii) Transactions are recorded with a brief narration that explains the transaction in simple language. It starts with the word (Being.... or For.....)
- (iii) It contains a chronological record of transactions for future reference.
 - ➤ Advantages of a Journal :
 - (i) Information about business transactions can be easily obtained on timely basis, as transactions are recorded in a chronological order.
- (ii) With the help of the narration that is mandatory for every transaction, it is possible to understand the correct nature of the entry.
- (iii) Chances of errors are minimized, as both debit and credit aspects are recorded.
- (iv) They form the basis for posting entries into the ledger.
 - > Opening Entry: Opening entry is an entry passed to record the opening balances of the various accounts transferred from the previous year to the new year. The accounts that are appearing on the assets side of the Balance sheet in the previous year are debited in the opening entry, while those accounts appearing on the liabilities side of the Balance sheet in the previous year are credited in the opening entry.

CHAPTER-4

RECORDING OF BUSINESS TRANSACTIONS-II

Topic-1 Cash Book



Revision Notes

- > Cash Book: Cash Book is a book in which all transactions relating to cash receipts and cash payments are recorded.
 - Cash Book is both a subsidiary book as well as a principal book. As a subsidiary book, it records all the cash transactions. Ledger accounts are prepared on the basis of each book records. Thus, it is a book of original entry or a subsidiary book. Cash Book represents cash account. Cash balance is directly entered in the trial balance from Cash Book. Therefore, it is a part of ledger also. Hence, it is also treated as a principal book of accounts. The Cash Book is thus, both a subsidiary book and a principal book. It is also known as Journalised Ledger.
- > Single Column Cash Book: The single column Cash Book records all cash transactions of the business in a chronological order, i.e., it is a complete record of cash receipts and cash payments.
- > Double Column Cash Book: In this type of Cash Book, there are two columns of amount on each side of the Cash Book, one for cash and other for bank transactions. The bank column is balanced in the same way as the cash column. However, in the bank column, there can be credit balance also because of overdraft taken from the bank. Overdraft is a situation when cash withdrawn from the bank exceeds the amount of deposit.
- > Petty Cash Book: This book is used for recording payment of petty expenses, which are of smaller denominations like postage, stationery, conveyance, refreshment, etc.
- > Advantages of Petty Cash Book

Following are the important advantages of maintaining a Petty Cash Book:

- (i) It saves the time of main cashier.
- (ii) It helps in controlling the petty expenses.
- (iii) Posting from Petty Cash Book is made at the end of a specified period. It saves the time and simplifies the posting.
- (iv) When expenses paid are reimbursed to petty cashier, these are checked by the main cashier. It reduces the chances of errors and frauds.
- > Imprest system of Petty Cash Book:

Under the imprest system, a fixed amount is advanced to the petty cashier to make the payments. The amount given to the petty cashier is known as 'imprest amount'. The amount is determined on the basis of past experience in such a way that it will be sufficient to meet the requirements for a given period. The period may be a week, a fortnight or a month. At the end of this period, the expenses paid by the petty cashier are reimbursed to him. Thus, he will again have the imprest amount in the beginning of the next period.

Petty Cash Book can be prepared in two formats. One is the simple Petty Cash Book, which is not used in practical. The second format is 'Analytical Petty Cash Book'.

Topic-2

Other Subsidiary Books and Ledger



Revision Notes

- Purchases Book: All credit purchases of goods are recorded in the purchases journal. i.e., Purchases Book
- > Purchases Returns Book: In this book, returns of goods earlier purchased are recorded.
- Sales Book: All credit sales of goods are recorded in the sales journal. Cash sales are recorded in the Cash Book.
- Sales Returns Book: This journal is used to record returns of goods by customers which were sold to them on credit.

- **Journal Proper:** A book maintained to record transactions, which do not find place in the above subsidiary books journals, is known as Journal Proper or Journal Residual.
- Purpose of maintaining subsidiary journal.
 - The purposes of maintaining subsidiary Journals are given below:
- (i) It saves time and efforts in recording.
- (ii) It enables division of work, leading to an enhancement of efficiency and effectiveness, as particular accountant takes care of particular books.
- (iii) It also makes each accountant more responsible and accountable for the books assigned to them.
- > Advantages of Sub-dividing the Journal:
- (i) Division of work: Since in the place of one Journal there will be so many subsidiary books, the accounting work may be divided amongst a number of clerks.
- (ii) Specialisation and efficiency: When the same work is allotted to a particular person over a period of time, he acquires full knowledge of it and becomes efficient in handling it. Thus, the accounting work will be done efficiently.
- (iii) Saving of time: Various accounting processes can be undertaken simultaneously because of the use of a number of books. This will lead to the work being completed quickly.
- (iv) Availability of information: Since a separate register or book is kept for each class of transactions, the information relating to each class of transactions will be available at one place.
- (v) Facility in checking: When the trial balance does not agree, the location of the error or errors is facilitated by the existence of separate books. Even the commission of errors and frauds will be checked by the use of various subsidiary books.
- Ledger: The entries recorded in the Journal are subsequently classified and grouped into different accounts i.e., transactions relating to a similar nature are categorized under one head in a separate book called 'Ledger'. The process of transferring entries from the Journal to the Ledger is called Posting. Ledger, is the Principal book of account, in which the balances of each account can be obtained. Accounts are in the form of a "T" shape and has two sides – the left side represents Debit (Dr.) and the right side represents Credit (Cr.). Once the entries are posted into the respective accounts, the balance in the accounts are obtained.
 - Only Real Accounts and Personal Accounts are balanced. Nominal accounts are not balanced as the balance at the end is transferred to the Trading A/c or Profit & Loss account.

Distinction between Journal and Ledger:

Basis	Journal	Ledger
(i) Nature	Book of Primary Entry.	Book of Final Entry.
(ii) Evidence Source Voucher Entries in the		Entries in the Journal.
(iii) Need	To record all transactions in chronological order.	To calculate the balances in every account.
(iv) Balance	Not balanced.	Real and Personal accounts are balanced.
(v) Process	The process of making entries is called journalising.	The process of recording entries in the ledger is called 'Posting'.
(vi) Relation with Final accounts	Do not have any direct relation with Final Accounts.	Forms the basis for preparing the Final accounts.

> Balancing of account: Account in the ledger is periodically balanced, generally at the end of the accounting period, with the object of ascertaining the precise position of the business firm with regard to them. Balancing of an account means that the two sides are totalled and the difference between them is inserted on the side, which has the less balance in order to make their totals equal. The word 'balance c/d' are written against the amount of the difference between two sides. The amount of balance is brought down in the next accounting period indicating that it is a continuing account, till finally settled or closed

In case the debit side exceeds the credit side, the difference is written on the credit side, if the credit side exceeds the debit side, the difference between the two appears on the debit side and is called debit and credit balance respectively. The accounts of expenses/losses and gains/revenues are not balanced but are closed by transferring to profit & loss account.

CHAPTER-5

BANK RECONCILIATION STATEMENT



Revision Notes

- ➤ Bank Reconciliation Statement: It is a statement prepared to reconcile the bank balance as per Cash Book with the balance as per pass book or bank statement, by showing the items of difference between the two accounts.
- > Causes of Difference :
 - (i) Due to different timing of recording the transactions.
 - (ii) Error made by business or by the bank.
- > Types of Difference:
- (A) Transactions shown in Cash Book Only:
 - (i) Cheques issued but not yet presented in the bank for payment.
 - (ii) Cheques deposited into bank but not yet credited or collected.
 - (iii) Cheques deposited into bank, but dishonoured.
- (B) Transactions shown in Pass Book Only:
 - (i) Interest allowed or credited by bank.
 - (ii) Interest charged or debited by bank.
 - (iii) Bank charges and commission charged by the bank.
 - (iv) Direct deposit into the bank by a customer.
 - (v) Payments made by the bank as per customer's standing instructions.
 - (vi) Payments collected by the bank.
 - (vii) Bills collected by the bank on behalf of the customer.
 - (viii) Dishonour of a bill discounted with the bank.

(C) Errors

It may be possible that while recording transactions in the Cash Book, the accountant might have committed some errors. Errors may also be committed by the bank in the firm's account. These error will also cause difference in bank balance shown by Cash Book and the Pass Book.

Need for the Preparation of BRS

Preparation of bank reconciliation statement is necessary due to following reasons :

- (i) It helps the management in checking the accuracy of entries recorded in Cash Book.
- (ii) It helps in keeping the track of cheques etc., sent to the bank for collection. Any undue delay in the clearance of cheques can be noticed.
- (iii) It helps in bringing out any errors that may have been committed either in cash book or in the pass book.
- (iv) A regular reconciliation discourages the staff of the firm or of the bank from embezzlement of funds.
- > For the purpose of audit, bank balance shown in balance sheet must be supported by a bank statement or pass book. The bank reconciliation statement explains any difference which have not been adjusted in the Cash Book.
- > Steps in Preparation of BRS:
 - (i) Step 1: Comparing bank column of Cash Book with Pass Book or Bank Statement: This step helps in finding the causes of difference in the bank balance shown by Cash Book and by Pass book. Whenever a bank statement or Pass book is received from the bank, it should be compared and points of difference should be noted. These may be: Cheques issued but not presented, cheques deposited but not collected, bank charges debited by bank, etc.
 - (ii) Step 2: Preparing Bank Reconciliation Statement: There are two types of formats used to prepare Bank Reconciliation Statement. Bank reconciliation statement may be started either with the bank balance shown by Cash Book or the balance shown by Pass Book. The points of difference are adjusted accordingly to find the balance shown by the other. If bank reconciliation statement is started with the bank balance as per Cash Book, after adjustments, we can find out the balance shown by Pass Book. Alternatively, if it is started with the balance shown by Pass Book, we shall find the bank balance shown by Cash Book

Format Bank Reconciliation Statement (as on)

	Parti arriano	Details	Amount
	Particulars	(₹)	(₹)
	Debit balance or bank balance as per Cash Book		×××
<i>Add</i> : (i)	Cheques issued or drawn but not yet presented for payment or		
711111 . (1)	cashed by the customers or debited in the Pass Book.	×××	
(ii)	Interest allowed or paid or collected or credited by the bank but not yet entered in the Cash Book or dividend directly collected by the bank.	×××	
(iii)	Cheques directly deposited by the customer into our account or the amount directly collected by the bank but not entered in the Cash Book.	×××	
(iv)	Cheques paid into bank but omitted to be entered in the Cash Book.	$\times \times \times$	
(v)	A bill payable retired by the bank under rebate, but full amount was credited in bank column (For rebate).	×××	
(vi)	Cheques issued but dishonoured.	×××	
(vii)	Cheque deposited in the bank but excess amount was credited by bank. (For difference).	×××	
(viii)	Any amount wrongly credited by the bank in the Pass Book.	×××	$\times \times \times$
Less: (i)	Cheques deposited or paid into bank but not yet collected or		
	cleared or credited by the bank.	×××	
(ii)	Interest on overdraft or interest charged or debited by the bank but not yet entered into Cash Book.	×××	
(iii)	Bank charges or collection charges or locker's rent charged and debited by the bank in the Pass Book but not entered in the Cash Book.	×××	
(iv)	Insurance premium or the rent of the shop or issue of the bank draft by the bank on our instruction or any other payment made by the bank on our behalf but not entered in the Cash Book.	×××	
(v)	Cheques deposited into bank but dishonoured.	×××	
(vi)	Discounted B/R dishonoured.	×××	
(vii)	B/R deposited into bank but dishonoured.	×××	
(viii)	Cheques entered in the Cash Book but omitted to be banked.	×××	
(ix)	Ch <mark>eques deposi</mark> ted in the bank but the bank credited fewer amounts (For difference).	×××	
(x)	Any amount wrongly debited by the bank in the Pass Book.	×××	×××
	Debit/Credit Balance as per Pass Book		×××

Bank Reconciliation Statement as on

Particulars		Details (₹)	Amount (₹)
	Overdraft as per Pass Book or Debit balance as per Pass Book		×××
<i>Add</i> : (i)	Cheques deposited or paid into bank but not yet collected or cleared or credited by the bank.	×××	
(ii)	Interest on overdraft or interest charged or debited by the bank.		
	but not yet entered into Cash Book.	$\times \times \times$	
(iii)	Bank charges or collection charges or locker's rent charged and debited by the bank in the Pass Book but not entered in the Cash Book.	×××	

(iv)	Insurance premium or the rent of the shop or issue of the bank draft by the bank on our instruction or any other payment made by the bank on our behalf but not entered in the Cash Book.	×××	
(v)	Cheques deposited into bank but dishonoured.	×××	
(vi)	Discounted B/R dishonoured.	×××	
(vii)	B/R deposited into bank but dishonoured.	×××	
(viii)	Cheques entered in the Cash Book but omitted to be banked.	×××	
(ix)	Cheques deposited in the bank but the bank credited fewer amounts (For difference).		
(x)	Any amount wrongly debited by the bank in the Pass Book.	XXX	XXX
		(×××
Less: (i)	Cheques issued or drawn, but not yet presented for payment or cashed by the customers or debited in the Pass Book.	×××	
(ii)	Interest allowed or paid or collected or credited by the bank but not yet entered in the Cash Book or dividend directly collected by the bank.	×××	>
(iii)	Cheques directly deposited by the customer into our account or the amount directly collected by the bank but not entered in the Cash Book.	×××	
(iv)	Cheques paid into bank but omitted to be entered in the Cash Book.	×××	
(v)	A bill payable retired by the bank under rebate, but full amount was credited in bank column (For rebate).	×××	
(vi)	Cheques issued but dishonoured.		
(vii)	Cheque deposited in the bank but excess amount was credited by bank. (For difference).	×××	
(viii)	Any amount wrongly credited by the bank in the Pass Book. Debit/Credit Balance (or overdraft) as per Cash Book	×××	×××

Bank Reconciliation Statement as on

	Particulars	Details (₹)	Amount (₹)
	Credit balance or bank balance as per Pass Book		×××
Add : (i)	Cheques deposited or paid into bank but not yet collected or cleared or credited by the bank.	×××	
(ii)	Interest on overdraft or interest charged or debited by the bank but not yet entered into Cash Book.	×××	
(iii)	Bank charges or collection charges or locker's rent charged and debited by the bank in the Pass Book but not entered in the Cash Book.	×××	
(iv)	Insurance premium or the rent of the shop or issue of the bank draft by the bank on our instruction or any other payment made by the bank on our behalf but not entered in the Cash Book.	×××	
(v)	Cheques deposited into bank but dishonoured.	×××	
(vi)	Discounted B/R dishonoured.	×××	
(vii)	B/R deposited into bank but dishonoured.	×××	
(viii)	Cheques entered in the Cash Book but omitted to be banked.	×××	
(ix)	Cheques deposited in the bank but the bank credited fewer amounts (For difference).	×××	
(x)	Any amount wrongly debited by the bank in the Pass Book.	×××	xxx
			×××

Less: (i)	Cheques issued or drawn but not yet presented for payment or		
	cashed by the customers or debited in the Pass Book.	×××	
(ii)	Interest allowed or paid or collected or credited by the bank but not yet entered in the Cash Book or dividend directly collected by the bank.	×××	
(iii)	Cheques directly deposited by the customer into our account or the amount directly collected by the bank but not entered in the Cash Book.	×××	
(iv)	Cheques paid into bank but omitted to be entered in the Cash Book.	×××	
(v)	A bill payable retired by the bank under rebate, but full amount was credited in bank column (For rebate).	×××	
(vi)	Cheques issued but dishonoured.	×××	
(vii)	Cheque deposited in the bank but excess amount was credited by bank. (For difference).	×××	
(viii)	Any amount wrongly credited by the bank in the Pass Book.	xxx	×××
	Debit/Credit Balance or overdraft as per Cash Book		×××



Key Terms

- Pass Book: It is a statement of account. It is provided by the bank to its account holders in the form of a small book.
- Causes of difference in the Cash Book and Pass Book Balances: (a) Timing difference, (b) Transactions, (c) Errors committed.

CHAPTER-6

DEPRECIATION, PROVISIONS AND RESERVES

Topic-1 Depreciation



Revision Notes

> Introduction

In every business, there are certain assets of a fixed nature that are needed for the conduct of business operations. Some examples of such assets are Building, Plant and Machinery, Motor Vehicles, Furniture, Office Equipment, etc. These assets have a definite span of life after the expiry of which the assets will lose their usefulness for the business operations. Fall in the value and utility of such assets due to their constant use and expiry of time is termed as depreciation. In other words, the process of allocation of the cost of a fixed asset over its useful life is known as depreciation.

> Definition of Depreciation

"Depreciation is the measure of the exhaustion of the effective life of an asset from any cause during a give period."

—Spicer & Peglar

"Depreciation is the gradual and permanent decrease in the value of fixed tangible assets from any cause."

—R.N. Carter

Features of Depreciation

- (i) Depreciation is a permanent decline in the value of fixed assets (except Land). Once the value of an asset is reduced due to depreciation, it cannot be restored to its original cost.
- (ii) Depreciation is a gradual and continuing process because the value of the assets will decline either by their constant use or obsolescence or due to expiry of time.

- (iii) Depreciation is not the process of valuation of asset but process of allocation of the cost of an asset to its effective span of life.
- (iv) It decreases only the book value of the asset, not the market value.
- (v) The term depreciation is used only in respect of tangible fixed assets. The term is not used for wasting assets such as mines, oil wells, etc.
- (vi) It is a non-cash expense. It does not involve any cash outflow.

Causes of Depreciation

- (i) Constant use
- (ii) Expiry of time
- (iii) Expiry of legal rights
- (iv) Obsolescence
- (v) Accident
- (vi) Depletion
- (vii) Permanent fall in market price.

> Factors affecting Depreciation

It is impossible to calculate the actual and true amount of depreciation. It can only be estimated by keeping the following factors into consideration:

- (i) Total cost of the asset
- (ii) Estimated useful life of asset
- (iii) Estimated scrap value.

> Methods of Depreciation

- (i) Straight Line Method
- (ii) Written Down Value Method.

> Difference between SLM and WDV

	SLM	WDV
(i)	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.
(ii)	Remains fixed during the useful life	Reduces every year
(iii)	Initially lower	Initially higher
(iv)	Increasing trend	Remains constant
(v)	Assets with negligible repairs and maintenance like leases, copyright.	Assets whose repairs increase, as they get older like machinery, vehicles etc.

Advantages of SLM

- (i) It is simple to understand and apply.
- (ii) Asset value can be completely written off using this method.
- (iii) Asset value can be made zero value at the end of useful life.
- (iv) It is easier to compare profits as an equal amount of depreciation is charged every year.
- (v) It is useful for those assets whose usage is made on a constant basis.

> Advantages of WDV

- (i) The method is simple to understand and easy to operate.
- (ii) The amount of annual depreciation reduces with the reducing balance of the asset.
- (iii) The amount of depreciation is higher in the earlier years when the machine is efficient and the cost of repairs is low.

> Methods of Recording Depreciation

- (i) Charging to Asset Account
- (ii) Creating Provisions for Depreciation
- (iii) Treatment for Disposal of Asset



Key Terms

'Depletion': 'Depletion' refers to the physical deterioration by the exhaustion of natural resources like quarries, mines, oil wells, etc. Due to mining or extraction, the stock of minerals/oil, etc. is depleted/reduced. In case of such assets, usually depreciation is charged on the basis of quantity produced.

- Amortisation: Amortisation refers to writing-off the cost of intangible assets like patents, copyright, trademarks, franchises, leasehold mines which have entitlements to use for a specific period of time.
- Obsolescence: Due to technological advancement, the currently using assets may become out-dated and lose a large part of its value.

Topic-2

Provisions and Reserves



Revision Notes

- > **Provisions**: Provisions are the amounts that are created against profit to meet a known liability, the amount of which is uncertain. A few examples of provisions are:
 - (i) Provision for bad and doubtful debts
 - (ii) Provision for depreciation
 - (iii) Provision for taxation
 - (iv) Provision for discount on debtors
- Reserves: Reserves are created for strengthening the financial position and future growth. It is created out of profit earned by business.
 - (i) **Revenue Reserve**: It is created out of revenue profit, *i.e.*, revenue earned from normal activities of the business. It can be used for either general purpose or specific purpose. It is of two types:
 - (a) General Reserve: When the reserve is created without any specified purpose, then the reserve is called general reserve.
 - **(b) Specific Reserve :** When reserve is created for some specific purpose, then the reserve is called specific reserve. Examples of specific reserve are:
 - (a) Debenture Redemption Reserve
 - (b) Investment Fluctuation Reserve
 - (c) Dividend Equalisation Reserve
 - (d) Workmen Compensation Fund
 - (ii) Capital Reserve: It is created out of capital profit, *i.e.*, gain from other than normal activities of business operations, such as sale of fixed asset, etc. The example of capital reserves are:
 - (a) Premium on issue of shares
 - **(b)** Premium on issue of debentures
 - (c) Profit on redemption of debentures
 - (d) Profit on sale of fixed assets
 - (e) Profit on reissue of forfeited shares
 - (f) Profit prior to incorporation

Difference Between Capital and Revenue Reserve

	Revenue Reserve	Capital Reserve
(i)	Revenue Reserve refers to the sum of money retained in business, so as to meet out future contingencies.	Capital Reserve alludes to a fund, that is created to finance long term project or write off capital expenses.
(ii)	Revenue profit of the firm is the source of revenue reserves.	Capital profit of the firm is the source of capital reserve
(iii)	Based on the type of reserve it can be utilized for any or particular purpose only	Capital reserve can be utilized for the purpose for which it is created.
(iv)	It is freely available for distribution as dividend	It is not available for distribution as dividend.



Key Terms

- > Open Reserves: These are those reserves which are shown in the Liabilities side of a Balance Sheet.
- > Secret Reserve: These are those reserves which are not shown in the Balance Sheet and are kept secret.
- Reserve Fund: If the reserve is invested outside the business in securities, it is called Reserve Fund.

CHAPTER-7

TRIAL BALANCE AND RECTIFICATION OF ERRORS



Revision Notes

- > **Trial Balance**: It is a statement showing the balance or total of debits and credits, of all the accounts in ledgers with a view to verify the arithmetical accuracy of posting into the ledger accounts.
- > **Objectives of Trial Balance**: The main objectives of preparing the trial balance are:
 - (i) to ascertain the arithmetical accuracy of the amounts recorded and posted in the books of accounts.
 - (ii) to help in locating errors, and (iii) to help in the preparation of the final accounts.
- > Limitations of a Trial Balance: Though the agreement of a Trial Balance ensures arithmetical accuracy, there may still exist some errors that may go undetected. Following are some examples of such errors:
 - (a) Transactions that are not recorded at all cannot be found out,
 - (b) Wrong amount written on both sides of a Trial Balance,
 - (c) Entry made in the wrong account,
 - (d) Complete posting omission of a transaction and
 - (e) Posting a complete entry more than once.

> Preparation of Trial Balance:

Balance Method: In this method, the trial balance has three columns. The first column is for the head of the account, the second column for writing the debit balance and the third for the credit balance of each account in the ledger.

Every ledger is balanced and the balance is carried forward to the Trial Balance. It is commonly used and helps in the preparation of financial statements.

➤ Various types of Errors :

- (i) Errors of Omission: Errors caused due to omission of recording a transaction entirely or partly in the books of account.
- (ii) Errors of Commission: Errors caused due to wrong recording of a transaction, wrong totalling, wrong casting, wrong balancing, etc.
- (iii) Errors of Principle: Errors which take place due to the wrong classification of capital and revenue nature of the items are called errors of principle.
- (iv) Compensating Errors: Two or more errors committed in such a way that they nullify the effect of each other on the debit and credit.
- Rectification of Errors: Errors affecting only one account can be rectified by giving an explanatory note or by passing a journal entry. Errors which affect two or more than accounts are rectified by passing a journal entry.
- > Suspense Account: Suspense account is an account in which the difference in the trial balance is put until such time that errors are located and rectified.
 - It facilitates the preparation of financial statements even when the trial balance does not tally.
- > Disposal of Suspense Account : When all the errors are located and rectified, the suspense account stands disposed off.



Key Words

- > Trial Balance: Once posting of entries into the ledger is done, a statement is prepared showing the abstract of the balances (debit or credit) of various accounts in the ledger. This statement is known as Trial Balance.
- > Totals Method of Preparing Trial Balance: Under this method total amount of debit side of each ledger account is shown on the debit side. Similarly total amount of credit side of each ledger account is shown on the credit side.
- ➤ Totals-cum-Balance Method of Preparing Trial Balance: Under this method four columns are provided for amount. Two columns for showing the debit and credit balances of various accounts and two columns for showing the debit and credit totals of various accounts.

PART - B: FINANCIAL ACCOUNTING-II

UNIT – III: FINANCIAL STATEMENTS OF SOLE PROPRIETORSHIP CHAPTER-8

FINANCIAL STATEMENTS



Revision Notes

- ➤ Meaning, Usefulness and Types of Financial Statements: After the agreement of the trial balance, a business enterprise proceeds to prepare financial statements. Financial statements or final accounts are the statements, which present periodic reports on the process of business enterprises and the results achieved during a given period. Financial statements include trading and profit & loss account, balance sheet and other statements and explanatory notes, which form part thereof. Information provided by financial statements is useful to management to plan and control the business operations. Financial statements are also useful to creditors, shareholders and employees of the enterprise.
- > Trading and Profit & Loss Account: The Trading and profit & loss account highlights the profit earned or loss sustained by the business entity in the course of business operation during a given period.
- > **Need :** The need for preparing the trading and profit & loss account is to ascertain the net result of business operations during a given period. The profit & loss account shows the items of revenue expenses and losses on the debit side, while items of gain and gross profit are shown on the credit side. For the preparation of the trading and profit & loss account, closing entries are recorded to transfer balances of account of items of expenses and revenues. Net profit or net loss shown by the profit & loss account is transferred to the capital account.
- Meaning, Characteristic, Need and Structure of the Balance Sheet: The balance sheet is a statement of assets and liabilities of a business enterprise and shows the financial position at a given date. The balance sheet is a part of the final account. But it is not an account, it is only a statement. In a balance sheet the totals of assets and liabilities are always equal. It portrays the accounting equation.
- A Balance Sheet has to be prepared to know the financial position of the business, and the nature and values of its assets and liabilities. Assets and liabilities shown in the balance sheet are marshalled in order of liquidity or in order of performance.



Key Words

- Financial Statements: Financial statements are the reports prepared to present a periodical review of financial performance and the financial position of a business enterprise.
- > **Income Statement**: Income statement is a statement showing true and fair view of the operating performance of the enterprise.
- ➤ **Gross Profit**: Gross profit is excess of sales over cost of goods sold.
- ➤ **Gross Loss**: Gross loss is excess of cost of goods sold over sales.
- ➤ **Cost of Goods Sold :** Cost of goods sold means the cost directly related to sale of goods.
- > **Direct Expenses**: Direct expenses are those expenses which are directly attributable to the purchase of goods and bringing the goods in saleable condition.
- > **Profit & Loss Account :** Profit & Loss Account is that account which is prepared to determine the income of the enterprise for a particular accounting period.
- Net Profit: Net profit is excess of gross profit and non-operating revenues over indirect expenses and non-operating expenses.
- > Net Loss: Net loss is excess of indirect expenses and non-operating expenses over gross profit and indirect revenues.
- > Operating Profit : Operating profit may be defined as the profit earned through the normal operations and activities of the business.
- > Balance Sheet: Balance Sheet may be defined as a statement depicting the exact financial position of a business on any date.
- Capital Expenditure: Capital expenditure is the expenditure which is incurred on purchase or construction of fixed assets such as building, plant and machinery, furniture and fixtures, etc. It benefits the business for a long

- period. It helps in generating revenues for the business. Normally the amount involved in capital expenditure is also substantial.
- ➤ Revenue Expenditure: Revenue expenditure may be defined as an expenditure which benefits the company for a short period. The benefits are normally derived within a year. Such expenditure is necessary to maintain the assets and to generate the revenue income in ordinary course of business. It is recurring in nature, and necessary to generate revenue income in ordinary course of business.
- > Deferred Revenue Expenditure: The expenditure for which payment has been made or a liability has been incurred in the current year, but deferred from being charged against the income of the current year is called deferred revenue expenditure. Such deference is based on the pre-assumption that it will be of benefit over a subsequent period or periods. These are written-off over the period of benefits.
- Fictitious Assets: Items shown as asset in the Balance Sheet, having no market value, are called fictitious assets. For example: Preliminary expenses, share issue expenses, underwriting commission, Misc. Expenditure. etc.
- > Fixed Assets: These assets are purchased for the purpose of operating the business and not for resale as these are required in the business for longer time period. Main examples of these are land, building, plant and machinery, furniture, etc.
- > Current Assets: Current assets are kept for short-term and are required for day-to-day business activity. Stock of raw material, semi-finished goods and finished goods, debtors, bills receivables, bank balance, etc., are some of the examples of current assets.
- > Tangible Assets: Tangible assets refer to those assets which can be seen and touched such as land and building, machinery, furniture, office equipment and motor vehicle, etc.
- > Intangible Assets: Intangible assets are those assets which have no physical existence, but can be sold and purchased. Goodwill, patents, copyright and trademarks are some of the examples.
- > Investments: Investments mean placing or spending money or something with the objectives of earning an income or profit from it. Amount invested in the business is known as capital.
- > Fixed or long-term Liabilities: These liabilities are payable after a long period, normally more than one year. For example, long-term loans, mortgage loan, debentures, etc.
- > Current Liabilities: These are obligations to be met in near future (generally within one year). For example, creditors for goods, outstanding expenses, bank overdraft, bills payable, short-term loans, etc.
- > Contingent Liabilities: Contingent liabilities are not the real liabilities of the business at present but may become real liabilities after sometime on happening of certain contingency. If that contingency happens, a liability will come into being, otherwise not. Such possible liabilities are termed as 'Contingent Liabilities'
- Marshalling of Assets and Liabilities: The arrangement of assets and liabilities in Balance Sheet in a systematic way is known as Marshalling of Balance Sheet.

CHAPTER-9

FINAL ACCOUNTS WITH ADJUSTMENTS



Revision Notes

- > Introduction: For the preparation of financial statements, it is necessary that all the adjustments arising out on the accrual basis of accounting are made at the end of the accounting period. Another important consideration in the preparation of final accounts with adjustments is the distinction between capital and revenue items. Entries which are recorded to give effect to these adjustments are known as adjusting entries.
- ➤ Outstanding Expenses: At the end of the accounting period, sometimes a business enterprise is left with some unpaid expenses due to one reason or another. Such expenses are termed as outstanding expenses and should be added to the relevant expense in the Trading A/c, Profit & Loss Account and shown at the liabilities side in the Balance Sheet. e.g. outstanding salary.
- ➤ Prepaid Expenses: At the end of the accounting year, it is found that the benefits of some expenses have not been fully received, a portion of total benefits would be received in the next accounting year. That portion of the expense, the benefit of which will be received during the next accounting period is known as 'prepaid expenses' and should be deducted from the relevant expense in the Trading A/c, Profit & Loss Account and shown on the assets side of the Balance Sheet.
- ➤ Advance or unaccrued on unearned Income: These are certain items received by a business enterprise but the whole amount of it does not belong to the current period. Such portion of income which belongs to the next accounting period is income received in advance and is known as "unearned income". This is to be deducted from the relevant income in the Trading A/c, Profit & Loss Account and shown at the liabilities side of the Balance Sheet.

- ➤ Accrued Income: This refers to the income that has fallen due till the end of the accounting year, but has not yet been received. It is added to the relevant income in the Trading A/c, Profit & Loss account and shown on the assets side of the Balance Sheet.
- ➤ **Depreciation**: Depreciation is the decline in the value of an asset, an account of wear and tear or passage of time. It actually amounts to writing-off a portion of the cost of an asset which has been used in the business for both the purpose of earning profits. In the Balance Sheet, the asset is shown at cost minus the amount of depreciation.
- > Provisions for Bad and Doubtful Debts: It is a normal feature of business operations that some debts prove irrecoverable. This means that the amount to be realised from these becomes bad. An estimate is made for the amount that may not be recovered and this amount is set aside from the profits to absorb such losses. The amount set aside is known as provision.

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