

# MODULE - I

# 1

## ACCOUNTING: AN INTRODUCTION

### Unit Structure

- 1.1 Accounting: the language of business
- 1.2 Accounting: an information system.
  - 1.2.1 Definitions
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### 1.1 ACCOUNTING: THE LANGUAGE OF BUSINESS

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Accounting is a business language. We can use this language to communicate financial transactions and their results. Accounting is a comprehensive system to collect, analyzes, and communicates financial information.

The origin of accounting is as old as money. In early days, the number of transactions was very small, so every concerned person could keep the record of transactions during a specific period of time. Twenty-three centuries ago, an Indian scholar named *Kautilya* alias *Chanakya* introduced the accounting concepts in his book *Arthashastra*. In his book, he described the art of proper account keeping and methods of checking accounts. Gradually, the field of accounting has undergone remarkable changes in compliance with the changes happening in the business scenario of the world.

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.

A bookkeeper may record financial transactions according to certain accounting principles and standards and as prescribed by an accountant depending upon the size, nature, volume, and other constraints of a particular organization.

With the help of accounting process, we can determine the profit or loss of the business on a specific date. It also helps us analyze the past performance and plan the future courses of action. As the basic purpose of business is to make profit, one must keep an ongoing track of the activities undertaken in course of business.

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## **1.2 ACCOUNTING: AN INFORMATION SYSTEM**

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### **1.2.1 DEFINITIONS**

#### **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):

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

### **1.2.2 OBJECTIVES OF ACCOUNTING**

#### **To Providing Information**

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.

#### **To keep systematic records:**

Accounting is done to keep systematic record of financial transactions. The primary objective of accounting is to help us collect financial data and to record it systematically to derive correct and useful results of financial statements.

### **Ascertainment of Results**

'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.

### **To ascertain the financial position of the business:**

A balance sheet or a statement of affairs indicates the financial position of a company as on a particular date. A properly drawn balance sheet gives us an indication of the class and value of assets, the nature and value of liability, and also the capital position of the firm. With the help of that, we can easily ascertain the soundness of any business entity.

**To assist in decision-making:** To take decisions for the future, one requires accurate financial statements. One of the main objectives of accounting is to take right decisions at right time. Thus, accounting gives you the platform to plan for the future with the help of past records.

**To fulfill compliance of Law:** Business entities such as companies, trusts, and societies are being run and governed according to different legislative acts. Similarly, different taxation laws (direct indirect tax) are also applicable to every business house. Everyone has to keep and maintain different types of accounts and records as prescribed by corresponding laws of the land. Accounting helps in running a business in compliance with the law.

**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.

### **1.2.3 FUNCTION OF ACCOUNTING**

The main functions of accounting are as follows:

**Measurement:** Accounting measures past performance of the business entity and depicts its current financial position.

**Forecasting:** Accounting helps in forecasting future performance and financial position of the enterprise using past data.

**Decision-making:** Accounting provides relevant information to the users of accounts to aid rational decision-making.

**Comparison & Evaluation:** Accounting assesses performance achieved in relation to targets and discloses information regarding accounting policies and contingent liabilities which play an important role in predicting, comparing and evaluating the financial results.

**Control:** Accounting also identifies weaknesses of the operational system and provides feedbacks regarding effectiveness of measures adopted to check such weaknesses.

**Government Regulation and Taxation:** Accounting provides necessary information to the government to exercise control on the entity as well as in collection of tax revenues.

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### 1.3 USERS OF ACCOUNTING INFORMATION:

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Generally users of accounts are classified into two categories:

- a) Internal User
- b) External User

Following are the various users of accounting information:

- i) **Investor:** They provide capital to business. They need information to assess whether to buy, hold or sell their investment. Also they are interested to know the ability of the business to survive, prosper and to pay dividend.
- ii) **Employees:** Growth of employees is directly related to the growth of the organisation and therefore, they are interested to know the stability, continuity and growth of the enterprise and its ability to provide remuneration, retirement and other benefits and to enhance employment opportunities.
- iii) **Lenders:** They are interested to know whether their loan-principal and interest will be paid when due.
- iv) **Supplier and Creditors:** They are also interested to know the ability of the enterprise to pay their dues that helps them to decide the credit policy for the relevant concern, rates to be charged and so on. Sometime, they also become interested in long term continuation of the enterprise if their existence becomes dependent on the survival of the business. Suppose, small ancillary units supply their products to a big enterprise, if the big enterprise collapses, the fate of the small units also becomes sealed.
- v) **Customers:** Customers are also concerned with the stability and profitability of the enterprise because their functioning is more or less dependent on the supply of goods, suppose, a company produces some chemicals used by pharmaceutical companies and supplies chemicals on three months credit. If all a sudden it faces some trouble and is unable to supply the chemical, the customers will also be in trouble.
- vi) **Government and their agencies:** They regulate the functioning of business enterprise for public good, allocated scarce resources among competing enterprise, control price, change excise duties and taxes, and so they have continued interest in the business enterprise.

**vii) Public:** The public at large is interested in the functioning of the enterprise because it may make a substantial contribution to the local economy in many ways including the number of people employed and their patronage to local suppliers.

**viii) Management:** On the basis of Accounts, management determine the effects of their various decisions on the functioning of the organisation. This helps them to make further managerial decisions.

External users of accounting information	External users include Investors Creditors Customers Suppliers Employees Government organizations
Internal users of accounting information	Internal users include Management Managers of operations

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## 1.4 BRANCHES OF ACCOUNTING

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Following are various branches of Accounting.

### 1.4.1 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."

### 1.4.2 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."

### 1.4.3 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.

#### **1.4.4 Social responsibility Accounting**

Social responsibility accounting is concerned with accounting for social costs incurred by the enterprise and social benefits created.

#### **1.4.5 Human Resource Accounting**

Human resource accounting is an attempt to identify, quantify and report investment made in human resource of an organisation that are not presently accounted for under conventional accounting practice.

#### **1.4.6 Difference between Management Accounting and Financial Accounting**

Management Accounting	Financial Accounting
1. Management Accounting is primarily based on the data available from Financial Accounting.	1. Financial Accounting is based on the monetary transactions of the enterprise.
2. It provides necessary information to the management to assist them in the process of planning, controlling, performance evaluation and decision making.	2. Its main focus is on recording and classifying monetary transactions in the books of accounts and preparation of financial statements at the end of every accounting period.
3. Reports prepared in Management Accounting are meant for management and as per management requirement.	3. Reports as per Financial Accounting are meant for the management as well as for shareholders and creditors of the concern.
4. Reports may contain both subjective and objective figures.	4. Reports should always be supported by relevant figures and it emphasizes on the objectivity of data.
5. Reports are not subject to statutory audit.	5. Reports are always subject to statutory audit.
6. It evaluates the sectional as well as the entire performance of the business.	6. It ascertains, evaluates and exhibits the financial strength of the whole business.

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### **1.5 BOOK-KEEPING**

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As defined by Carter, 'Book-keeping is a science and art of correctly recording in books-of accounts all those business transactions that result in transfer of money or money's worth'.

Book-keeping is an activity concerned with recording and classifying financial data related to business operation in order of its occurrence.

**Book-keeping is a mechanical task which involves:**

- Collection of basic financial information.
- Identification of events and transactions with financial character i.e., economic transactions.
- Measurement of economic transactions in terms of money.
- Recording financial effects of economic transactions in order of its occurrence.
- Classifying effects of economic transactions.
- Preparing organized statement known as trial balance.

**The distinction between book-keeping and accounting is given below:**

Book-Keeping	Accounting
Output of book-keeping is an input for accounting.	Output of accounting permit informed judgments and decisions by the user of accounting information.
Purpose of book-keeping is to keep systematic record of transactions and events of financial character in order of its occurrence.	Purpose of accounting is to find results of operating activity of business and to report financial strength of business.
Book-keeping is a foundation of accounting.	Accounting is considered as a language of business.
Book-keeping is carried out by junior staff.	Accounting is done by senior staff with skill of analysis and interpretation.
Objects of book-keeping is to summarize the cumulative effect of all economic transactions of business for a given period by maintaining permanent record of each business transaction with its evidence and financial effects on accounting variable.	Object of accounting is not only bookkeeping but also analyzing and interpreting reported financial information for informed decisions.

**1.5.1 ACCOUNTING CYCLE**

When complete sequence of accounting procedure is done which happens frequently and repeated in same directions during an accounting period, the same is called an accounting cycle.

**Steps/Phases of Accounting Cycle**

The steps or phases of accounting cycle can be developed as under:

**Recording of Transaction:** As soon as a transaction happens it is at first recorded in subsidiary book.

**Journal:** The transactions are recorded in Journal chronologically.

**Ledger:** All journals are posted into ledger chronologically and in a classified manner.

**Trial Balance:** After taking all the ledger account closing balances, a Trial Balance is prepared at the end of the period for the preparations of financial statements.

**Adjustment Entries:** All the adjustments entries are to be recorded properly and adjusted accordingly before preparing financial statements.

**Adjusted Trial Balance:** An adjusted Trail Balance may also be prepared.

**Closing Entries:** All the nominal accounts are to be closed by the transferring to Trading Account and Profit and Loss Account.

**Financial Statements:** Financial statement can now be easily prepared which will exhibit the true financial position and operating results.

### 1.5.2 BASIC ACCOUNTING TERMS

In order to understand the subject matter clearly, one must grasp the following common expressions always used in business accounting.

**Transaction:** It means an event or a business activity which involves exchange of money or money's worth between parties.

**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.

**Profit:** The excess of Revenue Income over expense is called profit. It could be calculated for each transaction or for business as a whole.

**Loss:** The excess of expense over income is called loss. It could be calculated for each transaction or for business as a whole.

**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. 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.

**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.



**Contingent Liability:** It represents a potential obligation that could be created depending on the outcome of an event.

**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.

**Drawings:** It represents an amount of cash, goods or any other assets which the owner withdraws from business for his or her personal use

**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.

**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.

**Trade Discount:** It is the discount usually allowed by the wholesaler to the retailer computed on the list price or invoice price.

**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.

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## 1.6 TEST YOUR UNDERSTANDING:

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### 1.6.1 Fill in the blanks:

- (a) The cash discount is allowed by ----- to the ----- .
- (b) Profit means excess of-----over -----.
- (c) Debtor is a person who -----to others.
- (d) In a credit transaction, the buyer is given a-----facility.
- (e) The fixed asset is generally held for-----.
- (f) The current liabilities are obligations to be settled in----- period.
- (g) The withdrawal of money by the owner of business is called -----
- (h) The amount invested by owners into business is called ----- .
- (i) Transaction means exchange of money or money's worth for----- .
- (j) The net result of an income statement is-----or ----- .
- (k) ----- The shows financial position of the business as on a particular date.

- (l) The----- discount is never entered in the books of accounts.
- (m) ----- Vehicles represent expenditure while repairs to vehicle would mean expenditure.
- (n) ----- Net worth is excess of over.

Ans 6.1 :

- (a) creditor, debtor
- (b) income, expenditure
- (c) Owes
- (d) Credit
- (e) Longer period
- (f) Short
- (g) Drawings
- (h) Capital
- (i) Value
- (j) Profit, loss
- (k) Balance sheet
- (l) Trade
- (m) Capital, revenue
- (n) Total assets, total liabilities

**1.6.2 Give one word or a term used to describe the following:-**

- (a) An exchange of benefit for value
- (b) A transaction without immediate cash settlement.
- (c) Commodities in which a business deals.
- (d) Excess of expenditure over income.
- (e) Things of value owned by business to earn future profits.
- (f) Amount owed by business to others.
- (g) An obligation which may or may not materialise.
- (h) An allowance by a creditor to debtor for prompt payment.
- (i) Assets like brand value, copy rights, goodwill

Ans 6.2 :

- (a) Transaction, (b) credit transaction, (c) goods, (d) loss, (e) Assets,
- (f) liability, (g) contingent liability, (h) cash discount, (i) intangible assets

**1.6.3 Indicate the best answer for each of the following questions:**

1. The prime function of accounting is to :
  - a) Record economic data,
  - b) Provide the informational basis for action
  - c) Classifying and recording business transaction
  - d) Attention on economic goals
2. The basic function of financial accounting is to:
  - a) Record all business transaction
  - b) Interpret the financial data
  - c) Assist the management if Performing functions effectively

3. Management accounting provides invaluable services to management in performing :
  - a) All management functions
  - b) Co-ordinating management functions
  - c) Controlling functions
4. Book keeping is mainly concerned with
  - a) Recording of financial data relating to business operations
  - b) Designing the system in recording classifying, summarising the recorded data
  - c) Interpreting the data for internal end users
5. An accountant:
  - a) Often directs and review the work of book keepers
  - b) Does more of a routine work
  - c) Is required to have a lower level of knowledge than what is required of a book keeper.
6. Management accounting:
  - a) Is a post mortem analysis of the past business activities
  - b) Is accounting for future
  - c) Portrays the position of the business as a whole

And 6.3 1- c, 2 -a, 3-a, 4-a, 5-a, 6-b

- 1.6.4 Define Accounting. State its Functions. How does it differ from Book Keeping?
1. 6.5 State the person who should be interested in accounting information



## **ACCOUNTING CONCEPTS, PRINCIPLES AND CONVENTIONS**

### **Unit Structure**

- 2.1 Accounting concepts, principle and conventions
  - 2.1.1 Meaning of accounting principles
  - 2.1.2 Accounting concepts
  - 2.1.3 Accounting conventions
- 2.2 System of book keeping
- 2.3 Accounting equation
- 2.4 System of accounting
- 2.5 Test your understanding:

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### **2.1 ACCOUNTING CONCEPTS, PRINCIPLE AND CONVENTIONS**

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#### **2.1.1 ACCOUNTING PRINCIPLES**

It is already been stated in chapter 1 that accounting are the language of business through which normally a business house communicate with the outside world. In order to make this language intelligible and commonly understandable by all, it is necessary that it should be based on certain uniform scientifically laid down standards. These standards are termed as accounting principles.

Accounting principles are basic guidelines that provide standards for scientific accounting practices and procedures. They guide as to how the transactions are to be recorded and reported. They assure uniformity and understand ability. Accounting concepts lay down the foundation for accounting principles. They are ideas essentially at mental level and are self-evident. These concepts ensure recording of financial facts on sound bases and logical considerations.

Accounting conventions are methods or procedures that are widely accepted. When transactions are recorded or interpreted, they follow the conventions. Many times, however, the terms-principles, concepts and conventions are used interchangeably.

#### **2.1.2 ACCOUNTING CONCEPTS**

Accounting concepts means the assumption or condition on which the whole accounting structure stands. They are predetermined conditions

which a book keeper must keep in mind while recording transaction in the books of accounts.

1. **Entity Concept:** This concept is also known as “Business Entity Concept” " Accounting Entity Concept"

This concept requires that the business and the persons who control and own the business are two different entities. An accounting entity is regarded as separate and distinct from its owners. Due to this concept, the owners and his business are considered to be separate. I.E as two separate entities.

All transactions of the business are recorded from the point of view of the business. Personal activities of the owners are not recorded in the accounting books of the business.

2. **Money Measurement Concept:** This concept states that only those facts will be recorded in the accounts which can be expressed in terms Money.

If a fact cannot be measured in terms of Money, then such a fact will not be recorded in the accounts Books. Money is a common denomination in which all transactions are measured for the purpose of recording in the books of accounts. If different transactions are not expressed, in terms of money, it will become meaningless to present the transaction.

For example if two tables and 5 Chairs are purchased. The various quantities of tables and chairs cannot be added. However the value of two tables and 5 chairs can be measured in terms of Money and their values can then be added.

3. **Cost concept:** This concept requires that Assets should be valued at acquisition cost, rather than at its Market Values. Though assets can be disclosed in the balance sheet at different values such as market value, Realisable value etc. It is proper to show asset at cost as valuing asset at cost is free from Bias. All other values involve an element of subjectivity in the valuation of the asset. For example an asset may be purchased for Rs 50,000, its market value be Rs 70,000. However Many a times, Market value of an asset may not be available. Also many a times Market value is not real market value but it is based on estimation.

4. **Going Concern Concept:**  
According to this concept, the enterprise is normally viewed as a going concern. It means that it is assumed that the enterprise will continue their operation is near or foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation. It is also assumed that the enterprise will not materially curtail down its operation in near future.

While preparing financial statements, it is assumed the Business activity will continue and there is no intention to close the business. This concept is a Fundamental Accounting Assumption.

5. **Realisation Concept:** This concept requires that profits should be accounted for only when it is actually realised. This means that revenue or profit should be recognised only when sale is affected or services are rendered. For example if the Market value of an Asset has increased, but the profit should be recognised only when the asset is sold.

However it should be noted that revenue may be recognized before cash is received. It is not necessary that cash should be received. However Revenue should be recognized only if a legal right to receive cash is established.

6. **Accrual Concept**

This Concept requires that Revenues and costs should be recognised as and when they are earned or incurred and not as and when money is received or paid. In other words we should follow mercantile system of Accounting and not cash system of Accounting. In cash system of Accounting Revenue is recognised only when cash is received and expenses are recorded when cash is paid. However this concept requires that, income and expenditure should be recorded in the period to which the expense belong and not in the period in which income are received or expenses are paid

7. **Dual Aspect.**

This concept is the core of Accountancy. According to this concept, every business transaction is recorded in the books of accounts has two aspects. The two fold aspects are increase or decrease in assets and liabilities. Every transactions or event has two aspects such as

1. It increases one asset and decreases another asset
2. It increases an asset and increases Liability (including Capital)
3. It decreases one asset and decreases a liability (including Capital)

For example when expenses are incurred, cash is reduced and capital also reduces.

When Machine is purchased, cash is reduced and book value of Machine increases.

8. **Matching Concept**

It is referred to as matching of expenses against incomes. It means that all incomes and expenses relating to the financial period to which the accounts relate should be taken into account without regard to the date of receipts or payment.

**9. Full Disclosure Concept**

As per this concept, all significant information must be disclosed. Accounting data should properly be clarified, summarized, aggregated and explained for the purpose of presenting the financial statements which are useful for the users of accounting information. Practically, this principle emphasizes on the materiality, objectivity and consistency of accounting data which should disclose the true and fair view of the state of affairs of a firm.

**2.1.3 ACCOUNTING CONVENTIONS**

Accounting convention are the customs or traditions usually adopted in preparation of accounting conducts or statements. Accounting systems have been developed in response to the needs of the management and the outside creditors for making economic decisions.

**1. Convention of Consistency:**

This concept requires that accounting policies adopted in preparing the financial statements should be consistently followed.

In other words the Accounting policies should not be changed unless it is absolutely necessary. If Accounting policies such as Method of depreciation, method of valuation of closing stock etc are frequently changed then it becomes meaningless to compare the financial statements of two different periods in which different accounting policies have been followed.

**2. Convention of Disclosure:**

This means that the accounts must be honestly prepared and they must disclose all material information. The accounting reports should disclose full and fair information to the proprietors, creditors, investors and others. This convention is especially significant in case of big business like Joint Stock Company where there is divorce between the owners and the managers. Therefore, The Indian Companies Act, 1956 not only requires that the accounts of the company must give a true and fair view of the state of affairs of the company but it has also prescribed the contents and forms of Profit and Loss Account and Balance Sheet.

**3. Convention of Materiality:**

The accountant should attach importance to material detail and ignore insignificant details. If this is not done accounts will be overburdened with minute detail. As per the American Accounting Association, "an item should be regarded as material, if there is a reason to believe that knowledge of it would influence the decision of informed investor." Therefore keeping the convention of materiality in view, unimportant items are either left out or merged

#### 4. **Convention of Conservatism:**

This convention cost of safety is a rule in the minds of businessman. As per this convention, all anticipated losses are taken into account but no profits are accounted until they arise.

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## 2.2 **SYSTEM OF BOOK KEEPING**

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Book keeping, as explained earlier, is art of recording pecuniary transactions in a regular and systematic manner, this recording of transaction may be done according to any of the following system:

**a) Single Entry System:** An incomplete double entry can be termed as a single entry system. According to Kohler, “It is a system of book keeping in which as a rule only records of cash and personal accounts are maintained, it is always incomplete double entry, varying with circumstances”. This system has been developed by some business houses, who for their convenience keep only some essential records. Since all records are kept, the system is not reliable and can be used only by small business firm.

#### **b) Double Entry System**

It was in 1494 that Luca Pacioli the Italian mathematician, first published his comprehensive treatise on the principles of Double Entry System. The use of principles of double entry system made it possible to record not only cash but also all sorts of mercantile transactions. According to it, every transaction has two fold aspects debit and credit and both the aspects are to be recorded in the books of accounts.

#### **Features of Double Entry System**

- Every transaction has two fold aspects, i.e., one party giving the benefit and the other receiving the benefit.
- Every transaction is divided into two aspects, Debit and Credit.
- One account is to be debited and the other account is to be credited
- Every debit must have its corresponding and equal credit.

#### **Advantages of Double Entry System**

- Since personal and impersonal accounts are maintained under the double entry system, both the effects of the transactions are recorded.
- It ensures arithmetical accuracy of the books of accounts, for every debit, there is a corresponding and equal credit. This is ascertained by preparing a trial balance periodically or at the end of the financial year.
- It prevents and minimizes frauds. Moreover frauds can be detected early.
- Errors can be checked and rectified easily.



- The balances of receivables and payables are determined easily, since the personal accounts are maintained.
- The businessman can compare the financial position of the current year with that of the past year/s.
- The businessman can justify the standing of his business in comparison with the previous year's purchase, sales, and stocks, incomes and expenses with that of the current year figures.
- Helps in decision making.
- The net operating results can be calculated by preparing the Trading and Profit and Loss A/c for the year ended and the financial position can be ascertained by the preparation of the Balance Sheet.
- It becomes easy for the Government to decide the tax.
- It helps the Government to decide sickness of business units and extend help accordingly.
- The other stakeholders like suppliers, banks, etc take a proper decision regarding grant of credit or loans.

#### **Limitations of Double Entry System**

- The system does not disclose all the errors committed in the books accounts.
- The trial balance prepared under this system does not disclose certain types of errors.
- It is costly as it involves maintenance of numbers of books of accounts.

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### **2.3 ACCOUNTING EQUATION**

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The whole Financial Accounting depends on Accounting Equation which is also known as Balance Sheet Equation. The basic Accounting Equation is:

- $\text{Assets} = \text{Liabilities} + \text{Owner's equity}$
- or  $A = L + P$
- or  $P = A - L$  } Where  $A = \text{Assets}$ ,  $L = \text{Liabilities}$ ,  $P = \text{Capital}$  or  $L = A - P$

While trying to do this correlation, please note that incomes or gains will increase owner's equity and expenses or losses will reduce it.

Students are advised to go through the following example to understand this equation properly.

**Example**

Prepare an Accounting Equation from the following transactions in the books of Mr. A for January, 2016:-

1. Invested Capital in the firm Rs. 20,000
2. Purchased goods on credit from Das & Co. for Rs. 2,000
3. Bought plant for cash Rs.8,000
4. Purchased goods for cash Rs.4,000
5. Sold goods for cash (cost Rs. 4,000 + Profit Rs. 2,000) Rs. 6,000.
6. Paid to Das & Co. in cash Rs.1,000
7. Received from B. Banerjee Rs. 300
8. Paid salary Rs.6,000
9. Received interest Rs 5,000
10. Paid wages Rs. 3,000

**Solution:**

Effect of transaction on Assets, Liabilities and Capital

Date	Transaction	Assets =	Liabilities +	Capital
January, 2016 1	Invested Capital in the firm ' 20,000	20,000	-	20,000
2	Purchased goods on credit from Das & Co. Rs.' 2,000	+2,000	+2,000	
	Revised Equation	22,000=	2,000+	20,000
3	Bought Plant for cash ' 8,000	+8,000 -8,000	-	-
	Revised Equation	22,000 =	2,000+	20,000
4	Purchased goods for cash ' 4,000	+4,000 -4,000	-	-
	Revised Equation	22,000=	2,000+	20,000
5	Sold Goods for cash (Cost ' 4,000 + Profit ' 2,000)	+6,000 -4,000		+2,000
	Revised Equation	24,000	2,000+	22,000
6	Paid to Das & Co. for ' 1,000	-1,000	-1,000	
	Revised Equation	23,000=	1,000+	22,000
7	Received from B.Banerjee for ' 300	+300 -300		
	Revised Equation	23,000 =	1,000+	22,000

8	Paid salary for ' 6,000	- 6,000		-6,000
	Revised Equation	17,000 =	1,000+	16,000
9	Received Interest for ' 5,000	+5,000		+5,000
	Revised Equation	22,000=	1,000+	21,000
10	Paid Wages for '3,000	-3,000		-3,000
	Revised Equation	19,000=	1,000+	18,000

## 2.4 SYSTEM OF ACCOUNTING

### a) Accrual Basis of Accounting

Accrual Basis of Accounting is a method of recording transactions by which revenue; costs, assets and liabilities are reflected in the accounts for the period in which they accrue. This basis includes consideration relating to deferrals, allocations, depreciation and amortization. This basis is also referred to as mercantile basis of accounting.

### b) Cash Basis of Accounting

Cash Basis of Accounting is a method of recording transactions by which revenues, costs, assets and liabilities are reflected in the accounts for the period in which actual receipts or actual payments are made.

Distinction between Accrual Basis of Accounting and Cash Basis of Accounting

Basis of Distinction	Accrual Basis of Accounting	Cash Basis of Accounting
1. Prepaid/Outstanding Expenses/ accrued/un accrued Income in Balance Sheet.	Under this, there may be prepaid/outstanding expenses and accrued/un accrued incomes in the Balance Sheet.	Under this, there is no prepaid/outstanding expenses or accrued/un accrued incomes.
2. Higher/lower Income in case of prepaid expenses and accrued income	Income Statement will show a relatively higher income	Income Statement will show lower income.
3. Higher/lower income in case of outstanding expenses and un accrued income	Income Statement will show a relatively lower income.	Income Statement will show higher income.
4. Availability of options to an accountant to manipulate the accounts by way of choosing the	Under this, an accountant has options.	Under this an accountant has no option to make a choice as such.

most suitable method out of several alternative methods of accounting e.g. FIFO/LIFO/SLM/WDV		
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**c) Hybrid or Mixed Basis**

Under the hybrid system of accounting, incomes are recognised as in Cash Basis Accounting i.e. when they are received in cash and expenses are recognised on accrual basis i.e. during the accounting period in which they arise irrespective of when they are paid.

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## **2.5 TEST YOUR UNDERSTANDING:**

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### **2.5.1 Fill in the blanks:**

- The double entry system of accounting originated in \_\_\_\_\_.
- Accounting principle are generally based on \_\_\_\_\_.
- Financial statement is a part of \_\_\_\_\_.
- Accounting equation is capital = \_\_\_\_\_ - \_\_\_\_\_.
- Revenue is generally recognised at the point of sale according to \_\_\_\_\_ principle.

Ans: 2.5.1 A- Italy, B- Practicability, C- Accounting, D - Assets, Liabilities, E- Revenue recognition.

### **2.5.2 State whether following statement are True or False.**

- Accounting principles are rules of action or conduct which are adopted by the accountants universally while recording accounting transactions.
- It is on the basis of going concern concept that the assets are always valued at market price.
- The convention of disclosure implies that all material information should be disclosed in the accounts.
- The convention of conservatism takes into account all prospective profit but leave all prospective losses.
- Since the life of the business is assumed to be indefinite, the financial statement of the business should be prepared only when it goes into liquidation.

- f) In accounting all business transactions are recorded as having a dual aspect.

Ans 2.5.2 : A –True, B- False , C- True, D- False, E- False, F- True.

**2.5.3 Choose the correct answer.**

- i. Accounting principles are generally based on :
- a) Practicability
  - b) Subjectivity
  - c) Convenience in recording
- ii The system of recording transactions based on dual aspect concept is called:
- a) Double accounting system
  - b) Double entry system
  - c) Single entry system
- iii The practice of appending notes regarding contingent liabilities in accounting statements is pursuant to :
- a) Convention of consistency
  - b) Money measurement concept
  - c) Convention of conservatism
  - d) Convention of disclosure
- iv The convention of conservatism is applicable:
- a) In providing for discount on creditor
  - b) In making provision for bad debts
  - c) Providing for depreciation
- v The convention of conservatism, when applied to the balance sheet, result in:
- a) Understatement of assets
  - b) Understatement of liabilities
  - c) Overstatement of capital
- vi All of the following are fundamental accounting concepts except:
- a) Dual Aspect
  - b) Going Concern
  - c) Full Disclosure
  - d) Business entity
- vii It is essential to standardize the accounting principles and policies in order to ensure:
- a) Transparency
  - b) Consistency
  - c) Comparability
  - d) All of the above

Ans 2.5.3 : i- a, ii –b, iii- d, iv-b, v-a, vi- c, vii-d

- 2.5.4 Discuss briefly the basic accounting concepts and fundamentals accounting assumptions
- 2.5.5 What are the accounting concepts and conventions. Name them and explain any two accounting concepts in details.
- 2.5.6 Explain any three of following accounting concepts:
- a) Money Measurement Concept
  - b) Business Entity Concept
  - c) Going concern Concept
  - d) Realisation Concept
  - e) Cost Concept
- 2.5.7 Show the effect of the following transactions on the assets, liabilities and capital of Mr. R Rajkumar through the accounting equation.
- 1 He started business with cash Rs.20,000
  - 2 He purchased goods for cash Rs. 5,000
  - 3 Purchased goods on credit from Mr. Madan for Rs.10,000
  - 4 Sold goods for cash costing Rs.8,000 for Rs.10,000
  - 5 Withdrew Rs.1,000 from business in cash to pay for his private expenses.
  - 6 Electricity bills paid for Rs.500
  - 7 He sold goods costing Rs.5,000 to Mr. Sanjay for Rs.6,000
  - 8 Rent outstanding Rs.400
  - 9 He borrowed Rs.5,000 from Mr. Lala
  - 10 Purchased goods for cash Rs.5,000



## MODULE - II

# 3

### ACCOUNTING PRINCIPLES

#### Unit Structure

- 3.1 Introduction
- 3.2 Accounting Concepts
- 3.3 Accounting Principles
- 3.4 Accounting Conventions
- 3.5 Widely Accepted Accounting Concepts

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#### 3.1 INTRODUCTION

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Accounting is the language of the business. Accounting Principles are the rules or guidelines which are developed to maintain a uniformity and consistency in accounting records. This **generally accepted accounting principles** (GAAP's) provides unity of understanding and unity of approach in the practice of accounting and also in better preparation of financial statements.

Let us imagine a situation where you give copies of your books of accounts to three different accountants and you ask them to prepare financial statements and to compute the income from business for the financial year on the basis of books of accounts given to them. All three accountants are ready with the financial statements and all three accountants have computed different figure of income i.e. profit from the business and that too with very wide variations among them. Guess in such a situation what impact would it leave on you about accounting profession. To avoid this, a generally accepted set of accounting principles/rules have been developed.

Financial statements prepared by the accountants to communicate financial information to the various users of financial statements for decision making purpose. Therefore, it is important that financial statements prepared by different business entities should be prepared on uniform basis. Also there should be consistency over a period of time in the preparation of these financial statements. If every accountant starts following his own methods and concepts for accounting different items then there will be confusion.

To avoid confusion and to achieve uniformity, accounting process is applied within the conceptual framework of 'Generally Accepted Accounting Principles' (GAAPs).

The term GAAPs is used to describe rules developed for the preparation of the financial statements and are called

1. Accounting Concepts;
2. Accounting Conventions;
3. Accounting Postulates ;
4. Accounting Principles

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### 3.2 ACCOUNTING CONCEPTS

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Accounting Concepts are certain rules that accountant should follow while recording business transactions and preparing accounts.

E.g. in India there is a basic rule to be followed by everyone that one should walk or drive on his/her left hand side of the road. It helps in the smooth flow of traffic. Similarly, there are certain rules that an accountant should follow while recording business transactions and preparing accounts.

Accounting concepts lay the foundation on the basis of which the accounting principles are followed. Concepts constitute the very basis of accounting. There are various concepts of accounting and all have been developed over the period of time from experience and thus, they are university accepted rules.

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### 3.3 ACCOUNTING PRINCIPLES

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#### **Meaning of Principles:**

A general law or rule followed or adopted as a guide to action is known as a principle.

#### **Definitions of Accounting Principles:**

1. According to **American Institute of Certified Public Accountants (AICPA)** : “The accounting principles are general law or rule adopted or preferred as a guide to action, a settled ground or basis of conduct or practice.”
2. According to **R.N Antony**: “The rules and conventions of accounting are commonly referred to as Principles.”

Accounting principles must satisfy following conditions:

1. They should be based on real assumptions;
2. They must be simple, understandable & self explanatory;
3. They must be followed consistently;
4. They should be able to reflect future predictions;
5. They should be informational for the users.



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### 3.4 ACCOUNTING CONVENTIONS

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An accounting convention refers to common practices which are universally followed in recording and presenting accounting statements of the business entity. Accounting conventions are followed like customs, traditions, etc. in a society. They make accounting information more clear and useful. They have evolved through the regular and consistent practice over the years. They facilitate uniform recording in the books of accounts.

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### 3.5 WIDELY ACCEPTED ACCOUNTING CONCEPTS

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1. Business Entity Concept
2. Money Measurement Concept
3. Accounting Period(Periodicity) Concept
4. Cost Concept
5. Realization Concept or Revenue recognition Concept
6. Matching Concept
7. Accrual Concept
8. Dual Aspect Concept
9. Materiality Concept
10. Conservatism or Prudence Concept

**1) Business Entity Concept:** Entity Concept states that Business Enterprise is separate entity from its owner. As per this concept business transactions to be recorded in business books and owner's transactions to be recorded in his personal books.

Entity concept means that enterprise owes to the owner for capital provided by the owner.

*Example: Mr. A Commenced business by investing Rs. 12,00,000/- with which he purchased Equipments & other Fixed assets required in business for Rs. 10,00,000/- & kept balance in hand. i.e. Rs. 2,00,000/- The financial position(Balance sheet) of business is as follows:*

#### ***Balance Sheet***

<b><i>Liabilities</i></b>	<b><i>Amount(Rs.)</i></b>	<b><i>Assets</i></b>	<b><i>Amount(Rs.)</i></b>
<i>Capital</i>	<i>1200000</i>	<i>Equipment &amp; Fixed Assets</i>	<i>1000000</i>
		<i>Cash in Hand</i>	<i>200000</i>
	<b><u>1200000</u></b>		<b><u>1200000</u></b>

*This means that Business Enterprise owes to Mr. A Rs.12,00,000/- now if Mr. A Spends/ uses Rs. 50,000/- for Household Expenses from business capital Fund then as per business entity concept it should not be classified/recorded as business expenses but should be charged to capital account i.e. Capital will get reduced by Rs. 50,000/- & revised Balance sheet will show following position*

### **Balance Sheet**

<b>Liabilities</b>		<b>Amount(Rs.)</b>	<b>Assets</b>	<b>Amount(Rs.)</b>
<i>Capital</i>	<i>12,00,000</i>		<i>Equipment &amp; Fixed Assets</i>	<i>10,00,000</i>
<b>Less:</b> <i>Drawings(Personal Expenses.)</i>	<i>(50,000)</i>	<i>11,50,000</i>	<i>Cash in Hand</i>	<i>1,50,000</i>
		<b><u>11,50,000</u></b>		<b><u>11,50,000</u></b>

- 2) **Money Measurement Concept:** This Concept states that only monetary transactions i.e. which can be measured in terms of money are to be recorded. In accounting, a record is made only of those facts or transactions that can be expressed in monetary terms. It provides a common unit for measurement, i.e., money for measuring, recording and summarizing the transaction. Events, which cannot be expressed in money terms, do not find a place in account books. *Example, salary paid to manager is recorded in account books but his competence is has no place in account books.*
- 3) **Accounting Period / Periodicity 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 periodicity or 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. Usually one year is taken as one accounting period which may be a calendar year or a financial year.

**Thus, the periodicity concept facilitates in:**

- (a) Comparing of financial statements of different periods
  - (b) Uniform and consistent accounting treatment for ascertaining the profit and assets of the business
  - (c) Matching periodic revenue with expenses for getting correct results of the business operations.
- 4) **Cost Concept:** As per cost concept value of asset recorded at its acquisition/purchase cost, in other words, at its historical cost.  
For example, if a plot of land is purchased for Rs. 1,50,000 then as per this concept, the asset will be recorded in the books at Rs. 1,50,000, even if its market value at that time is Rs. 2,00,000.
- 5) **Realization Concept or Revenue recognition Concept:** This Concept deals with the problem, when the revenue should be recognized? According to this concept, the sale should be recognised at the point, when the property in goods passes to the buyer and he becomes legally liable to pay and other income is recognised, when they accrue.

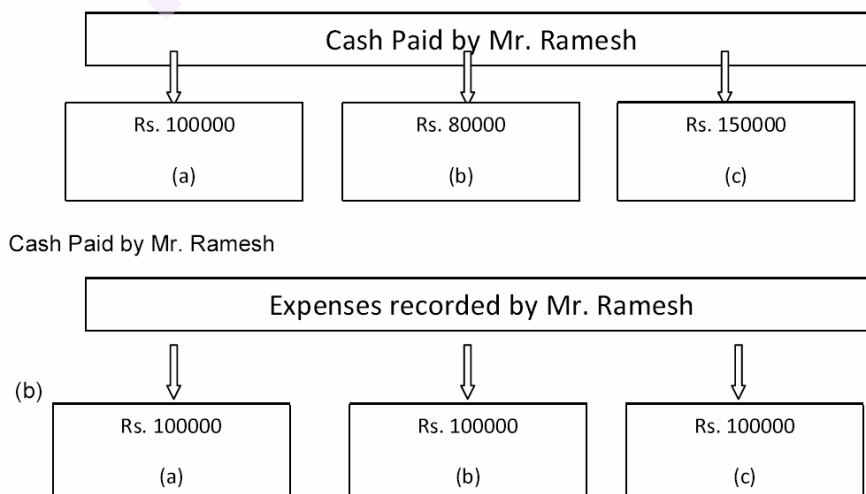
Example: Mr. A places an order with Mr. B for supply of certain goods, which are yet to be manufactured. On receipt of order, Mr. B purchases raw materials employs workers, produces the goods and delivers finished goods to Mr.A. Mr. A makes payment on receipt of goods. In this case, the sale will be presumed to have been made not at the time of receipt of the order for the goods, but at the time, when goods are delivered to Mr. A.

- 6) **Matching Concept:** In this concept, all expenses matched with revenue of that period should only be taken into consideration. The objective of running business is to earn profit in order to ascertain the profit made by the business during a period. It is necessary that the revenues of the period should be matched with the cost (Expenses) of the period. The term matching means appropriate association of related revenues and expenses.

Example: ABC Ltd. purchases a large appliance from wholesalers for Rs.5,000 and resells it to a local restaurant for Rs.8,000. At the end of the period, ABC Ltd. should match the Rs.5,000 cost with the Rs.8,000 revenue.

- 7) **Accrual Concept:** Under Accrual concept/ Accrual basis of accounting, income must be recorded in the accounting period in which it is earned. Therefore, accrued income must be recognized in the accounting period in which it arises rather than in the subsequent period in which it will be received. Conversely, prepaid income must be not be shown as income in the accounting period in which it is received but instead it must be presented as such in the subsequent accounting periods in which the services or obligations in respect of the prepaid income have been performed.

**Example:** Suppose Mr. Ramesh rents a house from Suresh at Rs.100,000 per year. Now consider the following three cases in which Ramesh pays cash to Suresh and records rent expense.



In above example, even though cash paid is different in all the three cases but the rent expense recorded is Rs.1,00,000 in each case. Justification behind that is the accrual concept of accounting in which expenses must be recorded in the accounting period in which they are incurred not in the period in which they are paid.

Notice that in case “b” Mr. Ramesh has paid Rs.80,000 cash but has recorded Rs.100,000 expense during the period because the annual rent is Rs.100,000 not Rs.80,000. The remaining Rs.20,000 will be paid subsequently. Also notice that in case “c” Mr. Ramesh has paid Rs.1,50,000 but has recorded Rs.100,000 expense, the balance of Rs.50,000 will be adjusted against the rent of subsequent period.

**8) Dual Aspect Concept:** This is a basic concept of accounting. According to this concept, every business transactions has dual effect-

- | <b>1<sup>st</sup> Aspects</b>                                | and | <b>2<sup>nd</sup> Aspects</b>   |
|--|-----|---|
| (i) It increases on Asset<br><b>[Purchase of Machinery]</b>  |     | decreases other Asset,<br><b>[Payment of Cash]</b>  |
| (ii) It increases an Asset<br><b>[Purchase of Machinery]</b> |     | simultaneously increase liability,<br><b>[Payment at future date<br/>(on credit basis)]</b> |
| (iii) It decreases one Asset,<br><b>[Payment of Cash]</b>    |     | decreases one Liability<br><b>[Settlement of Liability]</b>                                 |
| (iv) It increase liability,<br><b>[Bank Loan Obtained]</b>   |     | decreases simultaneously liability<br><b>[Payment to Creditors<br/>(Using Loan Amount)]</b> |

**For example,** suppose Mr. Rahul purchases Assets of Rs. 100000 in cash. In this business transaction, Mr. Rahul receives the assets of Rs. 100000, but on the other hand, Cash balance will decrease by Rs. 100000 So, Assets Account and Cash Account shall be affected by this transaction.

Thus in every business transaction, one aspect represents the assets or expenses other represents the claim or income and these two expects are always equal. This approach generates the concept of accounting equation, which can be summarized as below:

Liabilities	=	Assets
External Liabilities + Capital	=	Assets

For example, if A starts a business with a capital of Rs. 1,00,000. There are no aspects of this transaction. On the one hand, the business has asset (in the form of cash) of Rs. 1,00,000, while on the other hand the business has to pay to the proprietor a sum of Rs. 1,00,000, which is known as proprietor's capital. This expression can be shown in the form of accounting equation as follows:

Capital (Liability)	=	Cash (Assets)
1,00,000	=	1,00,000

In the example given above, if the Machinery worth Rs. 50,000 is purchased, the situation will be as follows:

Capital (Rs. 1,00,000) = Cash (Rs. 50,000) + Machinery (Rs. 50,000)

Thus, this concept develops a relationship between liabilities and assets. The Accounting Equation can be technically started as “for every debit, there is an equivalent credit”. As a matter of fact, the entire Double Entry System of Book-Keeping is based on this concept.

- 9) **Materiality Concept:** As per the concept of materiality, all the items having significant economic effect on the business of the enterprise should be disclosed in the financial statements and any insignificant item which will only increase the work of accountant but will not be relevant to the users need should not be disclosed in the financial statements.

The term materiality depends not only upon the amount of the item but also upon the size of the business, nature & level of information, level of the person making decision etc. Moreover an item material to one person may be immaterial to another person. What is important is that omission of any information should not impair the decision-making of various users.

- 10) **Conservatism or Prudence Concept:** Conservatism states that the accountant should not anticipate income and should provide for all possible losses. When there are many alternative values of an asset, an accountant should choose the method which leads to the lesser value. Later on we should see that the golden rule of current asset valuation – ‘cost or market price ‘whichever is lower originated from this concept.

#### Exercise :

- 1) Provision for bad debts is made due to the principle of :
  - A. Conservatism
  - B. Revenue matching
  - C. Full disclosure
  - D. Both (a) and (b)
 Answer : A
- 2) Recording of fixed assets at cost ensures adherence of :
  - A. Conservatism
  - B. Cost concept
  - C. Going concern concept
  - D. Accrual concept
 Answer : B

- 3) Fundamental accounting assumptions are :  
A. Going concern, conservatism, accrual  
B. Going concern, matching, consistency  
C. Going concern, consistency, accrual  
D. Going concern, entity, periodicity  
Answer : C
- 4) When fixed assets are sold :  
A. Total assets will increase  
B. Total liabilities will increase  
C. Total assets will decrease  
D. There is no change in total assets  
Answer : D
- 5) The accounting equation is based on :  
A. Going concern concept  
B. Dual aspect concept  
C. Money measurement concept  
D. All of these  
Answer : B
- 6) ..... Concept is the basic idea that the business is separate from owner.  
A. Dual aspect  
B. Entity  
C. Realization  
D. Materiality  
Answer : B
- 7) The owner of a company includes his personal medical expenses in the company's income statement. Indicate the principle that is violated.  
A. Cost principle  
B. Conservatism  
C. Disclosure  
D. Entity concept  
Answer : D
- 8) Two primary qualitative characteristics of financial statements are :  
A. Understandability and materiality  
B. Relevance and reliability  
C. Materiality and reliability  
D. Relevance and understandability  
Answer : B
- 9) Money owed from an outsider is a :  
A. Asset  
B. Liability  
C. Expense  
D. Capital  
Answer : A

- 10) GAAP's are
- A. Generally accepted accounting policies
  - B. Generally accepted accounting principles
  - C. Generally accepted accounting provisions
  - D. None of these
- Answer : B
- 11) ..... Refer to the general agreement on the usage and practices in social or economic life :
- A. Accounting assumptions
  - B. Accounting conventions
  - C. Accounting policies
  - D. Accounting principles
- Answer : B
- 12) Double entry principle means :
- A. Writing twice the same entry
  - B. Writing all the entries twice in the book
  - C. Having debit for every credit and credit for every debit
  - D. All of the above
- Answer : C
- 13) No inference of profit and the provision making policy for all possible losses is due to :
- A. Convention of consistency
  - B. Convention of conservatism
  - C. Convention of disclosure
  - D. Convention of materiality
- Answer : B
- 14) The underlying accounting principle necessitating amortization of intangible assets is / are
- A. Cost concept
  - B. Realization concept
  - C. Matching concept
  - D. Both b and c
- Answer : C
- 15) If going concern concept is no longer valid, which of the following is true?
- A. All prepaid assets would be completely written off immediately
  - B. The allowance for uncollectible accounts would be eliminated
  - C. Intangible assets would continue to be carried at net amortized historical cost
  - D. Land held as an investment would be valued at its realizable value.
- Answer : D

- 16) Window dressing of accounts means :
- A. Presenting accounts in a beautiful manner
  - B. Showing more losses to avoid income tax
  - C. Showing more profits to attract investment
  - D. All of the above
- Answer : C
- 17) Which financial statement represents the accounting equation?  
 $\text{Assets} = \text{Liabilities} + \text{Owner's equity}$
- A. Income statement
  - B. Cash flow statement
  - C. Balance sheet
  - D. Funds flow statement
- Answer : C
- 18) During the life-time of an entity, accountants prepare financial statements at arbitrary points of time as per :
- A. Prudence
  - B. Consistency
  - C. Periodicity
  - D. Matching
- Answer : C
- 19) The accounting convention of matching means :
- A. Profit for the period to be matched with sales revenue
  - B. Profit for the period to be matched with investment
  - C. Expenses of one period to be matched against the expenses of another period
  - D. Expenses of one period to be matched against the revenue of the same period.
- Answer : D
- 20) Recording of capital contributed by the owner as liability ensures adherence of principle of
- A. Matching
  - B. Going concern
  - C. Double entry
  - D. Separate entity of business
- Answer : D
- 21) Omission of paise and showing the round figures in financial statement is based on :
- A. Conservatism concept
  - B. Consistency concept
  - C. Materiality concept
  - D. Realization concept
- Answer : C



- 22) Accounting does not record non-financial transactions because of
- A. Accrual concept
  - B. Cost concept
  - C. Continuity concept
  - D. Money measurement concept
- Answer : D
- 23) Which of these not a fundamental accounting assumption?
- A. Going concern
  - B. Consistency
  - C. Conservatism
  - D. Accrual
- Answer : C
- 24) Fixed assets and current assets are categorized as per concept of :
- A. Separate entity
  - B. Going concern
  - C. Consistency
  - D. Time period
- Answer : D
- 25) The obligations of an enterprise other than owner's fund are known as :
- A. Assets
  - B. Liabilities
  - C. Capital
  - D. None of these
- Answer : B
- 26) Which concept requires that only those transactions which can be expressed in terms of money should be recorded in books of account?
- A. Business entity
  - B. Dual aspect
  - C. Money measurement
  - D. None of these
- Answer : C
- 27) An asset was purchased for Rs. 6,60,000. Cash was paid Rs. 1,20,000 and for the balance Rs. 5,40,000 loan was taken. What will be the effect on fixed assets? It will go up by
- A. Rs. 1,20,000
  - B. Rs. 5,40,000
  - C. Rs. 6,60,000
  - D. NIL
- Answer : C

- 28) Cash of Rs. 2,000 is withdrawn for personal expenses. This will be debited to which account :
- A. Drawings A/c
  - B. Creditor A/c
  - C. Capital A/c
  - D. Cash A/c
- Answer : A
- 29) Estimated selling price less estimated cost of sales is
- A. Net realizable value
  - B. Cost of purchase
  - C. Cost of goods sold
  - D. None
- Answer : A
- 30) Proprietor is treated as creditor of business due to :
- A. Periodicity concept
  - B. Materiality concept
  - C. Entity concept
  - D. Consistency concept
- Answer : C
- 31) Outstanding expenses is included in P & L A/c, according to which concept
- A. Matching
  - B. Full disclosure
  - C. Accrual
  - D. Going Concern
- Answer : C
- 32) Which does not follow dual aspect concept?
- A. Increase in one asset, decrease in other
  - B. Increase in both asset and liability
  - C. Decrease in one asset, decrease in other
  - D. Increase in one asset and capital
- Answer : C
- 33) According to which concept, the owner of an enterprise pays the "interest on drawings"
- A. Accrual concept
  - B. Conservatism concept
  - C. Entity concept
  - D. Dual Aspect concept
- Answer : C
- 34) If market value of closing inventory is reduced below cost price, which concept will play role?
- A. Materiality
  - B. Entity
  - C. Realization
  - D. Consistency
- Answer : C

- 35) Cost concept basically recognize
- A. Fair market value
  - B. Historical cost
  - C. Realisable value
  - D. Replacement cost
- Answer : B
- 36) Matching concept is based on : Revenue - ----- = Profit
- A. Liability
  - B. Expense
  - C. Asset
  - D. None
- Answer : B
- 37) Small items like stapler are not shown in books as fixed assets although they are used in business for long period due to :
- A. Consistency
  - B. Materiality
  - C. Accrual
  - D. Cost
- Answer : B
- 38) XYZ Ltd. Follows the written down value method for depreciating machinery year after year due to
- A. Consistency
  - B. Convenience
  - C. Comparability
  - D. Conservatism
- Answer : A
- 39) Human resource cant be shown in the Balance Sheet because of -----  
--- concept
- A. Realisation
  - B. Conservatism
  - C. Going concern
  - D. Money measurement
- Answer : D
- 40) The policy of “anticipate no profit and provide for all possible lossess” arises due to convention of
- A. Consistency
  - B. Disclosure
  - C. Conservatism
  - D. Matching
- Answer : C



## BASICS OF ACCOUNTING STANDARDS

### Unit Structure

4.1 Meaning & Introduction

4.2 Accounting Standards in Brief

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### 4.1 MEANING & INTRODUCTION

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Accounting standards are the written policy documents issued by the regulatory authority, experts accounting body or by the government covering various aspects of recognition, treatment, measurement, presentation & disclosure of accounting transactions and events in the financial statements. The accountant has to adhere to various accounting standards while preparing financial statements of the entities.

Accounting standard provide framework and standard accounting policies so that the financial statement of different enterprises become comparable.

The accounting standards deals with the issues of –

- i. Recognition of events and transactions in the financial statements;
- ii. Measurement of these transactions and events;
- iii. Presentation of these transactions and events in the financial statements in a manner that is meaningful and understandable to the reader; and
- iv. The disclosure requirements which should be there to enable public at large and the stakeholders and the potential investors in particular, to get insight into what these financial statement are trying to reflect and thereby facilitating them to take prudent and informed business decisions.

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### 4.2 ACCOUNTING STANDARDS IN BRIEF


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**AS-1-Disclosure of Accounting Policies:** Accounting Policies refer to specific accounting principles and the method of applying those principles adopted by the enterprises in preparation and presentation of the financial statements.


**AS-2-Valuation of Inventories:** The objective of this standard is to formulate the method of computation of cost of inventories / stock, determine the value of closing stock / inventory at which the inventory is to be shown in balance sheet till it is not sold and recognized as revenue.


**AS 3-Cash Flow Statements:** Cash flow statement is additional information to user of financial statement. This statement exhibits the flow of incoming and outgoing cash. This statement assesses the ability of the enterprise to generate cash and to utilize the cash. This statement is one of the tools for assessing the liquidity and solvency of the enterprise.

**AS 4-Contingencies and Events occurring after the balance sheet date:** In preparing financial statement of a particular enterprise, accounting is done by following accrual basis of accounting and prudent accounting policies to calculate the profit or loss for the year and to recognize assets and liabilities in balance sheet. While following the prudent accounting policies, the provision is made for all known liabilities and losses even for those liabilities / events, which are probable. Professional judgment is required to classify the likelihood of the future events occurring and, therefore, the question of contingencies and their accounting arises. Objective of this standard is to prescribe the accounting of contingencies and the events, which take place after the balance sheet date but before approval of balance sheet by Board of Directors. The Accounting Standard deals with Contingencies and Events occurring after the balance sheet date.

 **AS 5-Net Profit or Loss for the Period, Prior Period Items and change in Accounting Policies:** The objective of this accounting standard is to prescribe the criteria for certain items in the profit and loss account so that comparability of the financial statement can be enhanced. Profit and loss account being a period statement covers the items of the income and expenditure of the particular period. This accounting standard also deals with change in accounting policy, accounting estimates and extraordinary items.

 **AS 6-Depreciation Accounting:** It is a measure of wearing out, consumption or other loss of value of a depreciable asset arising from use, passage of time. Depreciation is nothing but distribution of total cost of asset over its useful life.

 **AS 7-Construction Contracts:** Accounting for long term construction contracts involves question as to when revenue should be recognized and how to measure the revenue in the books of contractor. As the period of construction contract is long, work of construction starts in one year and is completed in another year or after 4-5 years or so. Therefore question arises how the profit or loss of construction contract by contractor should be determined. There may be following two ways to determine profit or loss: On year-to-year basis based on percentage of completion or on completion of the contract.

 **AS 8-Accounting for Research & Development:** Accounting for research & development, is withdrawn from the date of AS 26, Intangible assets, becoming mandatory for respective enterprises.

📖 **AS 9-Revenue Recognition:** The standard explains as to when the revenue should be recognized in profit and loss account and also states the circumstances in which revenue recognition can be postponed. Revenue means gross inflow of cash, receivable or other consideration arising in the course of ordinary activities of an enterprise such as the sale of goods, rendering of services, and use of enterprises resources by other yielding interest, dividend and royalties. In other words, revenue is a charge made to customers / clients for goods supplied and services rendered.

📖 **AS 10-Accounting for Fixed Assets:** AS 10 prescribes accounting for fixed assets used by entity in the business. AS defines term fixed asset. It is an asset, which is held with intention of being used for the purpose of producing or providing goods and services not held for sale in the normal course of business and expected to be used for more than one accounting period.

📖 **AS 11-The Effects of changes in Foreign Exchange Rates :** Effect of Changes in Foreign Exchange Rate shall be applicable in Respect of Accounting Period commencing on or after 01-04-2004 and is mandatory in nature. This accounting Standard applicable to accounting for transaction in foreign currencies in translating in the financial statement of foreign operations. Effect of changes in foreign exchange rate, an enterprises should disclose following aspects:







- a) Amount Exchange Difference included in Net profit or Loss;
- b) Amount accumulated in foreign exchange translation reserve;
- c) Reconciliation of opening and closing balance of Foreign Exchange translation reserve;

📖 **AS 12-Accounting for Government Grants:** Accounting standard 12 deals with accounting for government grants both capital and revenue from government. Government Grants are assistance by the Govt. in the form of cash or kind to an enterprise in return for past or future compliance with certain conditions. Government assistance, which cannot be valued reasonably, is excluded from Govt. grants,. Those transactions with Government, which cannot be distinguished from the normal trading transactions of the enterprise, are not considered as Government grants.

📖 **AS 13-Accounting for Investments:** AS 13 provides accounting principles for investments in the financial statement and related disclosure requirements. As per AS 13 Investment means the assets held for earning income by way of dividend, interest and rentals, for capital appreciation or for other benefits.


📖 **AS 14-Accounting for Amalgamation:** This standard prescribes accounting for amalgamation. This accounting standard deals with accounting to be made in books of Transferee Company in case of amalgamation. The standard is applicable when acquired company is


dissolved and separate entity ceased exist and purchasing company continues with the business of acquired company


-  **AS 15-Employee Benefits:** Accounting Standard 15 prescribes the accounting and disclosure for employee benefits. This Standard covers all forms of employee benefits i.e. Short term employee benefits (Salaries, Leave, bonus, housing, mediclaim etc.), Post employment benefits (gratuity, pension, post employment medical care etc.) and other long term employee benefits and termination benefits.
-  **AS 16-Borrowing Costs :** Enterprises are borrowing the funds to acquire, build and install the fixed assets and other assets, these assets take time to make them useable or saleable, therefore the enterprises incur the interest (cost on borrowing) to acquire and build these assets. The objective of the Accounting Standard is to prescribe the treatment of borrowing cost (interest + other cost) in accounting, whether the cost of borrowing should be included in the cost of assets or not.
-  **AS 17-Segment Reporting:** An enterprise needs in multiple products/services and operates in different geographical areas. Multiple products / services and their operations in different geographical areas are exposed to different risks and returns. Information about multiple products / services and their operation in different geographical areas are called segment information. Such information is used to assess the risk and return of multiple products/services and their operation in different geographical areas. Disclosure of such information is called segment reporting.
-  **AS 18-Related Party Disclosure:** Sometimes business transactions between related parties lose the feature and character of the arms length transactions. Related party relationship affects the volume and decision of business of one enterprise for the benefit of the other enterprise. Hence disclosure of related party transaction is essential for proper understanding of financial performance and financial position of enterprise.
-  **AS 19-Accounting for leases:** Lease is an arrangement by which the lesser gives the right to use an asset for given period of time to the lessee on rent. It involves two parties, a lessor and a lessee and an asset which is to be leased. The lessor who owns the asset agrees to allow the lessee to use it for a specified period of time in return of periodic rent payments.
-  **AS 20-Earning Per Share:** Earning per share (EPS) is a financial ratio that gives the information regarding earning available to each equity share. It is very important financial ratio for assessing the state of market price of share. This accounting standard gives computational methodology for the determination and presentation of earning per share, which will improve the comparison of EPS. The statement is





applicable to the enterprise whose equity shares or potential equity shares are listed in stock exchange.


 **AS 21-Consolidated Financial Statements:** The objective of this statement is to present financial statements of a parent and its subsidiary (ies) as a single economic entity. In other words the holding company and its subsidiary (ies) are treated as one entity for the preparation of these consolidated financial statements. Consolidated profit/loss account and consolidated balance sheet are prepared for disclosing the total profit/loss of the group and total assets and liabilities of the group. As per this accounting standard, the consolidated balance sheet if prepared should be prepared in the manner prescribed by this statement.


 **AS 22-Accounting for Taxes on Income:** This accounting standard prescribes the accounting treatment for taxes on income. Traditionally, amount of tax payable is determined on the profit/loss computed as per income tax laws.

 **AS 23-Accounting for Investments in Associates in consolidated financial statements:** The accounting standard was formulated with the objective to set out the principles and procedures for recognizing the investment in associates in the consolidated financial statements of the investor, so that the effect of investment in associates on the financial position of the group is indicated.

 **AS 24-Discontinuing Operations:** The objective of this standard is to establish principles for reporting information about discontinuing operations. The focus of the disclosure of the Information is about the operations which the enterprise plans to discontinue rather than disclosing on the operations which are already discontinued. However, the disclosure about discontinued operation is also covered by this standard.

 **AS 25-Interim Financial Reporting (IFR):** Interim financial reporting is the reporting for periods of less than a year generally for a period of 3 months.

 **AS 26-Intangible Assets :** An Intangible Asset is an Identifiable non-monetary Asset without physical substance held for use in the production or supplying of goods or services for rentals to others or for administrative purpose

 **AS 27-Financial Reporting of Interest in joint ventures:** Joint Venture is defined as a contractual arrangement whereby two or more parties carry on an economic activity under 'joint control'. Control is the power to govern the financial and operating policies of an economic activity so as to obtain benefit from it. 'Joint control' is the contractually agreed sharing of control over economic activity.



📖 **AS 28 Impairment of Assets:** The dictionary meaning of 'impairment of asset' is weakening in value of asset. In other words when the value of asset decreases, it may be called impairment of an asset. As per AS-28 asset is said to be impaired when *carrying amount* of asset is more than its *recoverable amount*.

*Carrying Amount* means book value of Asset

*Recoverable Amount* means Market value of Asset

📖 **AS 29-Provisions, Contingent Liabilities And Contingent Assets:** Objective of this standard is to prescribe the accounting for Provisions, Contingent Liabilities, Contingent Assets, Provision for restructuring cost

**Provision:** It is a liability which can be measured only by using a substantial degree of estimation

**Liability:** A liability is present obligation of the enterprise arising from past events the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

#### Exercise :

- 1) The accounting standards are mandatory for
  - A. Companies
  - B. Partnership concern
  - C. Charitable organizations
  - D. Sole proprietorshipAnswer : A
- 2) Accounting standards refers to specific accounting :
  - A. Principle
  - B. Methods of applying those principles
  - C. Both a and b
  - D. NoneAnswer : C
- 3) Construction Contract :
  - A. AS-5
  - B. AS-6
  - C. AS-7
  - D. AS-9Answer : C
- 4) Accounting standards ----- the status
  - A. Can over-ride
  - B. Cannot over-ride
  - C. May over-ride
  - D. NoneAnswer : B

- 5) Revenue Recognition is  
A. AS-9  
B. AS-12  
C. AS-10  
D. AS-11  
Answer : A
- 6) AS-8 on accounting for research and development :  
A. Is replaced by As-26  
B. Is applicable only to listed companies  
C. Is mandatory for research institutions  
D. Is still in use  
Answer : A
- 7) The purpose of accounting standards is to :  
A. Harmonies accounting policies  
B. Eliminate the non comparability of financial statements  
C. Improve reliability of financial statements  
D. All of the above  
Answer : D
- 8) AS-2 is on :  
A. Disclosure of accounting policies  
B. Valuation of inventories  
C. Revenue recognition  
D. Depreciation accounting  
Answer : B
- 9) AS are issued by  
A. Central Government  
B. Company Law Board (CLB)  
C. ICAI  
D. Income Tax Department  
Answer : C
- 10) Till date the no of Standards issued are  
A. 29  
B. 30  
C. 31  
D. 32  
Answer : D
- 11) Accounting Standard 6 is on :  
A. Disclosure of accounting policies  
B. Depreciation  
C. Valuation of Inventories  
D. Contingent Asset and Contingent Liabilities  
Answer : B



## INTRODUCTION TO IFRS

### Unit Structure

5.1 Introduction

5.2 Purpose

5.3 Scope

5.4 International Financial Reporting Standards

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### 5.1 INTRODUCTION

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IFRS stands for **International Financial Reporting Standards**. IFRS are developed by International Accounting standards boards (IASB). IFRS is set of standards used in many parts of the world, including the European Union, Hong Kong, Australia, Malaysia, Russia, South Africa, Singapore etc. for preparation of financial statements. Different Countries uses different set of accounting standards while preparation of financial statements for e.g. India uses its own set of Accounting standards issued by the ICAI, United states have their US GAAP, Canada has its Canadian GAAP and United Kingdom has its UK GAAP.

#### Conceptual Framework

**Introduction:** Financial statements are prepared and presented for external users by many many entities around the world. Although such financial statements may appear similar from country to country, there are differences which have probably been caused by a variety of social, economic and legal circumstances and by different countries having in mind the needs of different users of financial statements when setting national requirements.

The International Accounting Standards Board is committed to narrowing these differences by seeking to harmonize regulations, accounting standards and procedures relating to the Preparation and presentation of financial statements. It believes that further harmonization can best be pursued by focusing on financial statements that are prepared for the purpose of providing information that is useful in making economic decisions.

The Board believes that financial statements prepared for the purpose of making economic decisions meet the common needs of most users. This is because nearly all users are making economic decisions, for example:

- (a) to decide when to buy, hold or sell an equity investment.
- (b) to assess the stewardship or accountability of management.
- (c) to assess the ability of the entity to pay and provide other benefits to its employees.

- (d) to assess the security for amounts lent to the entity.
- (e) to determine taxation policies.
- (f) to determine distributable profits and dividends.
- (g) to prepare and use national income statistics.
- (h) to regulate the activities of entities.

The Board recognises, however, that governments, in particular, may specify different or additional requirements for their own purposes. These requirements should not, however, affect financial statements published for the benefit of other users unless they also meet the needs of those other users.

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## **5.2 PURPOSE**

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This Conceptual Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. The purpose of the Conceptual Framework is:

- (a) To assist the Board in the development of future IFRSs and in its review of existing IFRSs;
- (b) To assist the Board in promoting harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by IFRSs;
- (c) To assist national standard-setting bodies in developing national standards;
- (d) To assist preparers of financial statements in applying IFRSs and in dealing with topics that have yet to form the subject of an IFRS;
- (e) To assist auditors in forming an opinion on whether financial statements comply with IFRSs;
- (f) To assist users of financial statements in interpreting the information contained in financial statements prepared in compliance with IFRSs; and
- (g) To provide those who are interested in the work of the IASB with information about its approach to the formulation of IFRSs.

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## **5.3 SCOPE**

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The Conceptual Framework deals with:

- (a) the objective of financial reporting;
- (b) the qualitative characteristics of useful financial information;
- (c) the definition, recognition and measurement of the elements from which financial statements are constructed; and
- (d) concepts of capital and capital maintenance.

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## 5.4 INTERNATIONAL FINANCIAL REPORTING STANDARDS

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International Financial Reporting Standards in a broad sense comprise:

- ❖ ***Conceptual Framework for Financial Reporting*** —stating basic principles and grounds of IFRS
- ❖ ***IAS***—standards issued before 2001
- ❖ ***IFRS***—standards issued after 2001
- ❖ ***SIC***—interpretations of accounting standards, giving specific guidance on unclear issues
- ❖ ***IFRIC***—newer interpretations, issued after 2001

### **IFRSs**

IFRS 1: First time Adoption of International Financial Reporting Standards

IFRS 2: Share-based Payment

IFRS 3: Business Combinations

IFRS 4: Insurance Contracts

IFRS 5: Non-current Assets Held for Sale and Discontinued Operations

IFRS 6: Exploration for and Evaluation of Mineral Resources

IFRS 7: Financial Instruments: Disclosures

IFRS 8: Operating Segments

IFRS 9: Financial Instruments

IFRS 10: Consolidated Financial Statements

IFRS 11: Joint Arrangements

IFRS 12: Disclosure of Interests in Other Entities

IFRS 13: Fair Value Measurement

IFRS 14: Regulatory Deferral Accounts

IFRS 15: Revenue from Contracts with Customers

### **IASs**

IAS 1: Presentation of Financial Statements

IAS 2: Inventories

IAS 7: Statement of Cash Flows

IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors

IAS 10: Events after the Reporting Period

IAS 11: Construction Contracts\*

IAS 12: Income Taxes

IAS 16: Property, Plant and Equipment

IAS 17: Leases

IAS 18: Revenue\*

IAS 19: Employee Benefits

IAS 20: Accounting for Government Grants and Disclosure of Government Assistance

IAS 21: The Effects of Changes in Foreign Exchange Rates

**Note: IAS 3, 4, 5, 6, 9, 13, 14, 15, 22, 25, 30, 31 and 35 have been superseded SICs**

SIC 7: Introduction of the Euro

SIC 10: Government Assistance – No Specific Relation to Operating Activities

SIC 15: Operating Leases – Incentives

SIC 25: Income Taxes – Changes in the Tax Status of an Entity or its Shareholders

SIC 27: Evaluating the Substance of Transactions Involving the Legal Form of a Lease

SIC 29: Service Concession Arrangements: Disclosures

SIC 31: Revenue – Barter Transactions Involving Advertising Services

SIC 32: Intangible Assets – Web Site Costs

Note: SIC 1, 2, 3, 4, 5, 6, 8, 9, 11, 12, 13, 14, 16, 17, 18, 19, 20, 21, 22, 23, 24, 26, 28, 30, 33 have been superseded

\*Will be superseded by IFRS 15 as of 1 January 2017

## **IFRICs**

IFRIC 1: Changes in Existing Decommissioning, Restoration and Similar Liabilities

IFRIC 2: Members' Shares in Co-operative Entities and Similar Instruments

IFRIC 4: Determining whether an Arrangement contains a Lease

IFRIC 5: Rights to Interests Arising from Decommissioning, Restoration and Environmental Rehabilitation Funds

IFRIC 6: Liabilities Arising from Participating in a Specific Market - Waste Electrical and Electronic Equipment

IFRIC 7: Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies

IFRIC 10: Interim Financial Reporting and Impairment

IFRIC 12: Service Concession Arrangements

IFRIC 13: Customer Loyalty Programmes\*

IFRIC 14: IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction

IFRIC 15: Agreements for the Construction of Real Estate\*

IFRIC 16: Hedges of a Net Investment in a Foreign Operation

IFRIC 17: Distributions of Non-cash Assets to Owners

IFRIC 18: Transfers of Assets from Customers\*

IFRIC 19: Extinguishing Financial Liabilities with Equity Instruments

IFRIC 20: Stripping Costs in the Production Phase of a Surface Mine

IFRIC 21: Levies

Note: IFRIC 3, 8, 9 & 11 have been withdrawn



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## Module - III

# 6

### CAPITAL AND REVENUE EXPENDITURE- DEFERRED REVENUE EXPENDITURE- CAPITAL AND REVENUE RECEIPTS

#### Unit Structure

- 6.0 Objectives
- 6.1 Introduction
- 6.2 Misclassification and effect of error
- 6.3 Capital and Revenue-
- 6.4 Revenue expenditure
- 6.5 Distinction between capital expenditure and Revenue expenditure
- 6.6 Distinction between capital receipt and Revenue receipt
- 6.7 Tests to be applied to transactions
- 6.8 For Capital Receipt/ Revenue Receipt
- 6.9 Deferred Revenue Expenditure-(DRE)

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#### 6.0 OBJECTIVES

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- ❖ To help the learner understand the concept of Capital and Revenue
- ❖ To help the learner distinguish between capital and revenue transactions
- ❖ To help the learner understand the importance of correctly identifying the capital and revenue transactions, the effect of errors due to misclassification and its presentation in the financial statements
- ❖ To help the learner know about the deferred revenue expenditure and its presentation in financial statements.

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#### 6.1 INTRODUCTION

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The Final Accounts prepared at the end of the year consists of Profit and Loss account and Balance sheet. The final accounts are prepared from Trial balance which gives a list of accounts showing debit balances and credit balances. The accounts appearing in the trial balance are to be taken to the trading, profit and loss account or balance sheet. The



profit and loss account (also known as Revenue Statement) shows the income and gains on the credit side and the various expenses and losses are shown on the debit side. The balance sheet is a statement showing the financial position as on a particular date and shows the capital and liabilities and assets.

It is necessary to classify the items appearing in the trial balance as capital or revenue so that they can be correctly shown in the trading, profit and loss account or balance sheet as the case may be. Such classification is necessary to comply with the concept of matching costs and revenue in a given period.

## 6.2 MISCLASSIFICATION AND EFFECT OF ERROR

Any misclassification impacts the correctness and accuracy of the financial statements – the profit and loss account will not show the correct Profit/ Loss and the Balance Sheet will not show the true position of assets and liabilities. Thus due to misclassification, the accuracy of the financial statements are affected and the statements do not depict the true and fair view of the state of affairs of the business enterprise.

**For example-** A computer is purchased and the accountant records the purchase along with purchase of raw materials in the trading account. The error will affect the profit or loss position as the transaction has been wrongly shown in trading account. The computer purchased should have been recorded as an asset in the balance sheet. In this way the error due to misclassification affects both the revenue statement and the balance sheet.

### Effect of error in classification

- 1) Trading account will not show correct gross profit/ gross loss.
- 2) Profit and loss account will not disclose true net profit/ net loss.
- 3) Balance sheet will not disclose true value of Assets and Liabilities.
- 4) Financial statements will not disclose True and Fair view of the state of Affairs of the organization.
- 5) It will be difficult to understand the capitalization of business.
- 6) These errors affect the accounts of the subsequent years

Error in classification	Impact on profit and impact on balance sheet/ value of asset
1) Revenue expenditure is wrongly treated as capital expenditure	Profit will be inflated , Value of asset will be inflated.
2) Capital receipt is treated as revenue receipt	Profit will be inflated , Value of asset will be inflated.
3) Capital expenditure treated as revenue expenditure	Profit will be deflated , Value of asset will be deflated.
4) Revenue receipt wrongly treated as capital receipt	Profit will be deflated.

It is thus clear that any error in classification or misclassification impacts the accuracy and correctness of the financial statements and hence it is very important to classify the transactions as capital or revenue and disclose the same correctly in the financial statements .

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## 6.3 CAPITAL AND REVENUE

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**Receipt or Expenditure transactions are to be classified as capital or revenue and further classified as capital expenditure, revenue expenditure capital receipt or revenue receipts.**

TRANSACTIONS	
Expenditure or receipt	
Expenditure transactions ( involves outflow of cash)	Receipt transactions ( involves inflow of cash)
Capital expenditure / Revenue expenditure	Capital receipt/ Revenue receipt

Capital transactions are further classified as capital expenditure and capital receipt and revenue transactions are classified as revenue expenditure and revenue receipt.

**Capital expenditure** is any expenditure which has any one or all of the following-

- ❖ It is a non- recurring expenditure
- ❖ The benefit of such expenditure is seen for more than one year.
- ❖ The expenditure increases the revenue earning capacity of the organization.

In short, if the benefits of the expenditure are expected to accrue for a long time, the expenditure is capital expenditure. Thus capital expenditure is that expenditure which results in the acquisition of an asset, tangible or intangible.

Some common examples of capital expenditure are-

**1) Purchase of an asset**

Any expenditure that is incidental to the purchase of an asset or has been incurred to put the asset in working condition for example – installation charges or commissioning expenses incurred with reference to purchase of asset is also to be treated as capital expenditure. All the expenses incurred on the assets till they yield income are capital in nature.

**2) Expenditure during construction-**

Any expenditure incurred during construction period or capital work in progress is considered as a capital expenditure.

3) Expenditure that improves the standard of performance of an existing asset.

Any expenditure which extends the useful life of the asset or improves the efficiency of the asset is to be capitalized and added to the cost of the fixed asset

- 4) Cost of an addition or extension to an existing asset
- 5) Investment in shares, debentures, immoveable properties
- 6) Cost of acquiring intangible assets like goodwill, patents, copyrights.
- 7) Cost of acquisition and development of wasting assets like mines, oil-wells.

Accounting of capital expenditure- Capital expenditures are shown in the asset side of Balance sheet

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## 6.4 REVENUE EXPENDITURE

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**Revenue expenditure** is any expenditure which has any one or all of the following-

- ❖ The expenditure is incurred in the day to day conduct of business and necessary to carry on the business.
- ❖ The expenditure is recurring in nature
- ❖ The benefit of such expenditure usually lasts for a short period of time

Kohler defines Revenue expenditure as an expenditure charged against operations.

Any expenditure which is not a capital expenditure and which is incurred for carrying out the day to day activities of business is called revenue expenditure.

Some common examples of revenue expenditure are-

- 1) Expenses relating to business activities-  
Expenses of production-Purchase of raw materials,  
Expenses of administration -Payment of Office salaries  
Expenses of selling and distribution  
Finance expenses
- 2) Expenses which are incurred to maintain the asset in a working condition-  
Repairs and maintenance expenses
- 3) Expenses incurred to earn income- -Interest on loan taken for purchase of shares

Accounting of Revenue expenditure-Revenue expenditures are shown on the debit side of Trading/ profit and loss account.

**Capital Receipt-**

Any receipt or cash inflow which has any one or all of the following

- ❖ The receipt is non- recurring in nature
- ❖ The receipts do not arise through normal activities of business
- ❖ Some common examples of capital receipt are-
  - a) Amount received on account of issue of fresh share capital/ debentures
  - b) Amount of loans raised
  - c) Proceeds on sale of fixed assets
  - d) Deposits

Accounting of capital receipt- Capital receipts are shown in the balance sheet.

**Revenue receipt**

Revenue receipts are those items of income which are received or accrued in the ordinary course of business.

Any cash inflow generated in the normal course of business activities are to be treated as revenue receipts- Income generated from cash/ credit sales, or from services rendered.

Accounting of revenue receipt- Revenue receipts are shown on the credit side of trading/ profit and loss account

Concept of capital and revenue can be summarized as under-

Capital transactions will be recorded in the balance sheet while revenue transactions will be shown in the revenue statements- Trading, profit and loss account

Trading, Profit and loss account (debit side)	Trading, Profit and loss account(credit side)
Revenue expenditure	Revenue receipts
To Salary	By sale of goods
To rent	

Balance sheet( Liability side)	Balance sheet (asset side)
Capital receipt	Capital expenditure
Loan from bank	Plant and Machinery purchased

## **6.5 DISTINCTION BETWEEN CAPITAL EXPENDITURE AND REVENUE EXPENDITURE**

<b>CAPITAL EXPENDITURE</b>	<b>REVENUE EXPENDITURE</b>
It is non- recurring in nature	It is recurring in nature
It is shown in the Balance sheet	It is shown in the revenue account
It is incurred for acquiring fixed assets intended for use in business	It is incurred for carrying out the day to day activities of the business
It increases the revenue earning capacity of the concern	It does not increase the revenue earning capacity of the concern.
Benefit of this expenditure extends for more than one year	The benefit of this expenditure is for a short period
Example- purchase of fixed asset	Example – Payment of salaries

## **6.6 DISTINCTION BETWEEN CAPITAL RECEIPT AND REVENUE RECEIPT**

<b>CAPITAL RECEIPT</b>	<b>REVENUE RECEIPT</b>
They are non recurring in nature	They are recurring in nature
They appear in the balance sheet- It is disclosed as a liability in the balance sheet	They appear in Revenue account- It is disclosed as an income in the P&L A/c
Capital receipts which are liabilities are to be repaid	Revenue receipts are not to be repaid as they are not liabilities.
They are not gains to the concern	They are gains to the concern
It represents capital brought in by the proprietor which are not of recurring nature	It represents income such as sale of goods, interest received
Example-Amount received on issue of debentures	Example-Interest received, recovery of bad debts

## **6.7 TESTS TO BE APPLIED TO TRANSACTIONS**

**To classify a transaction as capital or revenue, one may use the following tests as indicators-**

### **FOR CAPITAL/ REVENUE EXPENDITURE**

- 1) **What is the period of benefit from expenditure?**
- 2) **What is the effect of expenditure?**
- 3) **What is the amount of expenditure?**

**Period of benefit from expenditure-** if the benefit is for short period and recurring in nature, it is generally treated as Revenue expenditure. Expenditure which will give benefit for a long period of time and which is non- recurring in nature will be generally classified as Capital expenditure. A non- recurring expenditure is always capital in nature unless materiality concept emphasizes the importance of recognizing it as revenue expenditure.

**Effect of Expenditure-** If the expenditure gives rise to a tangible asset or right, treat it as capital expenditure

**Amount of expenditure-** Generally the capital expenditures involve huge amounts but this cannot always be treated as a conclusive , reliable test for classification

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## 6.8 FOR CAPITAL RECEIPT/ REVENUE RECEIPT

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- 1) What is the source or cause of receipt or profit?
- 2) What is the nature of the receipt?
- 3) What is the impact of the receipt transaction on the profit / loss ?

**Source of receipt-** If the receipt is from trading transaction, then it should be treated as revenue receipt. Eg -sale of goods. If the receipt is from other transactions, then it should be considered as capital receipt. eg Loan taken from bank, amount realized on sale of fixed assets. Thus if receipt arises in the course of business activity, then it is to be treated as revenue receipt. If it arises out of financing activity, it is to be treated as Capital receipt.

**Nature of receipt-** Non- recurring receipts are capital receipts while recurring receipts are revenue receipts.

Impact of the transaction on profit/ loss during the year- Capital receipts have no bearing on the profit made or loss incurred during the year . Only revenue receipts are taken into account to ascertain the profit made by the business. This is a fairly reliable indicator/ parameter for classifying transactions as capital receipt/ revenue receipt.

In case of receipts, the general rule is that if the receipt is against the supply of goods or services and related to period under review, the receipt is revenue receipt. This will be shown in the P&L A/C .Capital receipts are to be shown as liability or reduced from assets appearing in Balance sheet.

Sometimes a part of the receipt may be capital and a part of it may be revenue-

For example proceeds on sale of asset-

- 1) If the sale proceeds is less than book value of asset , the receipt is capital receipt to be deducted from asset

- 2) If the sale proceeds is more than book value but less than cost, the receipts are to be segregated as-
  - a) equal to book value of asset is capital receipt to be reduced from asset
  - b) excess as revenue receipt giving rise to revenue profit.
- 3) If sale proceeds is more than cost, the receipts are to be accounted for as under-
  - a) equal to book value capital receipt to be reduced from asset
  - b) between book value and cost, revenue receipt giving rise to revenue profit
  - c) excess over cost, revenue receipt giving rise to capital profit.

However it is not always easy to classify transactions as capital/ revenue. There is a good deal of difference of opinion in deciding whether a particular item is capital or revenue. Hence it has to be decided based on the facts of the case on a case to case basis.

**For example-** Purchase of motor car is a capital expenditure as it involves acquisition of an asset. However purchase of Motor car by a car dealer who deals with purchase and sale of motor cars on a regular basis is not a capital expenditure. In the second case the purchase of car is to be treated as revenue.

Expenditure incurred in converting an ordinary screen in a cinema hall to a cinemascope – It is difficult to accurately ascertain the nature of this transaction. It may be argued that as the seating capacity of the hall has not changed, it should be treated as revenue expenditure. However, the second argument could be cinemascope pictures attract large audience and as the expenditure will result in higher earnings, it is to be treated as capital expenditure.

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## 6.9 DEFERRED REVENUE EXPENDITURE-(DRE)

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According to the Guidance note issued by ICAI, “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 be of benefit over a subsequent period/ periods.”

**For example-** Normal annual advertising expenses is considered as revenue expenditure and debited to the profit and loss a/c. If the heavy expenses are incurred on advertising campaign to launch a new product, then the whole amount should not be debited to P&L a/c of that year. The benefit accrues for a long period of time. Hence so much of the expenditure as benefits the current year may be considered as revenue and debited to profit and loss a/c the balance to be shown as deferred expenditure- revenue expenditure which is deferred or postponed.

There are some transactions which may appear revenue in nature but the benefits of such expenditure are seen for a long period of time. Such expenses are treated as deferred revenue expenditure. For example- Heavy advertisement expenses or promotion expenses to launch a product- As such expenditure yields the benefit for a long period, it is necessary to spread the amount over such number of years. If not spread over the years, then the revenue statement of the year in which the expenditure was incurred may not show the true picture of Profit/ loss. Hence in order to have more credible financial statements the expenditure is deferred and a part of the expenditure is shown in the current year Profit and loss account. The balance amount (not yet written off) is shown as a debit balance in the asset side of the balance sheet.

Other common examples of Deferred revenue expenditure are-

- Preliminary expenses
- Cost of market research for a new product
- Commission on issue of debentures
- Cost of issuing shares / debentures or raising loans

Accounting for Deferred Revenue expenditure- For eg - Association fees paid Rs 60,000 for three years (2016-17, 2017-18, 2018-19).

1<sup>st</sup> year- Accounting for the year 2016-17- This expenditure has to be shown in Profit and loss a/c. However it is evident that the expenditure is incurred in the financial year 2016-17, but the benefit of the expenditure is enjoyed in the subsequent periods too. Hence the amount of Rs 60,000 should be spread over three years and the annual amount to be determined ( $60000/3$ ) Rs 20,000. The profit and loss account of the year 2016-17 will be debited with Rs 20,000. The balance (60,000-20,000) Rs 40,000 not written off will be shown in the asset side of balance sheet. Here the expenditure is – deferred and hence known as DRE.

2<sup>nd</sup> year- Accounting for the year 2017-18- The amount of Rs 20,000 will be debited to profit and loss account and the balance Rs 20,000 (40,000-20,000) not written off will be shown in the asset side of balance sheet.

3<sup>rd</sup> year- Accounting for the year 2018-19- The amount of Rs 20,000 will be debited to profit and loss account and there is no balance to be shown in the balance sheet.

Thus the amount has been spread over three years and accounted for in the books.

Revenue expenditure that becomes capital expenditure-

The following revenue expenses under certain circumstances become capital expenditure



Expenses	Circumstances
1) Repairs	Amount spent on repairs of plant and machinery, furniture, building which are regular in nature and incurred to maintain the asset in a working condition are to be considered as revenue expenditure. However repairs to the second hand assets to improve the operational efficiency is to be treated as capital expenditure.
2) Wages	Wages paid is a revenue expenditure. Wages paid for installation of machinery or construction of fixed assets is considered as capital expenditure.
3) Legal charges	Legal charges are basically revenue in nature and are shown in the debit side of P&L a/c. Legal charges incurred in connection with purchase of fixed asset are capital in nature
4) Transport charges	Transport charges are basically revenue in nature. Transport charges incurred for purchase of machinery , furniture are capital in nature.
5) Interest on capital	Interest on capital paid during the construction of works, building and plant is capital in nature.
6) Raw material and stores	This is basically a revenue expenditure but if it is used for construction of fixed assets, it is considered as capital and added to the cost of the asset
7) Development expenditure	The development expenditure incurred during the development period with reference to tea and rubber plantations should be treated as capital expenditure

To summarize the revenue expenditure incurred in connection with purchase of asset or which is incidental to the purchase of asset, expenses incurred in development of asset is to be treated as capital expenditure.

**Problems-****Q1- Error in classification or misclassification-**

The following is the Trading account for the year ended 31 st March 2016

Particulars	Amt( Rs)	Particulars	Amt (Rs)
To opening stock	60,000	By Sales	4,00,000
To purchases	3,00,000	By Closing stock	1,00,000
To wages	1,00,000		
To Gross Profit	40,000		
	5,00,000		5,00,000

**Additional Information-**

- 1) Sales included sales of old furniture Rs 10,000
- 2) Purchases included purchase of machinery Rs 70,000
- 3) Some workers were employed for construction of a gallery to the office building. Wages of these workers amounting to Rs 30,000 were included in the above wages.

Redraft the trading account to arrive at the correct profit after considering the above additional information-

**Solution-** There has been an error in the classification of items as capital/ revenue.

- 1) Sale of old furniture is a capital receipt. The same has been wrongly shown as revenue receipt. Hence Rs 10,000 has to be deducted from sales.
- 2) Purchase of Machinery is a capital expenditure. It has been wrongly shown as revenue and included in the purchases. Rs 70,000 has to be deducted from purchases and shown in the asset side of Balance sheet.
- 3) The wages of workers who have been employed for construction of gallery to office building are of capital nature .Rs 30,000 should be deducted from wages and added to the cost of office building.

The corrected trading account will be redrafted as under-

Particulars	Amt ( Rs)	Particulars	Amt ( Rs)
To opening stock	60,000	By sales	
To Purchases		Less sale of old furniture	3,90,000
Less machinery purchased	2,30,000	By closing stock	1,00,000
To wages			
Less capitalized	70,000		
<b>To gross profit</b>	<b>1,30,000</b>		
	4,90,000		4,90,000

**Q2 How would you treat the following items?**

- 1) Carriage paid on purchases Rs 1,000- **Revenue expenditure**
- 2) Expenditure on advertising campaign Rs 500-**Revenue expenditure**
- 3) Freight and carriage of a new machinery purchased Rs 2,000- **Capital expenditure**
- 4) Spent Rs 6,000 as legal expenses for abuse of trademark – **Revenue expenditure**
- 5) Received Rs 1,00,000 on issue of equity shares-**Capital receipt**
- 6) Paid to the government excise duty Rs 50,000- **Revenue expenditure**
- 7) Paid Rs 70,000 for construction of railway sidings- **Capital expenditure**
- 8) Purchased Land Rs 1,00,000-**Capital expenditure**
- 9) Labour charge on plant and Machinery Rs 3,000-**Capital expenditure**
- 10) Repairs to furniture Rs 1,500- **Revenue expenditure**

**Q3 State with reasons whether the following are capital ,Revenue or Deferred revenue expenditure**

- 1) Legal expenses in issuing shares and debentures Rs 12,500
- 2) Legal expenses incurred in an action for infringement of trademarks
- 3) Rs 25,000 spent on air-conditioning the office of the Managing Director
- 4) Rs 7,000 spent on registration of design
- 5) Legal expenses incurred in an Income tax appeal
- 6) Legal expenses Rs 5,000 incurred in connection the purchase of business premises
- 7) Rs 1,00,000 paid for the application and allotment of a plot of land
- 8) Legal expenses Rs 8,000 incurred in defending a suit for breach of contract to supply of goods

(Mumbai University April 2008)

**Solution**

- 1) **Deferred Revenue expenditure**-These expenses should be written off over certain number of years. These expenses benefit the organization for many years

- 2) **Revenue expenditure**-These expenses are incurred in the normal course of operation
- 3) **Capital expenditure**-It is capitalized as per AS-10
- 4) **Capital expenditure**-It is to be added to the cost of design which is an asset
- 5) **Revenue expenditure** These expenses are incurred in the normal course of operation
- 6) **Capital Expenditure** It increases the cost of business premises
- 7) **Capital Expenditure** It increases the cost of land
- 8) **Revenue expenditure** These expenses are incurred in the normal course of business operations. The benefit is exhausted within one year.

**Q4 State with reasons the nature of the following expenses/ receipts**

- 1) Sold investments 4% government securities for Rs 1,40,000
- 2) Preliminary expenses paid Rs 42,000
- 3) Carriage outward paid Rs 40,000
- 4) Import duty paid on purchase of computer equipment Rs 85,000 to be used in the office
- 5) Received Rs 5,00,000 on the issue of 5% Debentures
- 6) Paid Rs 10,000 underwriting commission on issue of shares
- 7) Legal expenses Rs 6,000 paid in connection with purchase of land
- 8) Repairing charges Rs 15,000 paid for keeping the machinery in working condition

**(Mumbai University March 2006)**

**Solution**

- 1) Capital receipt-The amount is received on sale of investment and not from normal business activity
- 2) Deferred Revenue expenditure -The expenditure benefits the current year and subsequent years and hence the amount has to be written off over a certain number of years.
- 3) Revenue expenditure- It is incurred in normal business operations
- 4) Capital expenditure- It is a direct cost on acquiring of fixed assets and hence has to be capitalized as per AS-10
- 5) Capital receipt- The amount is received on issue of Debentures and not from normal business activity
- 6) Deferred Revenue expenditure--The expenditure benefits the current year and subsequent years and hence the amount has to be written off over a certain number of years.

- 7) Capital expenditure-It is a cost incurred in acquisition of fixed asset
- 8) Revenue expenditure-it is incurred for keeping the machinery in working condition

**Summary-**

An organization has to incur various expenses and receives different incomes. Some expenses are regular while some are onetime expenses. The expenses whose benefits will be enjoyed over a long period are called capital expenditure. Revenue expenditure refers to those expenses which are incurred for the day to day operations of business.

Receipts whose benefits will be enjoyed over a long period are classified as capital receipts while day to day operational receipts such as sales are revenue receipts.

**ONLY MAIN POINTS (for revision)**

**Capital expenditure-** Large amount, Increases cost of fixed asset, increases life of fixed asset, non- recurring in nature, increases profit earning capacity of the business enterprise, brings the fixed asset into working condition, benefit of expenditure is not exhausted within one year, shown in balance sheet

**Revenue expenditure-** smaller amount, recurring in nature, benefit is exhausted within the year, shown in P&L A/c

Capital receipts do not arise in the normal course of operation

Revenue receipts are received in the normal course of operation

**Deferred revenue expenditure-** basically revenue in nature, benefit not exhausted within one year, expenditure to be written off over certain number of years.

**Key terms-**

**Capital expenditure-** It is the expenditure which is incurred to raise earning capacity of an organization.

**Revenue expenditure –** It is the expenditure which is recurring in nature incurred in connection with day to day operations of an organization.

**Capital receipt-** It is a receipt which is not received in the normal course of operation

**Revenue receipt-** Revenue receipt is the receipt which is recurring and received in the normal course of operation.

**Deferred Revenue expenditure –**It is the revenue expenditure the benefit of which is not exhausted within one year.

**Test your understanding-**

**Multiple choice questions-** Select the correct alternative and rewrite the complete sentence

- 1) Revenue expense is that expense
- Which is not recurring in nature
  - Benefit of which is exhausted in one year
  - Which increases useful life and productivity of asset
  - Which is shown on asset side of balance sheet

Ans- Revenue expense is that expense benefit of which is exhausted in one year

- 2) Purchase of machinery is a
- Deferred revenue expenditure
  - Capital expenditure
  - Capital receipt
  - Revenue expenditure

Ans – Purchase of machinery is a capital expenditure

- 3) Expenses incurred on installation and erection of new machinery is
- Revenue expenditure
  - Deferred revenue expenditure
  - Capital expenditure
  - None of the above

Ans - Expenses incurred on installation and erection of new machinery is a capital expenditure

- 4) Following is an example of Deferred Revenue expenditure
- Rent of the warehouse
  - Depreciation of Delivery van
  - Salesmans salary and commission
  - Heavy advertising expenses incurred to launch a product in the market

Ans - Following is an example of Deferred Revenue expenditure- Heavy advertising expenses incurred to launch a product in the market

- 5) Capital expenditure shown as revenue expenditure-
- Increases profit
  - Decreases profit
  - Decreases net worth
  - Decreases both profit and net worth

Ans-Capital expenditure shown as revenue expenditure decreases profit

**State whether the following statements are True or False-**

- 1) Expenditure intended to benefit current period is revenue expenditure –**TRUE**
- 2) Capital receipt is recurring in nature-**FALSE**
- 3) Amount paid for acquisition of patents is a capital expenditure- **TRUE**

- 4) Expenditure on repairs of furniture is a capital expenditure- **FALSE**
- 5) If revenue expenditure is shown as capital expenditure, profit and loss account shows more profit- **TRUE**
- 6) Heavy expenses incurred on advertising at the time of introducing a new product is a deferred revenue expenditure- **TRUE**
- 7) Revenue receipt is the receipt which is recurring and received in the normal course of operation.-**TRUE**
- 8) Amount received as subsidy from the state Government is revenue receipt- **TRUE**
- 9) Expenses on extension of a gallery to the building is a revenue expenditure- **FALSE**
- 10) Recovery of bad debts is a revenue receipt- **-TRUE**

**Match the columns and rewrite the answer**

<b>COLUMN A</b>	<b>COLUMN B</b>
1) Heavy advertisement and promotion expenses incurred to launch a product	i) revenue expenditure
2) Term loan from bank	ii) capital expenditure
3) Renewal of factory licence	iii) Capital receipt
4) Sale of goods	iv) Deferred revenue expenditure
5) Legal expenses incurred in connection with purchase of land	v) revenue receipt

**ANSWERS- (1-iv , 2-iii , 3-i , 4-v , 5-ii,)**

#### **Theory Questions-**

1. Distinguish between Capital expenditure and Revenue expenditure
2. Distinguish between Capital receipts and Revenue receipts
3. Explain the concept of capital expenditure .
4. Bring out the importance of classification of expenditure as capital and revenue.
5. Explain the concept of revenue expenditure. Give suitable examples.
6. Write short notes on-
  - Capital expenditure
  - Revenue expenditure
  - Capital receipt
  - Revenue receipt
  - Deferred Revenue expenditure



## DEPRECIATION

### Unit Structure

- 7.0 Objectives
- 7.1 Meaning, Definition and Features of Depreciation
- 7.2 Depreciation, Depletion and Revaluation

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### 7.0 OBJECTIVES

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- To help the learner understand the concept of Depreciation
- To help the learner understand the need for providing depreciation
- To help the learner understand the causes of depreciation
- To help the learner understand the calculation of depreciation, the methods of providing depreciation and accounting in the books of accounts

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### 7.1 MEANING, DEFINITION AND FEATURES OF DEPRECIATION

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The word depreciation has been derived from the Latin word ‘Depretium’ which means decline or reduction in price or value. Fixed assets have a definite life but they lose their value due to usage or passage of time. Depreciation refers to this decline in value due to usage, passage of time or due to obsolescence.

According to William Pickles, Depreciation is the gradual and permanent decrease in the value of the asset. Depreciation refers to the decline or reduction in the value of fixed asset. Depreciation is the permanent and continuing diminution in the quality, quantity or value of an asset.

The Institute of Chartered Accountants of India (ICAI) defines depreciation as “a measure of the wearing out, consumption or other loss of a value of a depreciable asset arising from use, efflux of time or obsolescence through technology and market changes”

Reduction in the value of the asset due to their productive use is called Depreciation. Depreciation in the value of asset is also due to natural wear and tear.



### **Features of Depreciation-**

Depreciation is a gradual reduction in the value of an asset  
The reduction could be due to various reasons.  
Depreciation is charged on assets- fixed assets

Depreciation is a part of operating expenses. It is non cash in nature as there is no real cash outflow even if it is accounted as an expense. It is to be provided on fixed assets which are used in the process of production and in the conduct of business. It is charged to profit and loss account.

The amount of Depreciation charged to P&L Account has to be deducted from value of asset shown in the balance sheet.

Depreciation is to be provided even if the business is incurring a loss.

Depreciation is a gradual and permanent decrease in the value of asset which is to be accounted for in the financial statements to arrive at the correct profit/ loss.

Thus, Depreciation means a fall in the quality or value of an asset.

Accounting Standard (AS) -6 (Revised) deals with Depreciation Accounting.

Depreciation is to be provided on pro-rata basis for the period for which the asset was used in a particular year at the specified rate.

The company adopts a policy regarding depreciation and as per AS-1- namely, disclosure of Accounting Policies, the method adopted in providing depreciation should be disclosed in the notes to accounts.

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## **7.2 DEPRECIATION, DEPLETION AND REVALUATION**

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Depreciation refers to a decrease in the value of the asset while depletion refers to the decrease in the value of wasting assets like oil wells, mines.

Revaluation refers to a revision in the value of the asset which could mean a decrease or an increase in the value of the asset.

**7.2 (A) Need for depreciation-**The Companies Act requires companies to write off or provide for depreciation in a specified manner.

- 1) To ascertain true and correct profit/ loss-**Depreciation is an operating expense which is provided on assets used in the process of production. Thus it is an expense to be included in the cost of

production. It is therefore logical that it must be matched with the income earned and charged to P&L Account to calculate the true and real profit/ loss of the business. Unless depreciation is charged to P&L Account, the correct profit/ loss cannot be arrived at.

- 2) **To present a true financial position of business**-Balance sheet is a statement which shows the financial position of the business enterprise as on a particular date. The fixed assets are to be shown at their true values. The balance sheet shows the true financial position only if the depreciation is deducted from the value of the asset. If the depreciation is not provided on assets, the assets will be overvalued and the balance sheet will not reflect the true financial position.
- 3) **Replacement of asset**-Every asset has a useful life. At the end of the useful life of the asset, it needs to be replaced. Providing the depreciation enables the business to replace the asset.
- 4) **Statutory requirement**-It is necessary to charge depreciation to comply with the provisions made under the Companies Act and the Income Tax Act. Providing the depreciation enables the business to compute and pay correct tax on taxable profit.

## 7.2 (B) Causes of Depreciation

- 1) **Natural wear and tear**-Wear and tear is the main cause of depreciation. Wear and tear takes place in case of tangible fixed assets like furniture, machinery due to its use. If the asset is used more, the wear and tear is also more.
- 2) **Efflux of time**-Even if the asset is not used and kept idle, its value falls over a period of time. Hence depreciation is provided on idle machinery too.
- 3) **Obsolescence**- A loss or reduction on account of new invention is called as obsolescence. With the new technological improvements, inventions and improvements in techniques of production, the old machinery becomes outdated and needs to be replaced.
- 4) **Depletion**-An asset like mines, oil wells may get exhausted due to continuous extraction due to which the value of the asset goes on diminishing. There comes a stage when the asset has been completely utilized and there is nothing left to be extracted. Such a decrease in the value of the asset is depletion.
- 5) **Natural calamities**- An asset may be damaged due to fire, flood and lose its value and may be disposed off as scrap. The loss of value is written off as depreciation.

## 7.2 (C) Factors affecting Depreciation

- a) **Cost of the asset**-The cost of the asset refers to the purchase price of the asset. The expenses related to the purchase of the asset are to be added to the purchase price to arrive at the cost of the asset. Incidental expenses like installation charges, wages for erection of asset, freight and transport charges are to be added to the purchase price. For example- purchase price of machinery is Rs 1,00,000 and Rs 5,000 were incurred on installation of machinery. The total cost of the asset is  $\text{Rs } 1,00,000 + 5,000 = 1,05,000$
- b) **Residual value or estimated scrap value**-Residual value refers to the value that can be realized at the end of the useful life of the asset when the asset will be sold as scrap .Such scrap value is to be deducted from the cost of the asset.
- c) **Estimated useful life of the asset**-The useful life of the asset in terms of number of years that the asset can be put into productive use needs to be estimated for calculating depreciation.

**7.2 (D) Formula for calculating depreciation**- After considering the above factors, the amount of depreciation can be calculated by using formula-

Depreciation per annum =  $\frac{\text{Original cost of the asset} - \text{estimated scrap value}}{\text{Estimated useful life of the asset}}$

Estimated useful life of the asset.

Depreciation =  $\frac{\text{original cost of the asset} - \text{estimated scrap value}}{\text{Estimated useful life of the asset}}$  (where the estimated scrap value is zero)

Where the original cost of the asset = Purchase price + incidental charges.

A company purchased machinery for Rs 44,000 and spent Rs 1,000 on the installation. It is estimated that the useful life of the asset is 10 years and at the end of the useful life the residual value is Rs 5,000. The depreciation per year will be worked out as under  
Cost of the asset =  $44,000 + 1,000 = 45,000$

Depreciation p.a =  $\frac{45,000 - 5,000}{10} = 4,000$

Depreciation as per Companies Act 2013 for Financial year 2014-15 and thereafter. (These provisions are applicable from 01.04.2014 vide notification dated 27.03.2014.)

- a) Depreciation is calculated by considering useful life of asset, cost and residual value.

- b) Any method WDV or SLM can be used.
- c) Schedule – II contains a list of useful life according to class of assets and the residual value shall not be more than five percent of the original cost of asset. However companies are free to adopt a useful life different from what specified in Schedule II and residual value more than 5%. The financial statements shall disclose such difference and provide justification in this behalf duly supported by technical advice.

## 7.2 ( E) Methods for providing depreciation-

Straight line method or fixed instalment method  
 Reducing balance method or Written down value method  
 Annuity method  
 Depreciation fund method  
 Insurance fund method  
 Revaluation method  
 Sum of the digits method  
 Depletion method  
 Machine hour rate method  
 Repairs provision method.  
 The first two methods are discussed.

### • **Straight line method (SLM) or fixed instalment method (FIM) or original cost method**

Meaning-Under this method a fixed percentage of the original value of the asset is written off every year. The value of the asset is reduced to zero at the end of the useful life of the asset. As the amount of depreciation remains constant every year, this method is called as fixed instalment method.

### • **Reducing balance method (RBM) or Written down method(WDV)**

Meaning- Under this method, depreciation is charged at a certain percentage each year on the balance of the asset which is brought forward from the previous year . The amount of depreciation charged in each year is not fixed but goes on reducing at the later years . As the amount of depreciation keeps reducing , it is known as reducing balance method. The depreciation is charged on the written down value of the asset hence known as written down value method.

## 7.2 (F) Distinction between FIM and WDV methods –

The following illustration will help to bring out the distinction between the two methods-

Let us assume the machinery was purchased for Rs 1,00,000 and Depreciation is to be provided @10% p.a.

Year	Depreciation as per FIM @10%	Depreciation as per WDV @10%
1	1,00,000 x 10% for 1 year=10,000 Value of asset at the end of the first year is 1,00,000-10,000= 90,000	1,00,000x10%for 1 year=10,000 Value of asset at the end of the first year is 1,00,000-10,000= 90,000
2	Depreciation @ 10% on 1,00,000= Rs 10,000. Value of asset at the end of the second year is 90,000-10,000=80,000	Depreciation @ 10% on 90,000= Rs 9,000. Value of asset at the end of the second year is 90,000-9,000=81,000
3	Depreciation @ 10% on 1,00,000= Rs 10,000. Value of asset at the end of the third year is 80,000-10,000=70,000	Depreciation @ 10% on 81,000= Rs 8,100. Value of asset at the end of the third year is 81,000-8,100=72,900
4	Depreciation @ 10% on 1,00,000= Rs 10,000. Value of asset at the end of the fourth year is 70,000-10,000=60,000 Thus depreciation is always @ 10% of original cost	Depreciation @ 10% on 81,000= Rs 8,100. Value of asset at the end of the fourth year is 72,900-7,290=65,610 Thus depreciation is always on 10% on the balance or WDV

The following points are observed from the above table-

The amount of depreciation remains same for all the years as per the FIM method while it keeps decreasing as per the WDV method.

The value of asset at the end of the tenth year would be zero as per the FIM while the asset value will never become zero as per the WDV method.

There is no difference in the amount of depreciation and the value of asset after charging depreciation in the first year under both the methods.

Fixed instalment or straight line method	Written down value or Reducing balance method
1)It is a method of depreciation in which depreciation at fixed percentage ( rate) is charged every year on original cost of fixed asset and the amount of depreciation remains the same ( constant) every year	1)It is a method of depreciation in which depreciation at fixed percentage ( rate) is charged every year . The amount of depreciation goes on reducing every year

2)The amount of depreciation is charged on the original cost of the asset	2)The amount of depreciation is charged on the written down value of the asset
3)After certain number of years the value of the asset becomes zero	3) The book value of the asset never becomes zero
4)This method of depreciation is not accepted for Income tax purposes	4)This method of depreciation is accepted for calculation and payment of Income tax
5)This method of depreciation is easy to calculate and more suitable for assets of lower value	5)This method of depreciation is suitable for assets of higher value having longer life requiring heavy expenditure in later life of the asset

**7.2 (G) Accounting treatment of Depreciation-** The transactions relating to purchase of asset and depreciation are recorded through journal entries and later posted in the relevant ledger accounts.

Journal entries

**A) When Provision for depreciation account is not maintained-**

**The transactions of purchase of asset, providing depreciation on asset, sale of asset, profit/ loss on sale of asset are recorded in the asset account.**

For purchase of asset for cash-	Asset a/c Dr To cash/ bank a/c
For purchase of asset on credit	Asset a/c Dr To supplier/party a/c
For payment of installation charges	Asset a/c Dr To cash/ bank a/c
For providing depreciation	Depreciation a/c Dr To Asset a/c
For transfer of depreciation to Profit and Loss a/c	Profit and Loss a/c Dr To Depreciation
For sale of asset	Cash/ bank a/c Dr To Asset a/c
For loss on sale of asset	Profit and Loss a/c Dr
	---To Asset a/c
For profit on sale of asset	Asset a/c Dr To Profit and Loss a/c

After passing the journal entries the relevant ledger accounts are to be prepared. The balance in the asset account will be carried down to the

next accounting period and the balance in the depreciation account will be transferred to profit and loss a/c.

At the end of the year, while preparing final accounts, Depreciation amount will be shown on the debit side of profit and loss account.

The asset will appear in the balance sheet at the written down value (value after providing for depreciation on the asset)

When the above entries are posted in the asset a/c the entries will be appearing in the asset account as under

Dr		ASSET A/C		Cr	
Date	Particulars	Amt	Date	Particulars	Amt
	To cash/ bank a/c (cash Purchase)			By Depreciation ( yearly depreciation )	
	To suppliers a/c ( Credit purchase)			By cash/ Bank ( sale of asset)	
	To cash/ Bank (installation charges)			By profit and loss a/c (loss on sale)	
	To profit and loss a/c ( profit on sale)				
	To balance c/d ( balancing figure)				

**B) When provision for depreciation account is maintained-**

- For purchase of asset for cash-
 

Asset a/c Dr  
 To cash/ bank a/c
- For purchase of asset on credit
 

Asset a/c Dr  
 To supplier/ partys a/c
- For payment of installation charges
 

Asset a/c Dr  
 To cash/ bank a/c
- For providing depreciation-
 

Depreciation a/c Dr  
 To Provision for Depreciation a/c
- For transfer of depreciation to Profit and Loss a/c
 

Profit and Loss a/c Dr  
 To Depreciation
- For sale of asset
 

Cash/ Bank a/c Dr  
 To Asset a/c

- On sale of asset, the amount of provision created for the asset sold is to be transferred to Asset a/c

Provision for Depreciation a/c Dr  
To Asset a/c

- For profit on sale of asset

Asset a/c Dr  
To Profit and Loss a/c

- For loss on sale of asset----

Profit and Loss a/c Dr  
To Asset a/c

Under this method, the amount of depreciation to be provided is not recorded in the Asset a/c but is shown in the Provision for Depreciation a/c.

The asset account will always show a debit balance and the provision for depreciation account will show a credit balance.

The Asset a/c appears in the Balance sheet at its original value on the Asset side and the provision for depreciation appears in the balance sheet on the liability side.

### **Solved Problems- straight line method**

- 1) M/s Raj and Sons purchased Machinery on 1<sup>st</sup> October 2007 at Rs 90,000 and spent Rs 10,000 on its installation. The firm provides depreciation at 10% p.a .under straight line method.

Show machinery a/c and depreciation a/c for the years 2007-08, 2008-09 and 2009-10 assuming books of accounts are closed on 31<sup>st</sup> March every year.

**Solution-** In the books of Raj and Sons

Working note for calculation of depreciation under SLM @ 10% p.a.

1 Oct 2007- cost of asset (90,000+10,000)	=	1,00,000
Less depreciation @ 10% for 6 months	=	-5,000
WDV as on 31 March 2008	=	95,000
Less depreciation @ 10% for 1 year	=	- 10,000
WDV as on 31 <sup>st</sup> March 2009	=	85,000
Less depreciation @ 10% for 1 year	=	- 10,000
WDV as on 31 <sup>st</sup> March 2010	=	75,000



Dr Machinery account			Cr		
Date	Particulars	Amt	Date	Particulars	Amt
2007 1 oct	To Bank	90,000	2008 31 march	By Depreciation	5,000
	To Bank	10,000		By balance c/d	95,000
		1,00,000			1,00,000
2008 1 April	To balance c/d	95,000	2009 31 march	By depreciation	10,000
		95,000		By balance c/d	85,000
					95,000
2009 1 April	To balance b/d	85,000	2010 31 march	By Depreciation	10,000
				By balance c/d	75,000
		85,000			85,000
2010 1 April	To balance b/d	75,000			

Dr Depreciation account			Cr		
Date	Particulars	Amt	Date	Particulars	Amt
2008 31 march	To Machinery a/c	5,000	2008 31 march	By P&La/c	5,000
		5,000			5,000
2009 31 march	To Machinery a/c	10,000	2009 31 march	By P&La/c	10,000
		10,000			10,000
2010 31 march	To Machinery a/c	10,000	2010 31 march	By P&La/c	10,000
		10,000			10,000

## 2) Written down value method-

On 1<sup>st</sup> April 2005, Karan Bros purchased furniture for Rs 40,000. On 1<sup>st</sup> October, 2005, additional furniture was purchased for Rs 20,000.

On 1<sup>st</sup> October 2007, they sold furniture which was purchased on 1<sup>st</sup> April 2005 for Rs 28,000. The accounts were closed on 31<sup>st</sup> March every year. Depreciation was provided @10% p.a. by WDV method

Prepare Furniture account and Depreciation account.

Solution-Working note for calculation of Depreciation @ 10% p.a. on WDV

Particulars	Furniture1	Furniture 2	Depreciation
Cost of furniture	40,000	20,000	
Less depreciation( on F-2 for 6 months)	4,000	1,000	5,000
WDV	36,000	19,000	
Less Depreciation	3,600	1,900	5,500
WDV	32,400	17,100	
Less Depreciation ( on F-1 for 6 months)	1,620	1,710	3,330
WDV	30,780	15,390	
Sold for	28,000		
Loss on sale	2,780		

**In the books of Karan Bros**

Dr			Furniture a/c			Cr		
Date	Particulars	Amt	Date	Particulars	Amt			
2005	To Cash/ Bank	40,000	2006	By Depreciation	5,000			
1 April	To Cash/ Bank	20,000	31march	By balance c/d	55,000			
1 Oct								
		60,000			60,000			
2006	To balance b/d	55,000	2007	By Depreciation	5,500			
1 April			31march	By balance c/d	49,500			
		55,000			55,000			
2007	To balance b/d	49,500	2007	By Depreciation	1,620			
1April			1 oct	By cash/ bank	28,000			
				By P& La/c	2,780			
			2008	By Depreciation	1,710			
			31March	By balance c/d	15,390			
		49,500			49,500			
2008	To balance b/d	15,390						
1April								

Dr			Depreciation a/c		Cr
Date	Particulars	Amt	Date	Particulars	Amt
2006 31march	To Furniture	5,000	2006 31march	By P&La/c	5,000
		5,000			5,000
2007 31march	To Furniture	5,500	2007 31march	By P&La/c	5,500
		5,500			5,500
2007 1 oct	To Furniture	1,620	2008 31march	By P&La/c	3,330
2008 31march	To Furniture	1,710			
		3,330			3,330

### 3) Provision for depreciation-

On 1<sup>st</sup> April 2009, following balances appeared in the books of Mangesh Traders

Machinery a/c Rs 4,00,000 Provision for Depreciation a/c Rs 1,60,000

On the above date , they decided to sell the machinery for Rs 1,00,000 which was purchased on 1<sup>st</sup> April 2006 for Rs 1,50,000. The firm provides Depreciation on 31 March every year @ 10% p.a. under straight line method.

Show Machinery account and Provision for depreciation account as on 31 March 2010.

**Solution-** Working note Depreciation @10% on SLM

Original cost of the machinery sold - 1,50,000 and depreciation at 10% p.a. is 15,000

Depreciation for three years ( 1-April 2006 to 31 March 2009) is  $15000 \times 3 \text{ years} = 45,000$

WDV as on 31 March 2009 =  $150000 - 45,000 = 105,000$

Sold for	1,00,000
Loss on sale of machinery	5,000
In the books of Mangesh Traders	

Dr Machinery account			Cr		
Date	Particulars	Amt	Date	Particulars	Amt
2009 1 april	To balance b/d	4,00,000	2009 1 april	By cash/bank	1,00,000
				By Provision for Depreciation a/c	45,000
				By P&L a/c (Loss on sale)	5,000
			2010 31 march	By balance c/d	2,50,000
		4,00,000			4,00,000
2010 1 april	To balance b/d	2,50,000			

Dr Provision for Depreciation a/c			Cr		
Date	Particulars	Amt	Date	Particulars	Amt
2009 1 april	To Machinery a/c	45,000	2009 1 april	By balance b/d	1,60,000
2010 31 march	To balance c/d	1,40,000	2010 31 march	By Depreciation	25,000
		1,85,000			1,85,000
			2010 1 april	By balance b/d	1,40,000

### Summary

Depreciation is the gradual and permanent decrease in the value of the asset. Depreciation refers to the decline or reduction in the value of fixed asset. Depreciation is the permanent and continuing diminution in the quality, quantity or value of an asset. Depreciation is required to be provided on fixed assets and charged to Profit and loss account so that the correct profit or loss can be ascertained and the balance sheet reflects the true financial position. Depreciation is caused due to natural wear and tear, efflux of time, obsolescence, depletion, natural calamities. The three factors affecting depreciation are- cost of the asset, estimated useful life of the asset and the residual or scrap value of the asset at the end of its useful life. Thus, Formula for calculating depreciation ----

Depreciation per annum =  $\frac{\text{Original cost of the asset} - \text{estimated scrap value}}{\text{Estimated useful life of the asset}}$

Estimated useful life of the asset.

There are two methods of calculating depreciation . They are-

**Straight line method (SLM) or fixed instalment method (FIM) or original cost method** -Under this method a fixed percentage of the original value of the asset is written off every year. The value of the asset is reduced to zero at the end of the useful life of the asset. As the amount of depreciation remains constant every year, this method is called as fixed instalment method.

**Reducing balance method (RBM) or Written down method(WDV)**- Under this method, depreciation is charged at a certain percentage each year on the balance of the asset which is brought forward from the previous year . The amount of depreciation charged in each year is not fixed but goes on reducing at the later years . As the amount of depreciation keeps reducing , it is known as reducing balance method. The depreciation is charged on the written down value of the asset hence known as written down value method.

Accounting Standard (AS) -6 ( Revised ) deals with Depreciation Accounting.

Depreciation is to be recorded in the debit side of Profit and Loss account and deducted from the value of the asset in the balance sheet.

#### **Key terms**

**Depreciation-** Depreciation is the gradual and permanent decrease in the value of the asset

**Cost of the asset-** The cost of the asset refers to the purchase price of the asset. The expenses related to the purchase of the asset are to be added to the purchase price to arrive at the cost of the asset.

**Residual value** - Residual value refers to the value that can be realized at the end of the useful life of the asset when the asset will be sold as scrap .Such scrap value is to be deducted from the cost of the asset.

**Straight line method-** It is a method of providing depreciation where the amount of depreciation remains constant or fixed every year . The depreciation is charged at a certain rate on the original cost of the asset.

**Written down value method-** It is a method of providing depreciation where the amount of depreciation goes on reducing every year. The depreciation is charged on the written down value of the asset.

#### **Objective Questions- (Test your understanding)**

**State whether the following statements are True or False-**

- 1) There is no need to provide depreciation if the asset is maintained with care- **False**
- 2) Depreciation is charged only on fixed assets – **True**

- 3) Depreciation is a non cash expense- **True**
- 4) Depreciation cannot be provided in case of loss in a financial year- **False**
- 5) Under the written down value method, Depreciation is calculated on the original cost of an asset- **False**
- 6) Depreciation amount is to be added to the value of the asset in the balance sheet- **False**
- 7) Depreciation refers to the reduction in the value of fixed assets- **True**
- 8) Depreciation is the same as revaluation – **False**
- 9) Depreciation increases the value of asset – **False**
- 10) Depreciation is the process of valuation of asset-**False**

**Write the term/ word/ phrase for the following-**

- 1) Type of asset on which depreciation is provided- **Fixed assets**
- 2) A gradual, continuous and permanent reduction in the value of fixed assets due to its use- **Depreciation**
- 3) Realizable amount of fixed asset at the end of its estimated life- **Scrap/ residual value**
- 4) The method of depreciation under which depreciation is calculated on original cost of asset-**Straight line/ original cost/ fixed instalment method**
- 5) The method of depreciation under which depreciation is calculated on the balance amount- **Reducing/ diminishing balance / written down value method**
- 6) Excess of selling price of a fixed asset over its written down value- **Profit on sale of asset**
- 7) An account to which the balance in the depreciation account is transferred- **Profit and loss account.**
- 8) Method of depreciation in which amount of Depreciation remains constant every year – **Straight line method/ original cost or fixed instalment method.**

**Select the most appropriate alternative and rewrite the sentences-**

- 1) Depreciation arises because of\_\_\_\_\_
  - a) Wear and tear
  - b) Inflation
  - c) Profit
  - d) Fall in the value of asset
- 2) The amount realized at the end of the working life of an asset is called \_\_\_\_\_

- a) Market price
- b) Original cost
- c) Residual value
- d) Written down value
- 3) The profit on sale of asset is debited to \_\_\_\_\_
- a) Reserves a/c
- b) Asset a/c
- c) Balance sheet
- d) Profit and loss a/c
- 4) The amount of depreciation goes on decreasing every year under the \_\_\_\_\_ method
- a) Revaluation method
- b) Straight line method
- c) Fixed instalment method
- d) Written down value method
- 5) Wages paid for installation of machinery is debited to \_\_\_\_\_ account
- a) Wages a/c
- b) Trading a/c
- c) Profit and loss a/c
- d) Machinery a/c

**Answers-**

- 1) a-wear and tear**
- 2) c- residual value**
- 3) b- asset a/c**
- 4) d- written down value method**
- 5) d- Machinery a/c**

**Problems- DIY**

- 1) From the following particulars , calculate the amount of Depreciation-
  - a) Cost of fixed asset Rs 1,00,000
  - b) Installation charges Rs 5,000
  - c) Scrap value of fixed asset Rs 25,000
  - d) Estimated life of the fixed asset- Rs 25,000

**( Answer- Depreciation Rs 8,000 p.a.)**

- 2) Deluxe company purchased furniture worth Rs 80,000 on 1<sup>st</sup> April 2009 and additional furniture on 1<sup>st</sup> October 2009 worth Rs 60,000. On 1<sup>st</sup> October 2011, they sold out furniture for Rs 60,000 which was purchased

on 1st April 2009. The books of accounts were closed on 31st March every year and the company charged depreciation @ 15% p.a. on Fixed Instalment basis.

Prepare Furniture a/c and Depreciation a/c for the year 2009-10, 2010-11, 2011-12.

**(Answer- Depreciation- 2009-10 Rs 16,500  
2010-11 Rs 21,000  
2011-12 Rs 15,000  
Profit on sale of furniture Rs 10,000  
Balance in Furniture a/c Rs 37,500)**

3) Atul Traders, Ratnagiri purchased Machinery for Rs 1,47,000 on 1<sup>st</sup> April 2008, and spent Rs 3,000 on its fixation and erection. In the same year, on 1<sup>st</sup> October, additional machinery costing Rs 50,000 was purchased. On 1<sup>st</sup> October 2010, the machinery purchased on 1<sup>st</sup> October 2008 was sold for Rs 35,000. Depreciation was provided annually on 31<sup>st</sup> March @ 10% on reducing balance method.

Prepare Machinery account and Depreciation account for three years.

**(Answer- Depreciation 2008-09 Rs 17,500  
2009-10 Rs 18,250  
2010-11 Rs 12,150 and on machinery sold Rs 2,138  
Loss on sale ---Rs 5,612  
Balance on machinery account----Rs 1,09,350.)**

**4) Answer in brief-**

- 1) Define Depreciation. Explain the need for providing depreciation.
- 2) What are the causes of depreciation?
- 3) What are the factors affecting depreciation?
- 4) Write a note on Straight line method.
- 5) Explain Written down value method and state how it differs from straight line method. Compare the methods with example.
- 6) Distinguish between FIM and WDV method of providing depreciation.





## ACCOUNTING RECORDS

### Unit Structure

8.1 Introduction

8.2 Process of Transaction and Its Record Generation 8.3 What is an Account?

8.4 Final Accounts

8.5 Horizontal or 'T' Format of Trading & P&L A/C

8.6 Vertical Format of Balance Sheet

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### 8.1 INTRODUCTION

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Accounting involves a series of processes like measuring economic value of a transaction, recording it and reporting it to various stake holders. Accounting information is used by a variety of users, like investors, creditors, workers, management, and government.

Accounting can be divided into financial accounting, management accounting, auditing, and tax accounting. Financial accounting focuses on the reporting of an organization's financial information, including the preparation of financial statements, to external users of the information, such as investors, regulators and suppliers and management accounting focuses on the measurement, analysis and reporting of information for internal use by management. The recording of financial transactions, so that summaries of the financials may be presented in financial reports, is known as bookkeeping, of which double-entry bookkeeping is the most common system.

Accounting records means internal or external documentary evidence maintained within the organisation to record the economic transaction which has taken place. These are important sources of information and evidences that are used to prepare the financial statements.

In book keeping and accountancy we will be recording only monetary transactions.

Accounting records can take on many forms and include:

- Invoices
- Vouchers
- Ledgers
- Journals
- Bank statements

- Contracts and agreements
- Verification statements
- Transportation receipts etc.

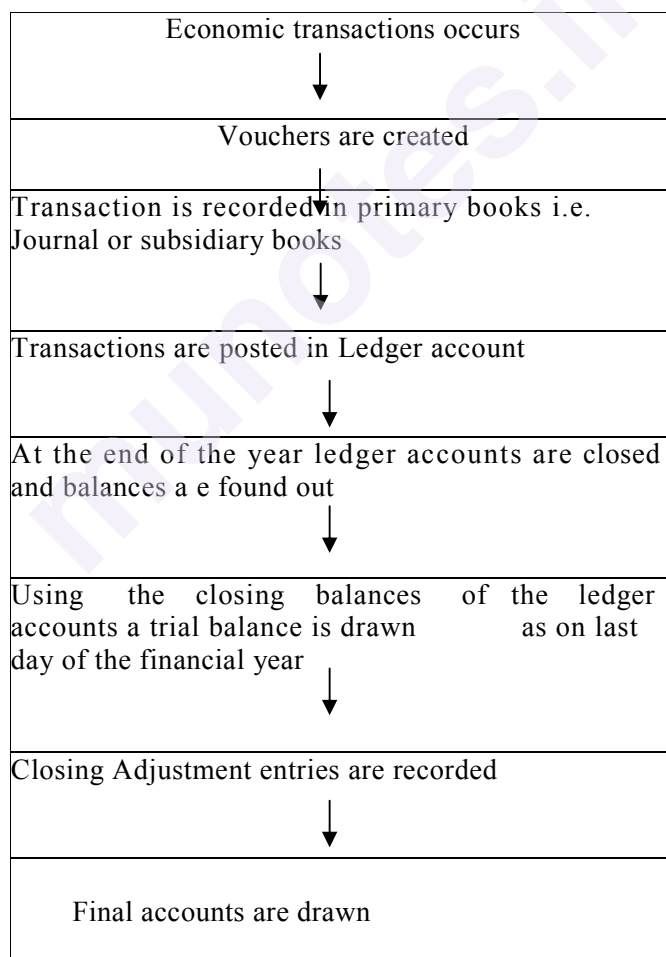
Vouchers are most important document in accounting records. Vouchers form basis for recording any transaction. Account voucher is an accounting document representing an internal intent to make a payment to an external entity, such as a vendor or service provider. A voucher is produced usually after receiving a vendor invoice, after the invoice is successfully matched to a purchase order. A voucher will contain detailed information regarding the payee, the monetary amount of the payment, a description of the transaction, and more.

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## 8.2 PROCESS OF TRANSACTION AND ITS RECORD GENERATION

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Let us see the entire process of accounting with the help of a chart



Now let us discuss the entire procedure in the order of flow chart

**1. Economic transactions occurs:** In accounts we record only those

transaction which has some monetary value. Accountancy is more of a historical record as it records whatever happens in money terms. One should not get confused with non cash and non-monetary transactions. A non cash transaction can be a monetary transaction e.g providing depreciation on fixed assets, is a non cash transaction but it is a monetary transaction as we know the amount of depreciation in money terms.

**2. Vouchers are created:** Whenever any transaction takes place a voucher is created depending upon the nature of transaction. Vouchers may be of following types

1. Receipt voucher
2. Payment vouchers
3. Journal vouchers
4. Cash memo
5. Contra entry vouchers
6. Purchase and returns invoice vouchers
7. Sales and returns vouchers

A voucher complete in all respects forms basis for recording the transaction. To be called a complete document it should be properly dated, amounted, authorised and signed by the party.

Any documentary evidence supporting the entries recorded in the books of accounts, establishing the arithmetic accuracy of the transaction, may also be referred to as a voucher for example, a bill, invoice, receipt, salary and wages sheet, memorandum of association, counterfoil of paying-in slip, counterfoil of cheque book, or trust deed.

Normally the following types of vouchers are used:

- (i) Receipt Voucher
- (ii) Payment Voucher
- (iii) Journal Voucher
- (iv) Supporting Voucher

Let us discuss each of these:

**(i ) Receipt Voucher:**

A Receipt voucher is used to record cash or bank receipt. Receipt vouchers are of two types which are as follows:

**(a) Cash receipt voucher** – These vouchers are created whenever any cash generation transaction occurs. E.g. sale of scrap for cash.

**(b) Bank receipt voucher** – it indicates receipt of a cheque or demand draft i.e. money is not received in the form of cash in hand, instead, the money will be credited to the bank account of the assessee.

### Contents of Receipt/Credit Voucher:

The following information are usually available from a receipt/credit voucher:

- (a) Names and address of the parties;
- (b) Date of preparing the voucher;
- (c) Voucher Number;
- (d) Amount of the transaction;
- (e) Heads of account;
- (f) Signature of the person who is preparing the voucher;
- (g) Authorized Signatory;
- (h) Narrations, i.e., short description of the transaction, and
- (i) Number of Supporting Voucher.

<b>CREDIT VOUCHER</b>										
<b>Oriental Company</b> <b>G.S Road, Bhangagarh, Guwahati – 781005</b>										
Voucher No. _____	Date _____									
<b>CREDIT</b> _____ A/C										
Being _____										
_____										
(Rupees ..... Only)	Total:	<table border="1" style="float: right; text-align: center;"><thead><tr><th colspan="2">Amount</th></tr><tr><th>Rs.</th><th>P</th></tr></thead><tbody><tr><td style="height: 40px;"></td><td></td></tr><tr><td></td><td></td></tr></tbody></table>	Amount		Rs.	P				
Amount										
Rs.	P									
Accountant _____	Manager _____	Proprietor _____								

### ii). Payment/debit Voucher:

A payment voucher is just the opposite of a receipt voucher. In the above, cash/ bank was debited, while in this case, cash or bank will be credited. In the above case, there was an inflow of funds, while in this case, there is an outflow of funds. A Payment voucher is used to record a payment of cash or cheque. Payment vouchers are also of two types which are:

- (a) Cash Payment voucher – it denotes payment of cash
- (b) Bank Payment voucher – it indicates payment by cheque or demand draft i.e. money is not paid in the form of cash in hand, instead, the money will be debited from the bank account of the assessee

### Contents of payment/debit Vouchers:

The following information are normally available from a debit voucher:

- (a) Names and Addresses of the Party
- (b) Date of voucher;
- (c) Voucher Sr. Number;
- (d) Amount or value of the transaction;
- (e) Heads of Account;
- (f) Signature of the person who is preparing the voucher;
- (g) Authorized signatory;
- (h) Narration i.e., short description of the

transaction and (i) Number of supporting Vouchers.

The format of a Debit Voucher is presented:

<b>Payment Voucher</b>		
Ref No: _____		
Amount:	Date:	
<b>Method of Payment</b>		
Cash:	Check#:	
To:		
The Sum of:		
Being:		Payee:
Approved By:	Paid By:	Signature

( If the amount of transaction exceeds Rs. 500 a revenue stamp valued Re 1. should be affixed.)

### iii) Journal Voucher:

These vouchers are used for non-cash transactions, they are basically used as a documentary evidence. e.g., Goods sold on credit. In such cases, the cash or the bank account of the assessee is unaffected. In the case of Goods sold on credit, the Voucher would debit the Debtor to whom the goods are sold on credit, while sales on credit account would be credited further.

<b><u>JOURNAL VOUCHER</u></b>	
Voucher No. ....	Dated... ..
	Amount (Rs)
DEBIT ..... A/C	xxxxxxxx
.....	
Total Rs.	xxxxxxxx
CREDIT ..... A/C	
.....	xxxxxxxx
(Rupees ..... ) only	Total Rs. xxxxxx
Accountant	Manager
	Partner/Proprietor

### iv) Supporting documents vouchers:

These vouchers are the documentary evidence of transactions that have happened. For example, you can attach the bill of an expense

along with the original voucher just to further support the primary voucher. Petrol Bills attached with the conveyance vouchers are a good example of Supporting Vouchers. Supporting Vouchers are the documentary evidence of business transactions which have happened.

**They are of two types:**

- (i) External Supporting Vouchers; and
- (ii) Internal Supporting Vouchers.

These vouchers are prepared by the third parties who are associated with the firm.

**For example:**(a) Debit Note Received; (b) Credit Note Received; (c) Cash Memo Received from the Sellers, etc.

The format of a Supporting Voucher is presented:

COMPANY NAME		INVOICE		
Street Address City, ST ZIP Code Phone: (123) 456 78 99 Fax: (123) 456 78 99		DATE: December 14, 2011 INVOICE: 100		
<b>Bill To:</b> Name Company Name Street Address City, ST ZIP Code Phone		<b>Ship To:</b> Name Company Name Street Address City, ST ZIP Code Phone		
SALES PERSON	SHIP VIA	SHIP	TERMS	
ID	DESCRIPTION	QUANTITY	UNIT PRICE, \$	LINE TOTAL
1	Item Description	23	44.77 \$	1,029.71
2	Item Description	4	12.44 \$	51.96
3	Item Description	2	49.99 \$	99.98
4	Item Description	14	6.34 \$	88.76
			\$	-
			\$	-
			\$	-
Subtotal TAX RATE SALES TAX SHIPPING AND HANDLING <b>TOTAL</b>			1,122.15 5.96% 66.94 - <b>1,189.09</b>	

**(ii) Internal Supporting Vouchers:**

These vouchers are prepared by the internal staff on behalf of 'the firm which are accepted by the third parties for the transaction so happened.

**For example:**

- (a) Counterfoil-of Challan for payment of income tax to a bank;
- (b) Counterfoil of pay-in-slip when money is deposited into bank, etc.

### 3. Transaction is recorded in primary books i.e. Journal books:

There are two sets of books maintained in any organisation viz. primary set of books and secondary set of books. Primary set of books is the one where initial transaction is recorded. It is the first instance of the recording of any economic transaction it includes journal and subsidiary books.

In order to record journal entries, one needs to have knowledge about following basics of accounting

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## 8.3 WHAT IS AN ACCOUNT?

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**ACCOUNT:** An account is a record of all transaction under one room relating to a particular person, income, expense, property etc.

### Types of accounts:

There are three type of accounts in accounting:

A] **Personal account:** Ashok, Anil, Dena Bank, Abcd ltd, prepaid or outstanding incomes or expenses. Personal accounts consist of all those accounts which are related to a person, business, firm etc. There are also subtypes of personal account:

I] Natural Personal Any person like Peter Account, Ram account etc.

II] Artificial Personal: Any company or group of people like Microsoft account, Hindustan Petroleum account etc.

III] Representative Personal this type of Personal a/c represents owner like. Capital a/c, drawings a/c etc.

B] **Real account:** Real accounts consist of all those accounts which are related to assets. For example: Plant and Machinery account, Stock account, Furniture & Fixture, cash etc.

C] **Nominal account:** Nominal accounts consist of all those accounts which are related to expenses, losses, Income and Gains. For example: Rent account, wages account, printing & stationary etc.

### Golden rules of accounting

There are three golden rules in accounting to record journal entries. Each of these rules is associated with separate account.

#### Personal accounts

"Debit the Receiver, Credit the Giver"

#### Real accounts

"Debit what Comes In, Credit what Goes out"

#### Nominal accounts

"Debit all Expenses and Losses, Credit all Income and Gains"

### How to record a journal entry

First understand the format of a journal

A journal has five vertical columns

JOURNAL				
DATE	PARTICULARS	L. F.	DEBIT Rs.	CREDIT Rs.
1.4.2-16	Account to be debited A/c Dr To Account to be credited (Being..narrate the transaction)		xxx	xxx

**Date** column records date of the transaction

**Particulars** column records the two effects of a given transaction, by using at least two ledger accounts, one of which will be debited and other one credited.

**Below these** two accounts we write brief description of transaction in brackets prefixing the word 'Being', called as narration.

**L.F.** column records ledger folio or page number where that account is opened in a ledger book.

**Debit (Amount) and Credit (Amount)** columns records amount against each ledger account.

### Steps to record a journal entry

1. Identify which accounts are involved
2. Identify types of accounts
3. Apply golden rules according to the type of account to determine which account will be Debited and which account will be Credited.

### Example: You are writing in the books of Ganesh

Transaction : Cash received from Jagdish Rs5,000, for this transaction we will pass journal entry by using above mentioned

1 Identify which accounts are involved : a) Cash b) Jagdish

2 Identify types of accounts:

- a) Cash : real account
- b) Jagdish: personal account

3 Apply golden rules according to the type of account to determine which account will be Debited and which account will be Credited.

- a) Cash : real account so: Debit what comes in
- b) Jagdish: personal account: credit the giver

Therefore Cash A/c will be debited and Jagdish A/c will be credited The entry will be as follows

Cash a/c-----Dr5,000  
To Jagdish a/c----- Cr 5,000  
(Being cash received from Jagdish)



**Example:** Journalise the following transactions:

2016		Rs.
April. 1	Started business with cash	50,000
April. 3	Deposited cash into Bank	40,000
April. 5	Sold goods to Ganesh	22,000
April. 9	Goods returned by Ganesh	2,000
April. 11	Goods purchased from Kishore	30,500
April. 15	Goods returned to Kishore	1,500
April. 18	Bought Furniture & Fixture for office use by	9,000
April. 22	cheque	1,000
April. 22	Purchased goods for cash	50
April. 30	Paid carriage	500
	Paid interest on loan	

**Solution:** Journal

Date	Particulars	L.F	Dr.(Rs.)	Cr. (Rs.)
2012				
April. 1	Cash A/c ...Dr. To Capital A/c (Being the business started with cash)		50,000	50,000
April 3	Bank A/c ...Dr. To Cash A/c (Being the amount deposited into the bank)		40,000	40,000
April 5	Ganesh To sales A/c (Being the goods sold to Ganesh)		22,000	22,000
April 9	Sales Returns A/c To Ganesh (Being the goods returned by Ganesh)		2,000	2,000
April 11	Purchases A/c ...Dr. To Kishore (Being the goods purchased from Kishore)		30,500	30,500
April 15	Kishore ...Dr. To purchases Return a/c (Being the goods returned to Kishore)		1,500	1,500
April 18				

April 22	Furniture & Fixture a/c ...Dr. To bank a/c (Being the Furniture & Fixture bought and paid by cheque)		9,000	9,000
April 26	Purchases A/c ...Dr. To cash a/c (Being the goods purchased against cash)		1,000	1,000
April 30	Carriage a/c ...Dr. TO cash a/c (Being the carriage paid)		50	50
	Interest on Loan A/c ...Dr. To Cash A/c (Being the payment of interest on Loan)		500	500
	<b>Total</b>		<b>1,57,550</b>	<b>1,57,550</b>

**4. Transactions are posted in Ledger account: Secondary set of books includes ledger accounts.** Now let us see format of a ledger account.

Dr.			LEDGER	ACCOUNT			Cr.
DATE	PARTICULARS	J.F.	AMOUNT	DATE	PARTICULARS	J.F.	AMOUNT
1.4.16	To Account credited in Journal		xxx	5.4.16	By Account debited in Journal		Xxx
	against this ledger a/c				against this ledger a/c		

The process of transferring the information contained in a Journal to a Ledger is called Posting.

i. Posting of debited item in a Journal Entry: The steps to be followed are:

Identify in the ledger the account to be debited. Then enter the date of the transaction in the 'Date' column on the debit side of the account. Then write the name of the account which has been credited in the respective entry in the 'Particulars' column on the debit side of the account as "To (name of account credited)". Then record the page number of the Journal where the entry exists in the Journal folio (J.F.) column. Then enter the relevant amount in the 'Amount' column on the debit side. Posting credit item in a journal entry: The steps to be followed are:

Identify in the ledger the amount to be credited then Enter the date of the transaction in the 'Date' column on the credit side of the account. Then write the name of the account which has been debited in the respective entry in the 'Particulars' column on the credit side of the account as 'By (name of account debited)'. Then record the page number of the Journal where the entry exists in the Journal folio (J.F.) column. Then enter the relevant amount in the 'Amount' column on the credit side.

Thus every transaction has two effects viz debit and credit. In a journal entry these are either debited or credited. One should always remember that total of debit should always match the total of credit.

**Consider the simple Journal entry to illustrate the above:** On April 16, 2014 Motor car Purchased for cash Rs. 12000

April 16	Motor car A/c	....Dr.	Rs. 12,000
To cash			Rs. 12,000

(Being the Motor car purchased)

An amount of Rs. 12,000 will be debited to the Motor car account and credited to cash account. The manner will be: in the Motor car account in the 'Particulars' column we shall write to cash a/c . In the account of cash will be written : 'By Motor car a/c'. The two accounts will, thus appear as under.:

**Motor car A/c**

Dr.

Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
April 16	To Cash A/c		12,000				

**Cash a/c**

Dr.

Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
				April 16	By Motorcar A/c		12,000

**Example 2:** Received Rs.14,000 in full settlement of a debt of Rs. 15,000 from Ram on Aug 8, 2014.

**SOLUTION - Journal Entry**

	Rs.	Rs.
Cash A/c Dr.	14,000	
Discount allowed A/c Dr	1,000	
To Anant		15,000
(Cash received and discount allowed)		

**Ledger A/c****Cash A/c**

Dr.

Cr.

Date	Particulars	L.F.	Rs.	Date	Particulars	L.F.	Rs.
2014							
Aug.8	To Anant		14,000				

**Discount Allowed A/c**

Dr.

Cr.

Date	Particulars	L.F.	Rs.	Date	Particulars	L.F.	Rs.
2014							
Aug.8	To Anant		10 00				

**Anant's Account**

Dr.

Cr.

Date	Particulars	L.F.	Rs.	Date	Particulars	L.F.	Rs.
				2014			
				Aug. 8	By cash A/c		14,000
					By Discount Allowed A/c		1,000

**5. At the end of the year ledger accounts are closed and balances are found out**

Dr.			LEDGER	ACCOUNT			Cr.
DATE	PARTICULARS	J.F.	AMOUNT	DATE	PARTICULARS	J.F.	AMOUNT
1.4.16	To abc Account		)(xx	5.4.16	By opq account		)(xx
)(xx	To xyz Account		)(xx	xxx	By rst Account		xxx
)(xx	To Balance c/d		)(xx				
			)(xxx				xxxx

**Using the closing balances of the ledger accounts a trial balance is drawn as on** last day of the financial year : A trial balance is a list of all the general ledger accounts of a business. This list will contain the name of ledger account and the balance of that ledger. Each nominal ledger account will hold either a debit balance or a credit balance. The debit balance values will be listed in the debit column of the trial balance and the credit value balance will be listed in the credit column. A trial balance always tallies. Ledger A/Cs which shows a debit balance is put on the Debit side of the trial balance.

The A/c's Showing credit balance are put on the Credit side of the Trial Balance. Accounts which show no balance i.e. whose Debit and Credit totals are equal are not entered in Trial Balance.

Then the two sides of the Trial Balance are totalled. If they are equal it is assumed that there are no arithmetical error in the posting and balancing of Ledger A/cs.

Normally at the year end or whenever a businessman is interested in knowing the position of various A/C s, the accounts are balanced. Various steps for this purpose are

- (1) Debit and Credit sides of each A/c are totalled.
- (2) The difference between the two sides is written on the side which is shorter so as to make their totals equal.
- (3) The words "Balance C/d" i.e. the balance carried down and written against the amount of difference.
- (4) In the next period, the balance is brought down on the other side by writing the words 'Balance b/d'.
- (5) If the Debit side exceeds the Credit Side the difference is a Debit Balance whereas.
- (6) If the Credit side exceeds the Debit side the difference is a Credit Balance.

### Objectives or Functions of Trial Balance

It helps in ascertaining the arithmetical accuracy of ledger accounts.

Helps in locating errors.

Provides the summary of Ledger A/cs.

Helps in the preparation of Final A/cs.

ABC Ltd		
Trial Balance as at .....		
Account Title	Debit	Credit
Share Capital		XXXX
Cash	XXX	
Sales		XXXX
Buildings	XXXX	
Furniture & Fixture	XXX	
Cost of Sales	XXX	
General Administration Expenses	XXX	
Creditors		XXX
Debtors	XXX	
Total	XXXX	XXXX

6. **Closing Adjustment entries** are recorded **Closing entries** are **journal entries** made at the end of an accounting period to transfer temporary accounts to permanent accounts. adjusting entries are journal entries usually made at the end of an accounting period to allocate income and expenditure to the period in which they actually occurred. The revenue recognition principle is the basis of making adjusting entries that pertain to unearned and accrued revenues under accrual-basis accounting. Eg Charging depreciation, providing for outstanding incomes and expenses etc.

### Treatment of items of Adjustment outside the Trial Balance

#### Treatment of items of Adjustment outside the Trial Balance

Adjustment	Effects
Closing Stock	Trading A/c Credit Side and Asset Side of balance sheet.
Outstanding expenses	Added with concerned item in trading or profit a loss a/c and liabilities side of BALANCE SHEET as a current liability.
Prepaid expenses	Less from concerned item in trading or profit and loss a/c and assets side of BALANCE SHEET as a current assets.
Accrued Income (income earned but not received)	Add with concerned income in P&L and Assets side of BALANCE SHEET as a current assets
Income received in advance	Less from concerned item in P&L and Liabilities Side of BALANCE SHEET as current liabilities.

Depreciation	Dr. side of P&L A/C & Deduct from concerned assets.
Bad Debts	Dr. side of P&L A/C & Deduct from debtors in Balance sheet.
Provision for doubtful debts	Dr. side of P&L A/C & Deduct from debtors
Provision for discount on debtors	Dr. side of P&L A/C & Deduct from debtors

### 7. Final accounts are drawn

From the derived trial balance an accountant can prepare final accounts for the year for which information is available.

Format of final accounts differ from organisation to organisation. Let us see format of final accounts for some trading commercial organisations.

An organisation can adopt either horizontal or vertical format, but vertical format is compulsory for joint stock companies.

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## 8.4 FINAL ACCOUNTS

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### Trading Account

Trading account is prepared to know the gross profit or gross loss arising or incurred as a result of the trading activities of a business. In other words, in case of a manufacturing concern a Manufacturing A/c is prepared to show the result of manufacturing activity, trading account indicates buying and selling of goods. If the amount of sales exceeds the amount of purchases and the expenses directly connected with such purchases, the difference is termed as gross profit. On the contrary, if the purchases, and direct expenses exceed the sales, the difference is called gross loss. The purpose of preparing the Trading Account is to find out the Gross Profit or Gross Loss of a concern during a particular period. The following equations are highly useful for determination of Gross Profit and Importance of Trading Account

Preparation of Trading Account serves the following objectives:

1. It provides information about Gross Profit and Gross Loss: It informs of the gross profit or gross loss as a result of buying and selling the goods during the year. The percentage of Current Year's gross profit on the amount of sales can be calculated and compared with those of the previous years. Thus, it provides data for comparison, analysis and planning for a future period.
2. It provides information about the direct expenses: All the expenses incurred on the purchase and manufacturing of goods are recorded in the trading account in a summarised form. Percentage of such expenses on sales can be calculated and compared with those of the previous years. In this way it enables the management to control and rationalise the expenses.
3. Comparison of closing stock with those of the previous years: closing stock has to be valued and recorded in a trading account. This stock can be compared with the closing stock of the previous years and if the stock shows an increasing trend, the reasons may be inquired into.
4. It provides safety against possible losses: If the ratio of gross profit has decreased in comparison to the preceding year, the businessman can take effective measures to safeguard himself against future losses. For example, he may increase the sale price of his goods or may proceed to analyse and control the direct expenses.

### 8.4 (a) Preparation of Trading Account

Trading Account is a Nominal Account and all expenses which relate to either purchase or manufacturing of goods are written on the Debit side of the Trading Account.

Item written on the Debit side of the Trading Account:

**1. Opening Stock:** The stock of goods remaining unsold at the end of the previous year is termed as the opening stock of the current year. In other words, the closing stock of the last year becomes the opening stock of the current year. Opening Stock will include the following:

- I. Opening Stock of Raw Material.
- II. Opening Stock of Semi-finished goods, and
- III Opening Stock of Finished goods.

**2. Purchases and Purchases Returns:** Goods which have been bought for resale are termed as Purchases and goods which are returned to suppliers are termed as purchase returns or returns outwards. Purchase Account will be given on the debit side of the trial balance and Purchase Return Account on the credit side of the trial balance. Purchase returns will be shown as a deduction from Purchases on the debit side of the trading account. Purchases include cash as well as credit purchases.

**3. Direct Expenses:** All expenses incurred in purchasing the goods, bringing them to the godown and manufacture of goods are called direct expenses. Direct expenses include the following:

**I. Wages:** Wages are paid to workers who are directly engaged in the loading, unloading and production of goods and as such are debited to the trading account. It should be noted that:

(i) If the item 'Wages and Salaries' is given in the question it will be shown on the trading account. On the contrary, if 'Salaries and Wages' is given it will be shown on the profit & loss account.

(ii) If wages are paid for bringing a new machine or for its installation it will be added to the cost of the machine and hence will not be shown in the trading account.

**II. Carriage or Carriage Inwards or Freight:** These expenses should be debited to trading account because these are generally paid for bringing the goods to the factory or place of business. However, if any carriage or freight is paid on bringing an asset, the amount should be added to the asset account and must not be debited to trading account.

**III. Manufacturing Expenses:** All expenses incurred in the manufacture of goods are shown on the debit side of the trading account such as Coal, Gas, Fuel, Water, Power, Factory Rent, Factory Lighting etc.

Items written on the Credit Side of the Trading Account:

**1. Sales and Sales Returns:** Both Cash and Credit sales will be included in sales. The sales account will be a credit balance whereas, the sales return account or returns inwards account will be a debit balance. Sales return will be deducted out of Sales on the credit side of the trading account.

**2. Closing Stock:** The goods remaining unsold at the end of the year is known as Closing Stock. It is valued at cost price or market price whichever is less. It includes the closing stock of raw material, Closing Stock of semi-finished goods and Closing Stock of finished goods.



Normally, the Closing Stock is given outside the Trail Balance. This is so because its valuation is made after the accounts have been closed. It is incorporated in the books by means of the following entry:

Closing	Stock
A/c	Dr.

To Trading A/c  
(Closing Stock transferred to Trading A/c)

When the above entry is passed, the Closing Stock Account is opened. On the one hand, it will be posted to the credit side of the trading account and on the other hand, will be shown on the Assets side of the Balance Sheet, in order to complete the double entry. Sometimes, the Closing Stock is given inside the Trail Balance. This means that the entry to incorporate the closing stock in the books has already been passed. It would imply that the Closing Stock must have been deducted out of Purchases Account. Hence, in such a case, Closing Stock will not be shown in the Trading Account but will appear on the Assets side of the Balance Sheet only.

#### **8.4 (b) Profit And Loss Account**

Trading account only discloses the gross profit earned as a result of buying and selling of goods. However, a businessman has to incur a number of expenses which are not taken to trading account. Hence, a businessman is more interested in knowing the net profit earned or net loss incurred during the year. As such, a Profit & Loss Account is prepared which contains all the items of losses and gains pertaining to the accounting period. According to Prof. Carter, "A Profit & Loss Account is an account into which all gains and losses are collected, in order to ascertain the excess gains over the losses or vice-versa"

#### **Need and Importance of Profit & Loss A/c**

1. To determine the Net Profit or Net Loss: A Trading Account only discloses the Gross Profit earned as a result of trading activities, whereas the Profit & Loss Account discloses the net profit (or net loss) available to the proprietor and credited to his capital account.
2. Comparison with previous years' profit: The net profit of the current year can be compared with that of the previous years. It enables the businessman to know whether the business is being conducted efficiently or no.
3. Control on Expenses: Profit & Loss Account helps in comparing various expenses with the expenses of the previous year. Also the percentage of each individual expenses to net profit is calculated and compared with the similar ratio of previous years. Such comparison will be helpful in taking concrete steps for controlling the unnecessary expenses.
4. Helpful in the preparation of Balance Sheet: A Balance Sheet can only be prepared after ascertaining the Net Profit through the preparation of Profit and Loss Account.

### **Preparation of Profit and Loss Account**

A Profit and Loss Account is started with the amount of gross profit or gross loss brought down from the Trading Account. As such, all those expenses and losses which have not been debited to the Trading Account are now debited to Profit &

Loss Account. These expenses include administrative expenses, selling expenses, distribution expenses etc. These are called 'Indirect Expenses'. Profit and Loss Account is a Nominal Account and as such, all the expenses and losses are shown on its debit side and all the incomes and gains are shown on its credit side.

#### **Items written on the Debit side of Profit & Loss Account**

1. Gross Loss: If trading account discloses Gross Loss, it is shown on the debit side first of all.
2. Office and Administrative Expenses: Such as salary of office employees, office rent, lighting, postage, printing, legal charges, audit fee etc.
3. Selling and Distribution Expenses: Such as advertisement charges, commission, carriage outwards, bad-debts, packing charges etc.
4. Miscellaneous Expenses: Such as interest on loan, interest on capital, repair charges, depreciation, charity etc.

#### **Items written on the Credit side of Profit & Loss Account**

1. Gross Profit: the starting point of the Cr. side of Profit and Loss Account is the gross profit brought down from the Trading Account.
2. Other Incomes and Gains: All items of incomes and gains are shown on the credit side of the Profit & Loss Account, such as income from investments, rent received, discount received, commission earned, interest received, dividend received etc.

If the credit side of the profit and loss account exceeds that of debit side, the difference is termed as net profit. On the other hand, the excess of the debit side over the credit side is termed as net loss. Net profit is added to the capital whereas net loss is deducted from the capital.

## 8.5 HORIZONTAL OR 'T' FORMAT OF TRADING & P&L A/C

Particulars	Amount (Rs)	Particulars	Amount (Rs)
To opening stock	.....	By sales	.....
To purchases	.....	less: returns	.....
less: returns	.....	By closing stock	.....
To carriage inward	.....		
To wages	.....		
To gross profit c/d (in case of gross profit)	.....	By gross loss c/d (in case of gross loss)	.....
	.....		.....
To gross profit b/d (in case of gross loss)	.....	By gross profit b/d (in case of gross profit)	.....
To salaries	.....	By interest earned	.....
To carriage outward	.....	By dividend earned	.....
To rates and taxes	.....	By rent earned	.....
To insurance	.....	By discount received	.....
To depreciation	.....	By profit on sale of fixed assets	.....
To bad debts	.....	By profit on sale of investments	.....
To advertising	.....		
To interest paid	.....		
To travelling expenses	.....		
To discount allowed	.....		
To loss on sale of fixed assets	.....		
To loss on sale of investments	.....		
To loss by fire	.....		
To net profit transferred to B/S (in case of net profit)	.....	By net loss transferred to B/S (in case of net loss)	.....
	.....		.....

E.g. Prepare Trading Account for the year ended 30<sup>st</sup> March, 2013 from the following balances.

	Rs		Rs.
Stock(1 <sup>st</sup> April, 2012)	10,000	Purchases	1,00,000
Wages	5,000	Carriage Inwards	1,000
Sales	1,70,000	Returns Inward	5,000
Returns Outward	8,000	Sales Tax paid	20,000
Freight	500	Octroi duty	2,500

Closing stock as on 30<sup>st</sup> March, 2013 was valued at Rs. 20,000 Also, pass the Closing Entries.

**Solution:**

### TRADING ACCOUNT

Dr. for the year ended 30 <sup>st</sup> March, 2013		Cr.	
Particulars	Rs	Particulars	Rs
To opening stock	10,000	By Sales	
To Purchases		1,70,000	1,60,000
1,00,000	90,000	Less : Sales tax	
Less: Returns Outward	5,000	10000	20,000
10,000	1,000		
To Wages	500	By Closing Stock	
To Carriage Inwards	2,500		
To freight	71,000		
To Octroi Duty			
To Profit and loss A/c (Gross profit)	1,80,000		1,80,000

### VERTICAL FORMAT OF REVENUE STATEMENT TRADING & P&L A/C

Particulars	Schedule	Amount (Rs)
<b>Income</b>		
Sales and operating income	1	.....
Other income	2	.....
Total		.....
<b>Expenditure</b>		
Cost of goods sold	3	.....
Operating and other expenses	4	.....
Depreciation/Amortisation		.....
Interest		.....
Total		.....
Add/(Less): Exceptional items		.....
<b>Profit/(Loss) before tax</b>		.....
Less: Tax		.....
<b>Profit/(Loss) after tax</b>		.....

### HORIZONTAL OR 'T' FORMAT OF BALANCE SHEET

Liabilities	Amount (Rs)	Assets	Amount (Rs)
Share capital .....		Fixed assets	
Add: net profit/less: net loss .....		Land & building	.....
Less: drawings .....	.....	Plant & machinery	.....
Long-term liabilities		Furniture & fixtures	.....
Debentures	.....	Vehicles	.....
Loans & advances from banks	.....	Goodwill	.....
Other loans & advances	.....	Investments	.....
Current liabilities		Current assets, loans & advances	
Sundry creditors	.....	Sundry debtors	.....
Bills payable	.....	Cash in hand	.....
Bank overdraft	.....	Cash at bank	.....
Outstanding expenses	.....	Bills receivable	.....
Income received in advance	.....	Prepaid expenses	.....
Provisions		Closing stock	.....
For taxation	.....		
For dividend	.....		
	.....		.....

## 8.6 VERTICAL FORMAT OF BALANCE SHEET

Particulars	Schedule	Amount (Rs)
<b>Sources of Funds</b>		
Shareholder's funds		
Share capital	1	.....
Reserves and surplus	2	.....
Loan funds		
Secured loans	3	.....
Unsecured loans	4	.....
<b>Total</b>		.....
<b>Application of Funds</b>		
Fixed assets		
Gross block	5	.....
Less: depreciation		.....
Net block		.....
Capital work-in-progress		.....
Investments	6	.....
Current assets, loans & advances		
Inventories	7	.....
Sundry debtors	8	.....
Cash & bank balances	9	.....
Loans & advances	10	.....
Other current assets		.....
Less: current liabilities & provisions		
Current liabilities	11	.....
Provisions	12	.....
Net current assets		.....
<b>Total</b>		.....

**FINAL ACCOUNTS AS PER REVISED SCHEDULE VI FORMAT  
BALANCE SHEET**

**Balance Sheet as at 31st March, 2011**

Particulars	Note No	Figures as at the end of current reporting period	Figures as at the end of previous reporting period
<b>I. EQUITY AND LIABILITIES</b>			
<b>(1) Shareholder's Funds</b>			
(a) Share Capital			
(b) Reserves and Surplus			
(c) Money received against share warrants			
<b>(2) Share application money pending allotment</b>			
<b>(3) Non-Current Liabilities</b>			
(a) Long-term borrowings			
(b) Deferred tax liabilities (Net)			
(c) Other Long term liabilities			
(d) Long term provisions			
<b>(4) Current Liabilities</b>			
(a) Short-term borrowings			
(b) Trade payables			
(c) Other current liabilities			
(d) Short-term provisions			
<b>Total</b>			
<b>II. Assets</b>			
<b>(1) Non-current assets</b>			
(a) <i>Fixed assets</i>			
(i) Tangible assets			
(ii) Intangible assets			
(iii) Capital work-in-progress			
(iv) Intangible assets under development			
(b) Non-current investments			
(c) Deferred tax assets (net)			
(d) Long term loans and advances			
(e) Other non-current assets			
<b>(2) Current assets</b>			
(a) Current investments			
(b) Inventories			
(c) Trade receivables			
(d) Cash and cash equivalents			
(e) Short-term loans and advances			
(f) Other current assets			
<b>Total</b>			

## STATEMENT OF PROFIT AND LOSS

Profit and Loss statement for the year ended 31st March, 2011

Particulars	Note No	Figures as at the end of current reporting period	Figures as at the end of previous reporting period
I. Revenue from operations			
II. Other Income			
<b>III. Total Revenue (I +II)</b>			
<u>IV. Expenses:</u>			
Cost of materials consumed			
Purchase of Stock-in-Trade			
Changes in inventories of finished goods, work-in-progress and Stock-in-Trade			
Employee benefit expense			
Financial costs			
Depreciation and amortization expense			
Other expenses			
<b>Total Expenses</b>			
V. Profit before exceptional and extraordinary items and tax	(III - IV)		
VI. Exceptional Items			
VII. Profit before extraordinary items and tax (V - VI)			
VIII. Extraordinary Items			
IX. Profit before tax (VII - VIII)			
X. Tax expense: (1) Current tax (2) Deferred tax			
XI. Profit(Loss) from the period from continuing operations	(VII-VIII)		
XII. Profit/(Loss) from discontinuing operations			
XIII. Tax expense of discounting operations			
XIV. Profit/(Loss) from Discontinuing operations (XII - XIII)			
XV. Profit/(Loss) for the period (XI + XIV)			



## SUMS FOR PRACTICE

**Example :** Journalize the following transactions:

2016			Rs.
May.	1	Ajay Started business with cash	50,000
May.	3	Deposited cash into Bank	40,000
May.	5	Sold goods to Ganesh	22,000
May.	9	Goods returned by Ganesh	2,000
May.	11	Goods purchased from Kishore	30,500
May.	15	Goods returned to Kishore	1,500
May.	18	Bought Furniture & Fixture for office	9,000
May.	22	use by cheque	1,000
May.	22	Purchased goods for cash	50
May.	30	Paid carriage	500
		Paid interest on loan	

### Journal

**Solution:**

Date	Particulars	L.F.	Dr.(Rs.)	Cr. (Rs.)
2012 May. 1	Cash A/c ... Dr. To Ajay's Capital A/c (Being the business started with cash)		50,000	50,000
May 3	Bank A/c To Cash A/c (Being the amount deposited into the bank)		40,000	40,000
May 5	Ganesh ... Dr. To sales A/c (Being the goods sold to Ganesh)		22,000	22,000
May 9	Sales Returns A/c To Ganesh (Being the goods returned by Ganesh)		2,000	2,000
May 11	Purchases A/c To Kishore (Being the goods purchased from Kishore)		30,500	30,500
May 15	Kishore To purchases Return a/c (Being the goods returned to Kishore)		1,500	1,500
May 18	Furniture & Fixture a/c To bank a/c (Being the Furniture & Fixture bought and paid by cheque)		9,000	9,000

May 22	Purchases A/c To cash a/c (Being the goods purchased against cash)		1,000	1,000
May 26	Carriage a/c TO cash a/c (Being the carriage paid)		50	50
May 30	Interest on Loan A/c To Cash A/c (Being the payment of interest on Loan)		500	500
	<b>Total</b>		<b>1,57,550</b>	<b>1,57,550</b>



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