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DEPARTMENT OF STUDIES AND RESEARCH IN MANAGEMENT

M.B.A I Semester

COURSE - 3

ACCOUNTING FOR MANAGERS

BLOCK

1

INTRODUCTION TO ACCOUNTING

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BLOCK - 1 INTRODUCTION TO ACCOUNTING

This block entitled Introduction to accounting. The primary function of accounting is to make records of all the transaction that the firm enters into , accounting, as an information system is the process of identifying, measuring and communicating the economic information of an organization to its users who need the information for decision making.

The first unit in this block on introduction and meaning of accountancy, book keeping, accounting information system and its uses, accounting concepts and conventions. The second unit of the block consists of accounting process and equations, double entry system of modern accounting. The third unit in the block highlights recording, classifying and summarizing of business transactions. The last unit in the block is devoted to preparation of final accounts of sole proprietorship.

UNIT -1 : INTRODUCTION TO ACCOUNTING

Structure

1.1 Objectives

1.2 Introduction

1.3 Meaning of Book Keeping, Accounting and Accountancy

1.4 Accounting Information System

1.5 Users of Accounting Information

1.6 Accounting Concepts and Conventions

1.7 Financial Accounting Vs Management Accounting

1.8 Summary

1.9 Self-Test

1.1 OBJECTIVES

After going through this unit, you should able to;

- Define Accounting and explain its role in making business decisions.
- Understand Accounting Information System.
- Identify the users of accounting information and their informational needs
- Distinguish between financial and management accounting.
- Discuss the various concepts and conventions underlying accounting measurement and explain their significance.

1.2 INTRODUCTION

Accounting is one of the fastest growing professions and is one of the most popular fields of study in colleges, universities and business schools. Accounting offers interesting, challenging and rewarding careers. Business enterprises, governmental agencies, charities and individuals need information to be able to make sound decisions. The accounting system provides relevant and reliable financial information to interested parties. This unit presents an overview of accounting and its role in today's organizations and society.

Accounting is often called the language of business. The function of a language is to facilitate communication among individuals in a society. Accounting is the common language used to communicate financial information from one person to another in the world of industry and commerce. Clearly, individuals who aspire to be professional accountants should be experts in accounting. However, a good knowledge of accounting terms, principles and techniques is also essential for non-accountants, such as investors, managers, employees, and government officials, who have to constantly interact with business organizations.

Accounting provides "information that is useful in making business and economic decisions – for making reasoned choices among alternative uses of scarce resources in the conduct of business and economic activities" It is a principal means of communicating financial information to owners, lenders, managers and others who have an interest in an enterprise. Accounting is not an end in itself. Indeed, accounting is an information development and communication function that supports economic decision making.

1.3 MEANING OF BOOK KEEPING, ACCOUNTING AND ACCOUNTANCY

Accounting as a discipline was introduced to have permanent and systematic record of business transactions. This would help a businessperson to record all relevant business transactions, to ascertain the profit earned during a particular period and finally evaluate the financial position of his/her business. Book keeping, accounting and accountancy are the terms used in the science of financial accounting.

Book keeping is defined as the science and art of recording business transactions in a systematic manner in a certain set of books known as books of accounts. It identifies the transactions and events, measures the identified transactions and events in a common measuring unit, records then in proper books of accounts and finally classifies them in another bookcalled the ledger.

Accounting is termed as language of business which records all events andtransactions that are of monetary value and facilitates communication among individuals in a society.

The American institute of Certified Public Accountants defines accounting as "the art of recording, classifying and summarizing in a significantmanner and in terms of money transactions and events which are, in part atleast, of a financial character, and interpreting the results thereof.

This definition brings out the following as attributes of accounting:

1. Events and transactions of a financial nature are recorded while the events of a non-financial nature cannot be recorded.
2. The record should reflect the importance of the transactions so recorded both individually and collectively, which includes summarization, thereby making it amenable to analysis.

Accountancy refers to a systematic knowledge of accounting. It explains "why to do? and "how to do? of various aspects of accounting. It tells us whyand how to prepare the books of accounts and how to summarize theaccounting information and communicate it to the interested parties.

The users of the financial statements should be able to obtain the messageencompassed in such financial statements, and it is the knowledge ofaccountancy, which enables the user to understand the contents of thefinancial statements.

1.4 ACCOUNTING INFORMATION SYSTEM

An oft-quoted publication of the American Accounting Association states that "essentially, accounting is an information system". A system converts inputs into outputs. The accounting system processes business transactions to provide information to various interested parties. There are external and internal users of the information produced by the accounting system of a firm. External users of accounting information are those who are outside the firm and include investors and lenders. Managing directors, marketing managers, production managers, materials mangers and financial controllers are examples of internal users of accounting information.

The following figure depicts the accounting information system.

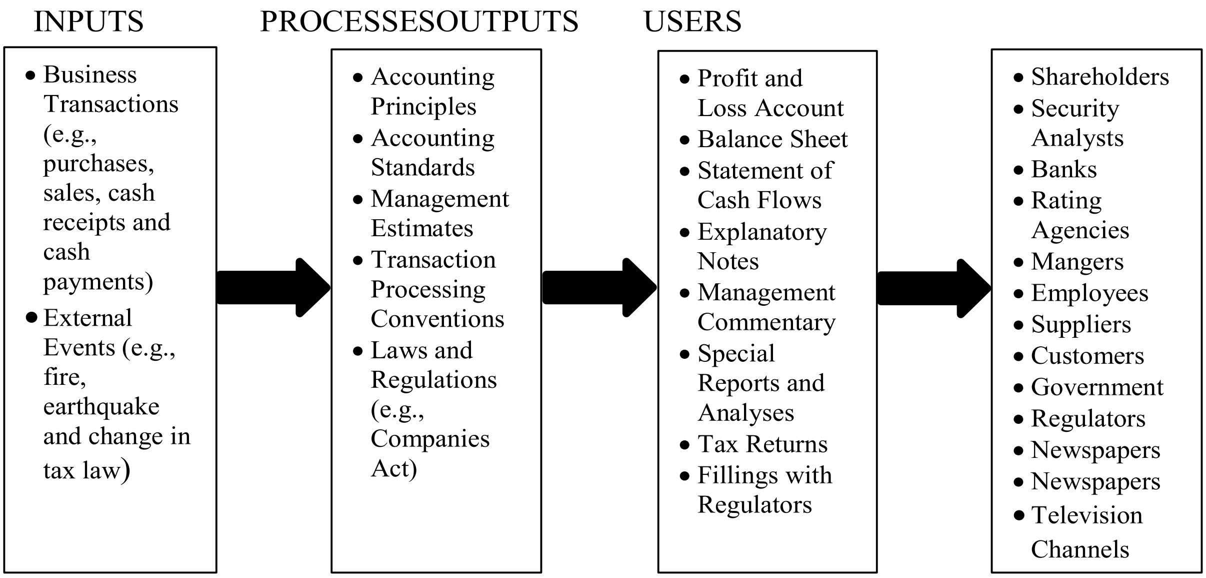

FIGURE 1.2 The Accounting Information System.

1.5 USERS OF ACCOUNTING INFORMATION

Investors and lenders are the most obvious users of accounting information. Their decisions and their user of information have been studied and described to a much greater extent than those of other user groups. Therefore, for reasons that are largely pragmatic, the objectives of financial reports are focused on information for investment and loan decisions. However, financial reports are also extensively used by other individuals and groups who have to rely on them as their major source of financial information. Potential users of accounting information include present and potential investors, lenders, security analysts and advisers, management, employees and trade unions, suppliers and other trade creditors, customers, governments and regulatory agencies and the public.

Exhibit showing users of accounting information and their informational needs

	USERS	INFORMATIONAL NEEDS
Investors	Individual shareholders Mutual funds Insurance companies	Is it time to buy, hold or sell an investment? Can the company pay good dividends regularly? Is the company's performance satisfactory?
Lenders	Banks Debenture holders	Can the borrower pay the loan and interest on time? What should be the security and interest rate for the loan?
Security analysts and advisers	Equity and bond analysts Stockbrokers Credit rating agencies	Same as investors and lenders
Management	Managing directors Finance directors Marketing managers Production mangers Profit centre heads	How does the company's performance compare with that of its competitors? Which projects should the company invest in? Are the company's profit and profitability adequate? Do the financial statements fairly communicate the intrinsic value of the company's share?
Employees and trade unions	Industrial workers Office staff Trade unions Federations of trade unions	How much wages and bonus can the company afford? Will the company continue to be in business? Can the company honour its future obligations for pension, health and other retirement benefits?
Suppliers and other trade creditors	Suppliers of raw materials and components Sub-contractors Utility companies	Is the company a major customer? Will it become one? If the company is a major customer, will the situation continue to be so? Can the company pay for its purchases on time?
Customers	Past, present and prospective customers	Can the company be expected to be a reliable and economical source of supply? Can the company service its products? Can the company honour its warranty obligations?
Government and regulatory agencies	Tax authorities Stock exchanges Securities and Exchange Board of India Competition commission of India Department of company affairs	Does it appear that the company is evading payment of tax? Should an industry be given bounties or be taxed more? Are companies overcharging consumers? Should an industry be given anti-dumping protection? Do companies make proper disclosures of their financial results as legally required?
The public	Local community Political parties Public affairs groups Consumer groups Environmental activists	Do companies exploit local suppliers? Are the products of companies safe and wholesome? Do companies take adequate pollution control measures? Do companies hinder competition in the industry?

1.6 FINANCIAL ACCOUNTING v/s MANAGEMENT ACCOUNTING

Financial accounting and management accounting both appear to be similar in as much as both study the impact of business transactions and events of the enterprise and report and interpret the results thereof. Both provide information for internal as well as external use. But management accounting, although having its roots in financial accounting, differs from the latter in the following respects.

1. Financial accounting deals with the business transactions and events for the enterprise as a whole. Management accounting, in addition to the study of events in relation to the enterprise as a whole takes organisation in its various units and segments and attempts to trace the impact and effect of the business transactions and events through its various divisions and sub divisions. Thus, while the financial statement - profit and loss account, balance sheet and cash flow statements reveal the overall performance and position of the enterprise. Management accounting reports emphasise on the details of operational costs, inventories, products, process and jobs. It traces the effect and impact of the business transactions and events on costs, inventories, processes, jobs and products.
2. Financial accounting is attached more with reporting the results and position of the business to persons and authorities other than management - Government, creditors, investors, owners, etc. At times, financial accounting follows window-dressing tactics in order to project a better than actual image of the enterprise. Management accounting is concerned more with generating information for the use of internal management and hence the information reflects the real or really expected position.
3. Financial accounting is necessarily historical. It records and analyses business events long after they have taken place. Management accounting analyses the events as they take place and also anticipates such events for the future. Thus, it uses data which generally has relevance to the future.
4. Since financial accounting data is historical in nature, it is more precise than the management accounting data, which generally reflects the expected future, and hence could only be estimation. This provides the necessary rapidity to management accounting information.
5. The periodicity in reporting financial accounts is much wider than in case of management accounting. In financial accounting, generally, results are reported on year to year basis. In management accounting, weekly, fortnightly and even monthly reporting is used.

6. Financial accounting has to be governed by the "generally accepted principles". This is so because; it has to cater for the informational needs of the outsiders. It has to stick to the generally accepted methods of presentation of such information. Regarding the contents and form of information, financial accounting has to abide by the legal provisions also. Management accounting has not to worry about such legal and/or conventional constraints and the "generally accepted principles". It is free to formulate its own rules, procedures and forms, because the information it generates is solely for internal consumption. In management accounting fixed assets may be stated at appraisal values, overhead costs may be omitted from inventories or revenues may be recorded before realisation. Generally accepted principles of financial accounting do not permit such accounts. What is important in management accounting is the usefulness of the information for managerial functions rather than its general acceptability. The form and content of management accounting information differs according to the needs and purpose.
7. Financial accounting is a must in case of joint stock companies to meet the statutory provisions of company law and tax laws. Even in case of sole proprietorship and partnership firms financial accounting becomes a necessity for tax purposes. Management accounting, on the other hand, is entirely optional and its forms and contents depend upon the outlook of the management.
8. Financial statements prepared under financial accounting, consists of monetary information only. Management accounting statements in addition to monetary information also consists non-monetary information, viz., quantities of materials consumed, and number of workers, quantities produced and sold and so on.
9. Financial statements are required to be published and audited by statutory auditors. Management accounting statements are for internal use and thus neither published nor audited.

1.7 ACCOUNTING CONCEPTS AND CONVENTIONS

The system of accounting is based on a set of principles, which are called Generally Accepted Accounting Principles (GAAP). These principles enable to certain extent standardization in recording and reporting of information so that the users, once they are aware of the principles, can read and understand financial statements prepared by diverse organizations.

Accounting principles may be defined as those rules of action or conduct which are adopted bythe accountants universally while recording accounting transaction. These principles can be classified into two categories:

1. Accounting concepts.
2. Accounting conventions

Accounting concepts

The accounting concepts include those basic assumption or conditions which the science of accounting is based. ***The following are the important accounting concepts:***

1. Money measurement concept,
2. Business entity concept,
3. Going concern concept,
4. Duality concept,
5. Cost concept,
6. Matching of cost and revenue concept,
7. Realization concept.
8. Accrual concept.

* **Money Measurement Concept:** In financial accounting, an event is recorded, only if it can be expressed in monetary terms. Recording, classification and summarization of business transactions requires a common unit of measurement, which is taken as money. The advantage of doing this is that money provides a common denominator by means of which heterogeneous facts about an entity can be expressed as numbers that can be added and subtracted. If events cannot be quantified in monetary terms then they do not facilitate accounting. Hence, all transactions are recorded through a common denominator - money. Thus, if a certain event, no matter how significant for the health or even existence of the business, cannot be measured in monetary terms, that event is not recorded in accounting. Money is expressed in terms of its value at the time an event is recorded in the accounts. Subsequent changes in the purchasing power of money do not affect this amount. For example, purchase of an inconsequential asset, which is easily measured in rupee terms, is accounted for in the business. However, the retirement or death of the Chairman of a company, even though it has far reaching consequences for the health of the business is not accounted for, since no monetary measurement of the event is possible.

* **Business Entity Concept :** In simple language the business is distinctly different and separate from its owner. A business entity or a company is an artificial company created by law, who has a common seal, which has a perpetual existence and does not die natural death. A business entity can be described as an undertaking under the control of a single management, which may include a sole-proprietor, a partnership firm, a company or a nonprofit making organization. Hence for accounting purpose, the owner and his business should be kept separate. Accounting records are kept from the point of view of the business unit and not the owner. So, if the owner contributes fund to the business, it will be treated as a liability of the business - say the business owes this much to the owner.

* **Going Concern Concept :** A business entity is having a perpetual existence, which does not die a natural death. It is assumed to carry on its operations forever. Seemingly inconsequential, this is a fundamental concept, which has far reaching consequences. This is because it is difficult to envisage any economic activity on the part of a business entity if its liquidation were shortly expected. Going concern concept implies that the resources of the concern would continue to be used for the purposes for which they are meant to be used. For instance, in a manufacturing concern, the land, buildings, machinery etc., are primarily required for carrying out the production and selling of certain products. Going concern concept implies that these land, buildings, machinery etc., would continue to be used for this purpose. In fact, it is because these assets would continue to be with the concern for a long time for producing and selling the end products, that these assets (as would be seen in subsequent paragraphs) are termed 'fixed assets'. If on the other hand, the above assumption were to be invalid, and these assets were to be sold off and not used for manufacturing and selling operations, then these assets could not even be labelled as 'fixed assets', but would be termed 'current assets'. Thus, the very categorization of assets into 'fixed' and 'current', presupposes the Going Concern Concept.

* **Cost Concept :** Cost Concept implies that in accounting, all transactions are generally recorded at cost, and not at market value. For example, if a piece of land is acquired for Rs.1 lakh, it would continue to be shown in the balance sheet at Rs.l lakh, even when the market value of the land rises to say Rs.10 lakhs. Why should this be so? This is because cost concept is in fact closely related to the going concern concept. If the land is acquired for the operations of the business and would continue to be used for its operations and would not be sold shortly, then it is largely immaterial what the land's market value is, since it is not going to be sold anyway. Thus, it is

consistent with going concern concept to keep recording the land at cost, i.e. Rs.l lakh on an ongoing basis. The cost, historical cost, at which the assets are acquired, forms the basis for subsequent accounting. Therefore the valuation does not reflect the current worth of the asset. The cost concept, though sacrificing a certain degree of current relevance, provides for feasibility and objectivity.

* **Dual aspect concept:** This concept is based on the double entry system of book keeping which says for every debit there is a correspondence credit. Therefore the total assets of the firm should have claims from both owners i.e., capital and outsiders i.e., liabilities.

The economic resources of an entity are called assets. The claims of various parties against these are called-equities. There are two types of equities:

1. Liabilities, which arc the claims of creditors (that is every one other than the owners of the business).

2. Owners ‘equity, which is the claims of the owners of the business.

Since all of the assts of a business are claimed by someone (either by its owner or by its creditors) and since the total of these claims cannot exceed the amount of assets to be claimed, it follows that

ASSETS = CLAIMS

This is the fundamental accounting equation, which is the formal expression of the dual aspect concept. To reflect the two types of claims, the equation is more commonly expressed as

ASSETS = LIABILITIES + OWNERS’EQUITY

* **Accounting Period Concept :** A business entity is an artificial person having a perpetual existence. It is a going concern. Because of the perpetual nature of a business concern, to measure income generated by the business or loss incurred by the business, the infinite life of the business is broken into small pieces called accounting periods. End of each such period it is ascertained what income the business generated” or what loss the business incurred and what is the financial position of the business. These small periods are known as accounting period. Generally accounting period is one year - January 01 to December 31 as in US and April 01 to March 31 as in India.

* **Matching Concept :** The purpose of the Accounting Period Concept is to ascertain whether the company generated some profit or incurred some loss in an accounting period. In order to ascertain this, the expenses related to this period must be compared

or matched with the revenues generated during this period. Relevant expenses or income of an accounting period implies that these should specifically relate to this period, irrespective of the fact that the cash transaction has taken place or not. Say, for example a company in India sold goods worth Rs.12 lakhs in the month of March 2004.on credit for two months, Hence, though the cash would be realized in the accounting period 2004-05, the revenue would relate to 2003-04 for accounting purposes. Similarly all expenses, though the cash outflow may occur in the next period, but if it is generated in this period, it will be treated as this period's expenses. All these relevant expenses incurred are matched with the relevant income and ascertained whether the business entity generated profit or incurred loss in that accounting period.

* **Realization Concept :** Realization concept deals with the point in time at which revenue may be deemed to be realized or when a sale can be said to have taken place. Normally revenue is said to be realized when efforts rendered are rewarded either in cash (or kind) or in the form of a promise of reward some time in future. Thus, revenue is normally recognized only when goods or services are transferred and a reward or a promise ofreward is forthcoming. If there is no transfer of goods or services, normally no reward may be expected either now or in future and hence no revenue is realized. Thus, normally revenue is recognized at the time of transfer of goods or services when a return consideration is either obtained immediately or there exists a reasonable certainty of receiving a return consideration in future.

* **Accrual concept :** Profit earned or loss suffered for an accounting period is the result of bothcash and credit transactions. It is possible that certain incomes are earned but not received and similarly certain expenses incurred but not yet paidduring an accounting period. But it is relevant to consider them whilecomputing the financial results just because they are related to the specific accounting period.Similarly the expenses that are incurred for the accounting period could be paid after the accounting period. Such accrued expenses are deducted while calculating the profit for the accounting period. This is the accrual concept.

* **Accounting Conventions :** The term convention denotes circumstances or traditions which guide the accountant while preparing the accounting statements. The following are the important accounting conventions:

  1. Conservatism
  2. Materiality

3. Consistency
4. Full Disclosure

* **Conservatism :** The idea behind the convention of conservatism is that recognition of revenue requires better evidence than recognition of expenses. This principle emphasizes that revenues and profits are to be recognized only when they are reasonably certain and expenses and losses are to be recognized as soon as they are reasonably possible. For example, the Foreign Trade Manager of a garment export firm in Kolkata might have received an order to deliver 10000 dozen silks carves to a client in London at an agreed value of £100000. But unless these items are produced and delivered to the client in London, there is no reasonable certainty about receiving the payment for these 10000 dozen carves. It is only thereafter that he can record the sales amount on those 10000 dozen scarves as due from the client. But, on the other hand, if the Outstanding Collection Department of HDFC Credit Cards comes to know that a customer has gone bankrupt and is likely to default payment, then the department should immediately provide for such loss. Thus a revenue or profit should be accounted only when there is a reasonable surety of recognizing but any anticipated loss or expense should be immediately accounted for.

* **Materiality Concept :** The criterion of 'True and Fair' in the preparation of the financial statements is necessary for arriving at a reasonable conclusion on the financial health of the company. This condition brings us to the relative concept of materiality, which by its very nature can be subject to variations. In other words, only things, which are materially important, should be given more importance in accounting. For example, for a small sized electronic repair and maintenance shop in Hyderabad has an error of Rs. 10000 in posting the expenses, where its total turnover in the year is Rs.200000 and a software company in Hyderabad has an error of the same nature and same amount, the only difference beingturnover of this software company is Rs.10 crores. In the former case, the error pertains to 5% of the total turnover, whereas in the latter, the error pertains to 0.01%. While in the case of the electronic repair and maintenance shop, the error is substantially important as it relates to 5% of the yearly turnover, for the software company, it is highly marginal. In the former case, ifit is not rectified, it will give a faulty profit picture but in the latter case, if already the accounts are finalized, it is not worthwhile to spend such money, time and energy to rectify this error. It could be easily rectified in the early next quarter. While for the shop, this is materially important, for the software company it is not materially important.

* **Consistency :** There are in practice several ways of treating a transaction that may be recorded in the accounts. The consistency concept requires that once an entity has decided on one method, it will treat all subsequent events of the same character in the same fashion unless it has a sound reason to change the method of treatment of that transaction. For example, if a concern is valuing its inventory by a particular method in one year it is expected to value its inventory in the subsequent years also in the same method unless there is a strong reason to change the same. Similarly, if it is charging depreciation by one method it is expected to follow the same method in the subsequent years also. This is to do comparison, intra-firm and inter-firm. Absolute values prove nothing, unless and until compared to figures of say the last year, or a same nature of business. Consistency Concept caters to this requirement of financial accounting.
* **Full Disclosure :** According to this convention, all accounting statements should be honestly prepared and to that end full disclosure of all significant information should be made. All information which is of material interest to proprietors, creditors, and investors should be disclosed in accounting statement. On the other hand, if there is no detailed disclosure in the profit and loss account undisclosed reserves accumulated in the past periods may be used to swell the profits in the year when the company is failing badly and the shareholders may be misled into thinking that company is making profit

1.8 SUMMARY

Business organisations offer goods and services in order to earn a profit. Accounting is the common language used to communicate financial information to the world of industry and commerce. Accounting is an information system that processes business transactions to provide financial reports to interested parties. It is not an end in itself. Accounting develops and communicates information that is useful in making sound decisions concerning use of scarce resources.

Accounting information is used by various individuals and groups. Major users of accounting information include present and potential investors and creditors, analysts, employees, management, governments and regulatory agencies.

There are two branches of accounting namely financial accounting and management accounting. Financial accounting differs from management accounting in the sense that financial accounting is the preparation and communication of financial information mainly for the use by those outside the enterprise, whereas management accounting is the provision of financial and other information for the internal use of management.

Accounting measures business transactions, economic events which affect a business. Accounting measures business transactions, economic events which affect a business. The major accounting concepts and conventions that underlie accounting measurement are discussed in detail above make it possible to summarize in money terms the results of business transactions for a period separately for each business.

1.9 SELF-TEST

1. Define Accounting and explain its role in making business decisions.
2. What is Accounting Information system?
3. Identify the major users of accounting information and what are their informational needs?
4. What is Financial Accounting? How does it differ from Management Accounting?
5. Explain the various accounting concepts and conventions underlying accounting measurement and explain their significance.

UNIT-2 : ACCOUNTING PROCESS AND ACCOUNTING EQUATION

Structure

2.1 OBJECTIVES

After going through this unit, you should able to;

- Describe accounting process
- Recognize accounting equation and commonly used asset, liability and owners' equity accounts.
- Describe double entry system and state the rules for debit and credit.

2.2 ACCOUNTING PROCESS

Accounting is the process of identifying the transactions and events, measuring the transactions and events in terms of money, recording them in a systematic manner in the books of accounts, classifying or grouping them and final y summarizing the transactions in a manner useful to the users of accounting information.

1. **Identifying the transactions and events :** This is the first step of accounting process. It identifies the transaction of financial character that is required to be recorded in the books of accounts. Transaction is transfer of money or goods or services from one person or account to another person or account. Events happen as a result of internal policies or external needs. Events of non financial character cannot be recorded even though such events may have an impact on the operational results of the firm.
2. **Measuring :** This denotes expressing the value of business transactions and events in terms of money (in terms of rupees in India).
3. **Recording :** It deals with recording of identifiable and measurable transactions and events in a systematic manner in the books of original entry that are in accordance with the principles of accountancy.
4. **Classifying :** It deals with periodic grouping of transactions of similar nature that appear in the books of original entry into appropriate heads by posting or transfer entries. For Eg: All purchases of goods made for cash or on credit on different dates are brought to purchase account.
5. **Summarizing :** It deals with summarizing or condensing transactions in a manner useful to the users. This function involves the preparation of financial statements such as income statement, balance sheet, statement of changes in financial position and cash flow statement.

6. **Analyzing :** It deals with the establishment of relationship between the various items or group of items taken from income statement or balance sheet or both. Its purpose is to identify the financial strengths and weaknesses of the enterprise. The above six process in the present day scenario are generally performed using software packages.
7. **Interpreting :** It deals with explaining the significance of those data in a manner that the end users of the financial statement can make a meaningful judgment about the profitability and financial position of the business. The accountants should interpret the statement in a manner useful to the users, so as to enable the user to make reasoned decision out of the alternative course of action. They factors on what has happened, why it happened, and what is likely to happen under specific conditions.
8. **Communicating :** It deals with communicating the analyzed and interpreted data in the form of financial reports/ statements to the users of financial information eg Profit and loss account, Balance Sheet, Cash flow and Funds Flow statement, Auditors report etc should explain various.

2.3 THE ACCOUNTING EQUATION

The accounting equation shows the relationship between the economic resources belonging to a business and the claims against those resources. At any given time, the following relationship holds:

Economic resources = Claims

Another term for economic resources is assets. Claims consist of creditors' claims, or liabilities, and owners' claims or owners' equity. The accounting equation may now be modified as follows:

Assets = Liabilities + Owners' equity

Every business transaction, regardless of size and complexity, can be analyzed in terms of its effect on the accounting equation.

1. **Assets :** Assets are resources controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise. Simply stated, assets are what an enterprise owns. Money is an asset because of its command over other assets. Investments and amounts receivable from customers are also assets because they can be converted into money. Some assets such as land, building and plant and machinery have a physical form, whereas others like patents and copyrights

confer legal rights but have no physical form. In sum, an asset is either cash or should be able to generate cash.

2. **Liabilities :** A liability is a 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. Simply stated, liabilities are the amounts owed by an enterprise and are settled by giving up cash or other assets. Loans payable, salaries payable estimated warranty obligation, pensions payable, and income tax payable are examples of liabilities. Most liabilities are the result of a binding contract or statutory requirement. Liabilities also arise from equitable or constructive obligations, which are commonly paid in the same way as legally binding contracts.

3. **Equity :** Equity, or owners' equity, is the residual interest in the assets of the enterprise after deducting all its liabilities. Thus, owners' equity is the difference between the enterprise's assets and its liabilities. The equity of a business enterprise is increased though investments of assets by owners and profits from operations and is decreased though distributions of assets to owner from the enterprise and losses from operations.

2.4 THE DOUBLE ENTRY SYSTEM : THE BASIS OF MODERN ACCOUNTING

The system of making two or double entries of equal value in two different accounts in opposite directions is called as "Double entry book keeping". It is a complete system of book keeping. It is followed by big business houses. Under this system, each business transaction is recorded in a minimum of two accounts so that the accounting equation is always in balance. Every transaction is recorded with equal debits and credits. As a result, the total of all the debits must equal the total of all the credits. This principle of duality is valid regardless of the complexity of a transaction or the number of accounts affected.

Debit and Credit Rules:

Under the double entry system, assets are entered on the debit side of the account, and liabilities and owners' equity are entered on the credit side of the account. The following describes the recording procedure in terms of the accounting equation:

The rules for debit and credit for assets, liabilities, and owners' equity may be stated as follows:

1. Increases in assets are debited to asset accounts. Decreases in assets are credited to asset accounts.
2. Increases in liability's and owners' equity are credited to liability and owners' equity accounts. Decreases in liabilities and owners' equity are debited to liability and owners' equity account.

Revenues increase owners' equity, and expenses and dividends decrease owners' equity. Thus, the expanded form of the accounting equation is

Assets = Liabilities + Capital + Revenues – Expenses – Dividends

The equation can be rewritten as follows:

Assets + Expenses + Dividends = Liabilities + Capital + Revenues

The rules for recording increases and decreases in owners' equity can now be extended to revenues, expenses and dividends. Revenues are recorded by credits, and expenses and dividends are recorded by debits. The rules for debit and credit may now be summarized as follows:

Effect	**Assets, Expenses, Dividends**	**Liabilities, Capital, Revenues**
Increase	**Debit**	**Credit**
Decrease	**Credit**	**Debit**

For the purpose of passing journal entries every business transaction has to be identified as to either individual, firm, companies or institution, or assets, properties or goods or expenses or losses and incomes or gains. The accounts, therefore, are classified in to three categories.

1. Personal Accounts
2. Real Accounts,
3. Nominal Accounts

Personal Accounts: They are accounts of persons with whom a concern carries on business. Personal accounts' may be

a. Representative personal accounts i.e. outstanding expenses A/c, income received in advance A/c.

b. Accounts of natural, or physical persons. Example, Ram's. A/c

c. Accounts of artificial or legal persons i.e. account of partnership firms, companies, club association, banking institution, Government institutions etc.

Real accounts: These are accounts of properties or assets or goods owned by a concern. Real or assets account may be

a. Tangible Assets like Goods *a/c.* cash a/c, furniture a/c, vehicles a/c, Land and buildings a/c. Machinery a/c.

b. Intangible Assets like Goodwill a/c patent rights a/c, copy rights a/c. trade marks a/c.

Nominal accounts: Nominal accounts or fictitious accounts are accounts of the expenses and losses which a concern incurs and incomes and gains, which a concern earns.

a. Revenue or incomes account i e., accounts of revenues, incomes, gains or profits.
b. Expenses account i,e., accounts of expenses or losses.

The fundamental rule of double entry system for debit and credit is that the account that receives the benefit of a transaction should be debited and the account that gives the benefit of the transaction should be credited.

The rules for debit and credit

The Rule of debiting and crediting in respect of all the categories of account stated, above are as follows:

1. **Personal Accounts :**

   Debit the receiverand Credit the giver

2. **Real, Property or- Asset Accounts :**

   Debit what comes inand Credit what goes out

3. **Nominal or Fictitious Accounts :**

   Debit all expenses and Losses and Credit all incomes and gains.

2.5 SUMMARY

Accounting process begins with the analysis and the journalizing of transactions, then posting them into the ledger accounts and preparation of trial balance to check the arithmetical accuracy of the books of accounts. The most important output of accounting process is financial statements i.e. final accounts.For recording transactions, double entry system of book keeping is followed wherein the accounting equation states that at a given time, the sum of assets must equal the sum of liabilities and owners' equity. The equation is 'Assets = Liabilities + Equity'. Each business transaction is recorded in a minimum of two accounts so that the total of all debits must equal to the total of all credits. The procedure for analysing transactions consists of three steps namely (a)examining how a transaction changes assets, liabilities, and owners' equity, (b) apply the rules for debit and credit and (c) make the journal entry.

2.6 SELF TEST

1. State the Accounting equation. Explain the major components of accounting equation.
2. Describe the steps in accounting process.
3. What is double entry system of book-keeping? State the rules of debit and credit for a) assets, b) liabilities and c) owners' equity.
4. What are personal, nominal and real accounts? Give suitable examples for each category.
5. On September 1, 2012, RashmiSinha established Lovely Beauty Salon. The business engaged in the following transactions in the first month:

a. RashmiSinha invested Rs.50, 000 cash in business.

b. Bought equipment for cash Rs.15,000

c. Took a bank loan Rs. 25,000.

d. Bought supplies on credit Rs.3,000

e. Paid rent Rs 12,500

f. Received fee for services provided Rs. 29,000.

Analyze the above transactions in terms of their effects on assets, liabilities and owners' equity.

UNIT-3 : RECORDING, CLASSIFYING AND SUMMARIZING BUSINESS TRANSACTIONS

Structure

3.1 OBJECTIVES

After going through this unit, you should able to;

- Record transactions in the journal.
- Post transactions from the journal to the ledger.
- Prepare a trial balance and recognize its uses and limitations.

3.2 RECORDING, CLASSIFYING AND SUMMARIZING BUSINESS TRANSACTIONS

3.2.1 The Journal

The journal is a chronological record of transactions entered into by a business. The word 'journal' derives from the Latin root, ***dies*** **meaning 'day'.** The journal is called the book of original entry or primary book because this is the accounting record where transactions are first recorded. The journal provides in one place a complete record of all transactions including necessary explanations. Also, if a transaction is directly recorded in the ledger, the effect of the transaction may be erroneously recorded as entering the debit twice or the credit twice or omitting the debit or the credit. The journal entry for a transaction consists of the date of the transaction, the individual accounts and the related amounts to be debited and credited, and a brief explanation of the transaction. The process of recording transactions in the journal is called journalizing.

Form of Journal :

Date	Particulars	LF	Debit	Credit

Illustration No 1 :

Journalize the above transaction.

1. Started business with Rs 2,00,0000 out of which 50,000 deposited into bank.
2. Purchase of goods from Thrilokh and sons worth Rs 40,000
3. Sold goods for cash Rs 20,000
4. Paid telephone bill through bank Rs 500
5. Purchased furniture worth Rs 25,000 for exchange of goods

6. Purchased a computer for personal use for Rs 20,000 paid through bank
7. Purchased goods from Sourabh& company at a invoice of price of Rs 12,000 at a trade discount of 10%
8. Paid office expenditure Rs 200
9. Issued a cheque to Sourabh& company to settlement of his company Rs 10,500

Solution:

Journal Entries

Date	Particulars	L/F	Dr	Cr
1	Cash a/c Dr Bank a/c Dr To Capital a/c [Being business commenced		150000 50000 -	- - 200000
2	Purchases a/c Dr To Thrilokh a/c [Being goods purchased from Thrilokh]		40000 -	- 40000
3	Cash a/c Dr To Sales a/c [Being goods sold for cash]		20000 -	- 20000
4	Telephone bill a/c Dr To Bank a/c [Being telephone bill paid by cheque]		500 -	- 500
5	Furnitures a/c Dr To purchase a/c [Being furniture purchased for goods]		25000 -	- 25000
6	Drawing s a/c Dr To Bank a/c [Being computer purchased for personal use]		20000 -	- 20000
7	Purchase a/c Dr To Sourabh& Co. [Being the goods purchased from sourabh& Co. @ 10% discount]		10800 -	- 10800
8	Office expense a/c Dr To Cash a/c [Being office expense paid]		200 -	- 200
9	Sourabh& Co. a/c Dr To Bank a/c To Discount a/c [Being payment made to sourabh& co. in full settlement of their a/c]		10800 -	- 10500 300

Illustration 2.

Journalize the following transactions:

1. Commenced business with cash Rs 10000
2. Deposited into bank Rs 5000
3. Purchased goods for cash Rs 3000
4. Sold goods for cash Rs 2500
5. Purchased goods from A on credit Rs 4000
6. Sold goods to Mr. B on credit Rs 4500
7. Withdrew from bank Rs 3000
8. Paid Mr. A on a/c Rs 2000
9. Received from B on a/c Rs 2500
10. Took loan from C Rs 5000
11. Gave a loan to Mr. D Rs 4000
12. Paid salaries Rs 1000
13. Received commission Rs 200
14. Cash withdrew from the business for personal use Rs 300
15. Rent due to Mr. E, the land lord Rs 1000.

Solution:

Journal Entries

3.2.2 The Ledger

Ledger is a book which contains various accounts. In other words, Ledger is a set of account; a ledger account may be defined as a summary statement of all the transaction relating to a person, assets, expenses or income which have taken place during period of time and shows their net effect. It is the main book of account. Ledger is also called Principal book as final information pertaining to the financial position of a business emerges only from the accounts.

Form of Ledger

Account

Date	Particulars	JF	Amount	Date	Particulars	JF	Amount

Illustration no 3.

Journalize the following transaction in the books of Sharma brothers and post them into Ledger accounts

2007 April 1 - commenced business with cash Rs 50000 & machinery Rs 10000

2007 April 2 - Deposited cash into bank Rs 20000

2007 April 4 - Purchased goods worth Rs 8000 less 10% trade discount & 2% cash Discount

2007 April 7 - Purchased goods from Roy son's for Rs 5000 less 20% trade Discount & 5% cash discount half of the amount was paid in cash

2007 April 10 - Withdrawn from bank for office use Rs 2000

2007 April 13 - Sold goods to Ashok for Rs 3000 less 5% trade discount

2007 April 16 - Appointed Mr. Manu as a cashier at a salary of Rs 1000 per month and received Rs 2000 from him as security deposit

2007 April 18 - Received Cash from Ashok Rs 2840 in full settlement of his a/c

2007 April 20 –Withdrew from business for personal use Rs 1000

2007 April 22 –Purchased goods for Rs 2000 from Patel and invoiced the same Sahil for Rs 2400.

In the books of Sharma & brothers

Date	Particulars	L/F	Dr	Cr
1-4-07	Cash a/c Dr Machinery a/c Dr To capital a/c [Being business started with cash & machinery]		50000 10000	- - 60000
2-4-07	Bank a/c Dr To cash a/c [Being cash deposited into bank]		20000 -	- 20000
4-4-07	Purchases a/c Dr To Creditors a/c [Being		7200 -	- 7200
4-4-07	Creditors a/c Dr To cash a/c To discount a/c [Being cash paid to suppliers to avail 2% cash discount]		7200 - -	- 7056 144
7-4-07	Purchases a/c Dr To Roy & Son's a/c [Being goods purchased from Roy's son's subject to 20% trade discount]		4000 -	- 4000
7-4-07	Roy's & Son's a/c Dr To discount a/c To cash a/c [Being		2000 - -	- 100 1900
	Purchases a/c Dr To Roy & Son To Discount 5% on 2000 To cash a/c [Being goods purchased from Roy on credit with subject to 20% trade discount & half of the amount paid in cash to avail 5% cash discount]		4000 - - -	- 2000 100 1900
10-4-07	Cash a/c Dr To bank a/c [Being cash withdrawn from bank]		2000 -	- 2000
13-4-07	Ashok a/c Dr To sales a/c [Being goods sold to Ashok on credit subject to 5% trade discount]		2850 -	- 2850
16-4-07	Cash a/c Dr To Manu's security deposit a/c [Being security deposit was received from Manu]		2000 -	- 2000
18-4-07	Cash a/c Dr Discount allowed a/c Dr To Ashok a/c [Being cash received from Ashok in full settlement of his a/c]		2840 10 -	- - 2850

20-4-07	Drawings a/c Dr To cash a/c [Being cash withdrawn for personal use]		1000 -	- 1000
22-4-07	Purchases a/c Dr To Patel's a/c [Being goods purchased from Patel on cedit]		2000 -	- 2000
22-4-07	Sahil a/c Dr To sales a/c [Being goods sold on credit to Sahil]		2400 -	- 2400

Date	Particulars	J/F	Amt	Date	particulars	J/F	Amt
1-4-07	To capital a/c		1000		By bal c/d		1000
			1000				1000
	To bal b/d		100				

Capital A/C

Date	Particular	J/F	Amt	Date	Particular	J/F	Amt
				1-4-07	By cash a/c		50000
	To bal c/d		60000	1-4-07	By machinery a/c		10000
			60000				60000
					By bal b/d		60000

Date	Particular	J/F	Amt	Date	Particular	J/F	Amt
1-4-7	To capital a/c		50000	2-4-07	By bank a/c		20000
10-4-07	To bank a/c		2000	4-4-07	By creditors a/c		7056
16-4-07	To Manu's security deposit		2000	7-4-07	By Roy's a/c		1900
18-4-07	To Ashok a/c		2840	20-4-07	By drawing a/c		1000
				30-4-07	By bal c/d (B/F)		26884
			56840				56840
1-5-07	To bal b/d		26884				

			20000				20000
	To bal b/d		18000				

Creditors A/C

Date	particulars	J/F	Amt	Date	particulars	J/F	Amt
4-4-07	To cash a/c		7056	4-4-07	By purchases		7200
4-4-07	To discount a/c		144				
			7200				7200

Purchases A/C

Date	particulars	J/F	Amt	Date	particulars	J/F	Amt
4-4-07	To creditor a/c		7200		By bal c/d		11300
4-4-07	To Roy & son's a/c		2000				
4-4-07	To discount a/c		100				
22-4-07	To Patel a/c		2000				
			11300				11300
	To Bal b/d		11300				

Discount received a/c

Date	particulars	J/F	Amt	Date	particulars	J/F	Amt
				4-4-07	By creditors a/c		144
	To bal c/d		244	7-4-07	By purchases a/c		100
			244				244
				31-5-07	By bal b/d		244

Roy & Son's A/C

Date	particulars	J/F	Amt	Date	Particulars	J/F	Amt
	To bal c/d		2000	7-4-07	By purchases a/c		2000
			2000				2000
				31-5-07	By bal b/d		2000

Ashok A/C

Date	particulars	J/F	Amt	Date	Particulars	J/F	Amt
13-4-07	To sales a/c		2850	18-4-07	By discount allowed		10
					By bal c/d		2840
			2850				2850
31-5-07	To bal b/d		2840				

Sales A/C

Date	particulars	J/F	Amt	Date	Particulars	J/F	Amt
	To bal c/d		5250	13-4-07	By Ashok a/c		2850
				22-4-07	By sahil a/c		2400
			5250				5250
				31-5-07	By bal b/d		5250

Manu's security deposit A/C

Date	particulars	J/F	Amt	Date	Particulars	J/F	Amt
	To bal c/d		2000	16-4-07	By cash a/c		2000
			2000				2000
				31-5-07	By bal b/d		2000

Discount allowed A/C

Date	particulars	J/F	Amt	Date	Particulars	J/F	Amt
18-4-07	To Ashok a/c		10		By bal c/d		10
			10				10
31-5-07	To bal b/d		10				

Drawing A/C

Date	particulars	J/F	Amt	Date	Particulars	J/F	Amt
20-4-07	To cash a/c		1000		By bal c/d		1000
			1000				1000
31-4-07	To bal b/d		1000				

Patel A/C

Date	particulars	J/F	Amt	Date	Particulars	J/F	Amt
	To bal c/d		2000	22-4-07	By purchases a/c		2000
			2000				2000
				31-4-07	By bal b/d		2000

Sahil A/C

Date	particulars	J/F	Amt	Date	Particulars	J/F	Amt
22-4-07	To sales a/c		2400		By bal c/d		2400
			2400				2400
31-5-07	To bal b/d		2400				

3.2.3 Trail Balance

A Trial Balance is a summary of all the General Ledger Balances outstanding as on a particular date, the entire debit balances from the ledger are shown on the one side and all the credit balances are shown on the other side. You are aware that a debit balance in a general ledger account indicates an excess of debit side ever the credit side of the ledger. Similarly, a credit balance in a ledger account indicates the excess of credit side over the debit side. Now, if all the debit and credit balances were recorded on the two sides of the Trial Balance, it stands to reason that the two sides should be equal, since in the journal for each item of debit, there was a credit item. Thus in other word Trial balance may be defined as a statement of debit and credit totals or balances extracted from the various accounts in the ledger with a view to test the arithmetical accuracy of the books.

A Trial Balance is prepared for the following objectives:

- It is a check on the accuracy of postings. If the Trial Balance agrees, it can be assumed that both the aspects of all the transactions have been correctly posted in the ledger
- It brings at one place, the balances of all the accounts, which facilitates the preparation of final accounts.

Illustration no. 4

Record the following transactions in the Journal,post them to Ledger accounts and prepare Trial balance:

Jan 1Started business with cash 10000

Jan 2Deposited into bank 90000

Jan 3 Machinery purchased for Rs 5000 from Javahar& give in a cheque for amount

Jan 15 Paid installation charges of machinery Rs 100

Jan 20 purchased timber from Naveen of the last price of Rs 2000 he allowed 10% trade discount.

Jan 23 Furniture costing Rs500 was used in furnishing the office.

Jan 25 sold furniture to Naresh of the last price of Rs 1000 & allowed him 5% trade discount.

Jan 28 Received cheque from Naresh for Rs 930 in full settlement & sent the cheque to bank

Jan 29 Sent to Naveen in full settlement a cheque for Rs 1750 paid wages Rs 350 & Rent 200

Journal Entries

Date	Particulars	L/F	Dr	Cr
Jan 1	Cash a/c Dr To capital a/c [Being business started with cash]		100000 -	- 100000
Jan 2	Bank a/c Dr To cash a/c [Being cash deposited into bank]		90000 -	- 90000
Jan 3	Machinery a/c Dr To bank a/c [Being machinery purchased from javahar& paid by cheque]		5000 -	- 5000
Jan 15	Machinery a/c Dr To cash a/c [Being installation charges were paid]		100 -	- 100
Jan 20	Purchases a/c Dr To Naveen a/c [Being timber purchased from Naveen on credit subject to 10% trade discount]		1800 -	- 1800
Jan 23	Furniture a/c Dr To Purchase a/c [Being furniture used for office purpose]		500 -	- 500
Jan 25	Naresh a/c Dr To sales a/c [Being furniture sold to Naresh on credit with 5% trade discount]		950 -	- 950
Jan 28	Bank a/c Dr Discount allowed a/c To Naresh a/c [Being received from Naresh in full settlement of his a/c]		930 20 -	- - 950
Jan 29	Naveen a/c Dr To bank a/c To discount received a/c [Being paid to Naveen in full settlement of his a/c]		1800 - -	- 1750 50
Jan 31	Wages a/c Dr Rent a/c Dr To cash a/c [Being wages & rent paid]		350 200 -	- - 550

Cash Account

Date	Particulars	J/F	Amt	Date	particulars	J/F	Amt
Jan 1	To capital a/c		100000	Jan 2	By bank a/c		90000
				Jan 15	By machinery a/c		100
				Jan 31	By wages a/c		350
				Jan 31	By Rent a/c		200
				Jan 31	By bal c/d		9350
			100000				100000
Feb 1	To bal b/d		9350				

Capital Account

Date	Particulars	J/F	Amt	Date	particulars	J/F	Amt
Jan 31	To bal c/d		100000	Jan 1	By cash a/c		100000
	To bank		100000				100000
				Feb 2	By bal b/d		100000

Bank Account

Date	Particulars	J/F	Amt	Date	Particulars	J/F	Amt
Jan 1	To cash a/c		90000	Jan 3	By machinery a/c		5000
Jan 28	To Naresh a/c		930	Jan 29	By Naveen a/c		1750
					By balance c/d		84180
			90930				90930
Jan 2	To bal b/d		84180				

Machinery Account

Date	Particulars	J/F	Amt	Date	Particulars	J/F	Amt
Jan 3	To bank a/c		5000				
	To cash a/c		100	Jan 21	By bal c/d		5100
			5100				5100
Feb 2	To bal b/d		5100				

Purchases Account

Date	Particulars	J/F	Amt	Date	Particulars	J/F	Amt
Jan 20	To Naveen		1800	Jan 23	By furniture a/c		500
				Jan 31	By bal c/d		1300
			1800				1800
Feb 1	To bal b/d		1300				

Naveen Account

Date	Particulars	J/F	Amt	Date	Particulars	J/F	Amt
Jan 29	To bank a/c		1750	Jan 20	By purchase		1800
Jan 29	To discount received		50				
			1800				1800

Furniture Account

Date	Particulars	J/F	Amt	Date	Particulars	J/F	Amt
Jan 23	To purchase a/c		500				
				Jan 31	By bal c/d		500
			500				500
Feb 1	To bal b/d		500				

Naresh Account

Date	Particulars	J/F	Amt	Date	Particulars	J/F	Amt
Jan 25	To sales		950	Jan 28	By bank a/c		930
				Jan 28	By discount allowed		20
			950				950

Discount Allowed

Date	Particulars	J/F	Amt	Date	Particulars	J/F	Amt
Jan 28	To naresh a/c		20	Jan 31	By bal c/d		20
			20				20
Feb 1	To bal b/d		20				

Discount Received Account

Date	Particulars	J/F	Amt	Date	Particulars	J/F	Amt
Jan 31	To bal c/d		50	Jan 29	By naveen a/c		50
			50				50
				Feb1	By bal b/d		50

Wages Account

Date	Particulars	J/F	Amt	Date	Particulars	J/F	Amt
Jan 31	To cash a/c		350	Jan 31	By bal c/d		350
			350				350
Feb 1	To bal b/d		350				

Rent Account

Date	Particulars	J/F	Amt	Date	Particulars	J/F	Amt
Jan 31	To cash a/c		200	Jan31	By bal c/d		200
			200				200
Feb 1	To bal b/d		200				

Sales Account

Date	Particulars	J/F	Amt	Date	Particulars	J/F	Amt
Jan 31	To bal c/d		950	Jan25	By naresh a/c		950
			950				950
				Feb 1	By bal b/d		950

Trial Balance

Sl. No	Name of the account	L/F	Dr	Cr
1.	Cash		9350	-
2.	Capital		-	100000
3.	Bank		84180	-
4.	Machinery		5100	-
5.	Purchase		1300	-
6.	Furniture		500	-
7.	Discount Allowed		20	-
8.	Discount received		-	50
9.	Wages		350	-
10.	Rent		200	-
11.	Sales		-	950
			101000	101000

3.3 SUMMARY

The journal is a chronological record in which transactions are first recorded. The journal is called the book of original entry or primary book because this is the accounting record where transactions are first recorded. The journal provides in one place a complete record of all transactions including necessary explanations.

Posting is the process of transferring information in the journal to the ledger. Ledger is a set of accounts; a summary statement of all the transactions relating to a person, assets, expenses or income which have taken place during period of time and shows their net effect.

Trial balance is a list of ledger accounts and their balances at a given time, and is used to verify equality of debits and credits in the ledger after which, at the end of the accounting period, final accounts are prepared.

3.4 SELF-TEST

1. Define Journal and Ledger. State the differences between journal and ledger
2. What is a trial balance? What are its objectives?
3. Pass journal entries for the following transactions and post them to ledger accounts.
   a. Suresh started business by cash Rs.5,00,000
   b. Bought goods Rs. 40,000
   c. Bought furniture Rs.50,000
   d. Sold goods for cash Rs. 2,400
   e. Sold goods to Mahendra on credit Rs, 4650
   f. Deposit into bank Rs. 8,000
   g. Paid salary Rs 4,600
   h. Withdraw from bank for personal use Rs. 3,000.
4. Prepare a trial balance using imaginary figures.
5. The following are the ledger account balances as on 31-03-2010. You are required to prepare a Trial Balance for the year ending 31-03-2010

Mr. Bharath's Capital	108090	Stock on 1-4-09	46800
Sales	289600	Sales returns	8600
Purchases	243000	Purchases returns	5800
Carriage & freight	18600	Rent and Taxes	5700
Salaries and wages	9550	Sundry Debtors	24000
Sundry Creditors	14800	Bank Loan @ 6%	20000
Bank interest paid	900	Printing &Advertising	14600
Income from investments	250	Cash at Bank	8200
Discount allowed	7340	Discount received	3690
Investments	5000	Furniture & Fittings	1800
General expenses	3600	Audit Fees	500
Insurance	800	Travelling expenses	2310
Postage and telegram	800	Cash in Hand	380
Bank Deposit @ 5%	30000	Drawings	10000
Bad debts	500	Bank Interest received	500
Reserve for bad debts	250		

UNIT -4 : PREPARATION OF FINAL ACCOUNTS OF SOLE PROPRIETORSHIP

Structure

4.1 OBJECTIVES

After going through this unit, you should able to;

- Understand the format of preparation of final accounts of sole proprietorship.
- Know the treatment of some common adjustments in preparation of final accounts of sole proprietorship.
- Prepare Trading and Profit and loss account of sole proprietorship business.
- Prepare Balance Sheet of sole proprietorship business.

4.2 INTRODUCTION

A form of organization owned and established by a single person is known as **"Sole trading concern". An a/c prepared by a sole trader at the end of accounting period is known as "final accounts of sole trading concern"**.

In order to known the profit or loss earned by a firm, Trading and profit and Loss account is prepared. Balance sheet or position statement will portray the financial condition of the firm on a particular date. These two statements i.e., Trading and Profit and Loss Account and Balance Sheet are prepared to give a final results of the business, that is why both these are collectively called as final accounts. Thus final account includes the preparation of:

- Trading and Profit and Loss Account; and
- Balance sheet

Dr.Format of Profit and Loss Account for the year ending ……… Cr

Particulars	**Rs**	**Particulars**	**Rs**
To opening stock	**XXX**	By sales	**XXX**
To Purchases	**XXX**	Less returns inwards/sales returns	**XXX**
Less Purchase returns/returns outwards	**XXX**	By Closing stock	**XXX**
To Carriage inwards	**XXX**		
To freight and octroi	**XXX**		
To wages	**XXX**		
To Add outstanding wages	**XXX**		
To Less prepaid wages	**XXX**		
To fuel and power	**XXX**		
To Gas, coal, electricity for production	**XXX**		
To Import duty and clearing charges	**XXX**		
To stores consumed	**XXX**		
To factory rent, insurance	**XXX**		
To other direct expenses	**XXX**		
To Royalty paid	**XXX**		
To Profit and Loss A/c (Gross Profit)	**XXX**		

4.3 FORMAT OF TRADING, PROFIT AND LOSS ACCOUNT AND BALANCE SHEET

Dr.Format of Trading Account for the year ending- - - - Cr

Particulars	Rs	Particulars	Rs
To Trading Account (GL)	**XXX**	By Trading account (GP)	**XXX**
To Salaries + Out standing –Prepaid	**XXX**	By Interest earned + Accrued interest	**XXX**
To Rent of the premises	**XXX**	By Commission earned	**XXX**
To Travelling expenses	**XXX**	By Discount earned	**XXX**
To Rates and Taxes	**XXX**	By Rent received	**XXX**
To Printing and stationery	**XXX**	By Bad debts recovered	**XXX**
To Postage and Telegram	**XXX**	By Interest on drawings	**XXX**
To Telephone charges	**XXX**	By Reserve for discount on Creditors	**XXX**
To Insurance	**XXX**	By Dividends received	**XXX**
To Interest paid	**XXX**	By Royalty Received	**XXX**
To Discount al owed	**XXX**	By Capital Account (Net Loss)	**XXX**
To Sundry expenses	**XXX**		
To Advertisement	**XXX**		
To Commission	**XXX**		
To Carriage outwards	**XXX**		
To Bad Debts	**XXX**		
To Reserve for Bad debts	**XXX**		
To Reserve for discount on Debtors	**XXX**		
To Depreciation	**XXX**		
To Legal charges	**XXX**		
To Audit fee	**XXX**		
To Interest on Capital	**XXX**		
To Capital Account (Net Profit)	**XXX**		

FORMAT OF BALANCE SHEET

Balance Sheet as on ……………..

Liabilities and Capital		**Amount**	**Assets**		**Amount**
Opening Capital	**XXX**		Fixed Assets		
Add: Additional capital	**XXX**		Less depreciation	xxx	
Add: Interest on capital	**XXX**		Land & Buildings		
Add: Net Profit	**XXX**		Plant & Machinery		XXX
	XXX		Furniture & Fittings		XXX
Less:Drawings	**(XXX)**		Goodwill		XXX
Less: Interest on Drawings	**(XXX)**		Closing Stock		XXX
Less: Net Loss	**(XXX)**		Bills Receivables		XXX
Closing Capital			Sundry Debtors less RBD		XXX
Sundry Creditors			Prepaid Expenses		XXX
Bills Payable			Outstanding Incomes		XXX
Bank Loan/ Overdraft		XXX		xxx	XXX
Outstanding Expenses		XXX			XXX
Incomes received in		XXX			XXX
advance		XXX			XXX
		XXX			
		XXX			
		XXX			
		XXX			
TOTAL		**XXXX**	**TOTAL**		**XXXX**

4.4 TREATMENT OF COMMON ADJUSTMENTS IN FINAL ACCOUNTS

There would be some business transactions or events that might have occurred after the preparation of trial balance but have to be accounted for before preparing the final accounts. They are either given as adjustments or as additional information with the Trial Balance. We have to consider them before preparing final accounts. Since we follow double entry system of book – keeping, even in the treatment of adjustments, we do follow the same. It means adjustments generally would be effected twice, once in trading account or profit and loss account and once in Balance Sheet. But there are few exceptional adjustments wherein both the effects would be in both Trading account and Profit and Loss Account or both the effects would be on either side of the Balance Sheet only. Some of the commonly given adjustments and their treatment are shown below.

1. Closing Stock:

Stock of goods – raw materials, semi finished goods, finished goods – at the end of the accounting year should be considered for preparing trading account and balance sheet. It is an internal adjustment. It should have two effects. Once, it is shown on the credit side of the Trading Account. Then, it is shown as a current asset on the Asset side of the Balance Sheet.

2. Expenses:

Expenses given in the adjustment can be outstanding expenses or expenses paid in advance.

A. Outstanding expenses means those expenses incurred for the current year but not yet paid. They have to be charged against the income of the current year. Hence, they have to be added to the concerned expenses on the debit side of either trading account or profit and loss account. Again, they should be shown as a liability on the liabilities side of the balance sheet.

B. Expenses paid in advance or prepaid expenses are those expenses not yet occurred for the current year but already paid. They have to be deducted from the concerned expenses on the debit side of trading or profit and loss account and then, it has to be shown as an asset on the asset side of the balance sheet.

3. Incomes:

Incomes given in the adjustment can be either outstanding incomes or incomes received in advance.

A. Outstanding incomes mean those incomes that are earned for the current year but not yet received. They have to be added to the concerned income on the credit side of profit and loss account and then it is shown as an asset on the asset side of the balance sheet.

B. Incomes received in advance means incomes that are not earned for the current year but the income is already received. Hence, they have to be deducted from the concerned income on the credit side of profit and loss account and then, it will appear as a liability on the liabilities side of the balance sheet.

4. Bad Debts

Bad debts are those debts which have become irrecoverable. Bad debts form loss to the business and reduce the amount of debtors. Since bad debts are losses, they are debited to profit and loss account. Again, it is deducted from Debtors on the asset side of the balance sheet.

5. Provision for Doubtful Debts

From the past experience of the business proprietor, what percentage of good debts may become bad in future can be estimated and in the current year an equal amount of profit is set aside. This provision is also known as Reserve for Bad Debts or Provision for Doubtful Debts or Reserve for Doubtful Debts.

Since the provision for bad debts is a charge against current year profit, first, it is debited to profit and loss account and again it is deducted from Debtors on the asset side of the balance sheet.

6. Depreciation on Fixed Assets

Depreciation is a non cash expense that reduces the value of a fixed asset due to wear and tear, passage of time, obsolescence or any for other reasons. It should first be debited to profit and loss account and again, it should be deducted from the concerned fixed asset on the asset side of the balance sheet.

4.5 PREPARATION OF FINAL ACCOUNTS OF SOLE PROPRIETORSHIP- SOME ILLUSTRATIONS

Illustration no. 1

From the following balances extracted from the books of Mr.X.,Prepare trading & profit & loss a/c and balance sheet as on 31/03/04

Trial Balance

Particulars	Dr	Cr
Purchase / Sales	71280	60000
Capital /Drawings	4440	60000
Computer	18000	-
Cash at bank	4380	-
Cash in hand	2836	-
Stock on 1//2001	3000	-
Miscellaneous receipts	-	220
patent	1540	-
Rent	10000	-
Trade mark	2090	-
Discount received		2000
Reserve fund		13000
Workmen compensation fund		2000
B R /B P	6720	10000
Fright inward	920	
Sunder creditor	22000	1800
IDBI share	6000	
Com		720
Computer repair	1156	
Office expense	1200	
Dividend		320
Provision for doubtful debts		432
Interest premium	550	
Entertainment expense	2000	
Wages	1800	
Salaries	16780	
Returns	1000	11000
	1,77,692	**1,7,692**

Adjustments :

- The value of closing stock Rs. 8000.
- Rent Outstanding Rs. 1000.
- Advance salary paid Rs. 1780.
- Dividend accrued but not received Rs. 180.
- Deprecation computer at 5% p.a. write off patents at 10% p.a.

- Create provision for discount on debtors & on creditors at 1% each.
- Interest premium prepaid Rs. 300.

Trading and profit & Lose Account for the year ending 31/3/04

Particulars	**Rs**	**Rs**	**Particulars**	**Rs**	**Rs**
To opening stock		3000	By sales	60000	
To purchases	71280		(-) retunes	1000	59000
(-) purchase returns	11000	60280	By closing stock		8000
To freight inwards		920			
To wages		1800			
To G/P c/d (b/f)		1000			
		67000			**67000**
To salaries	16780		By G/P c/d		1800
(-) advance salary	1780	15000	By miscellanea		
To rent	10000		By discount received	2000	
(+) o/s rent	1000	11000	(+) prevision for discount on CR	180	2180
To computer repairs Expenses		1156	By commission		720
To office expenses		1200	By dividend	320	
To interest premium	550		(+) dividend accrued but not received	180	500
(-) prepaid interest	300	250	By provision for doubtful debt		432
To entertainment		2000			
To provision for discount on debtor		220	By net loss (B/F)		26828
To deprn on computer		900	Transferred to capital a/c		
To deprn on patent written off		154			
		31880			**31880**

Balance Sheet as on 31-3-02

Liabilities	**Amt**	**Amt**	**Assets**	**Amt**	**Amt**
Capital	60000		Computer	18000	
(-) net loss	26828		(-) deprecation	900	17100
	33172		Cash at bank		4380
(-) drawings	4440	28732	Cash in hand		2836
Reserves fund		13000	Patent	1540	
workmen Computation		2000	(-) written off	154	1386
B.P.		10000	Trade make		2090
Secured creditor	18000		B.R		6720
(-) provision for discount on creditor	180	17820	s. debtor	22000	
Outstanding rent		1000	(-) provision for discount on debtor	220	21780
			IDBI share	6000	
			(+) dividend accrued but not received	180	6180
			Closing stock		8000
			Advance salary		1780
			Interest premium prepaid		300
		72552			**72552**

Illustration : 2

The following is the trial balance of Sri Chandra kanth as on 31/12/2009.

Particular	**Dr**	**Cr**
Drawing & capital	4000	72000
Plant & machinery	20000	
Stock on 1/1/2009	12000	
Purchase & sales	80000	125000
Return inwards	3000	
Furniture	10000	
Debtors and Creditors	35000	10000
Carriage outwards	1000	
Carriage on purchase	3000	
Life ins premium	1000	
Printing & stationary	900	
Rent & taxes	4800	
Purchase returns		2000
Provision for bad debt		1000
Fire insurances	1200	
Cash in hand	5000	
Cash at bank	8000	
B.R/B.P	6000	4000
Bad debt written off	500	
General expenses	1100	
Salaries & wages	7000	
Advertisement	1000	
Income tax	500	
Discount	1000	2000
Goodwill	10000	
	2,16,000	**2,16,000**

Prepare trading & P&L a/c for the year ended 31/12/2009. And balance sheet as on that date after taking into account the following adjustment.

- Closing stock was valued at Rs. 20,000
- Write off further bad debt Rs.400, and maintain provision for bad debt at 5% on debtor.
- Provide deprecation at 10% on plant and machinery and 5% of furniture
- Prepaid fire insurance Rs 300
- Provide interest on capital @ 5% p.a
- Goods costing Rs 800 were distributed on free samples
- Purchases include goods worth Rs 1000, purchased for private purpose.
- Goods to the value of Rs. 4000 have been destroyed by fire and the insurance company admitted a claim of Rs.2700

Trading and P&L Account for the year ended 31/12/2009

Particulars	Rs	Rs	Particulars	Rs	Rs
To opening stock		12000	By sales		
To purchase	80000		(-) return inward		
(-)purchase retunes	2000		By goods destroyed		
	78000		By fire		
(+)carriage on purchase	3000		By closing stock		
	81000				
(-)goods destroyed free sample	800				
	80200				
(-) goods used for private purpose	1000	79200			
To G/P c/d		54800			
		1,46,000			**1,46,000**
To salaries & wages		7000	By G/P b/d		54800
To carriage out wards		1000	By discount		2000
To printing & stationary		900			
To rent & tax		4800			
To general expense		1100			
To fire insurance	1200				

(-) pre paid	300	900			
To bad debt	500				
(+) new bad debt	400				
(+) new RBD	1730				
	2630				
(-) old RBD	1000	2630			
To advertisement	1000				
(+) goods distributed as free sample	800	1800			
To discount		1000			
To interest on capital		3600			
To loss by fire		1300			
To deprecation on P&M		2000			
To dep on furniture		500			
To net profit (B/F) Transfer to capital		29270			
		56800			**56800**

Balance Sheet as on 31/12/2009

Liabilities	Amt	Amt	Assets	Amt	Amt
Capital	72000		Plant & machinery	20000	
(+) interest on capital	3600		(-) depreciation	2000	18000
Net profit	29270		Furniture	10000	
	104870		(-) depreciation	500	9500
(-) drawings	6500	98370	Drs	35000	
Creditor		10000	(-) new bad debt	400	
B.P		4000		34600	
			(-) new R.B.D	1730	
			Cash in hand		5000
			Cash at bank		8000
			B.R		6000
			Good will		10000
			Closing stock		20000
			Prepaid insurance		300
			Amt due from Insurance company		2700
		1,12,370			**1,12,370**

4.5 SUMMARY

For recording transactions, double entry system of book keeping is followed wherein the accounting equation states that at a given time, the sum of assets must equal the sum of liabilities and owners' equity. The equation is 'Assets = Liabilities + Equity'. Each business transaction is recorded in a minimum of two accounts so that the total of all debits must equal to the total of all credits. The procedure for analyzing transactions consists of three steps namely (a) examining how a transaction changes assets, liabilities, and owners' equity, (b) apply the rules for debit and credit and (c) make the journal entry.

The journal is a chronological record in which transactions are first recorded. Posting is the process of transferring information in the journal to the ledger. Trial balance is a list of ledger accounts and their balances at a given time, and is used to verify equality of debits and credits in the ledger after which, at the end of the accounting period, final accounts are prepared. Final accounts, in case of a sole proprietor consists of Trading Account, Profit and Loss Account and a Balance Sheet. Trading, Profit and Loss Account is prepared to show the financial results of a business, profit or loss, during an accounting period; and the Balance Sheet is prepared to show the financial position, position of assets and liabilities, of a business as on a particular date.

4.6 SELF TEST

1. How do you treat outstanding and prepaid expenses while preparing final accounts?
2. The following are the ledger account balances as on 31-03-2010. You are required to prepare Trading and Profit & Loss A/c for the year ending 31-03-2010 and a Balance Sheet as on that date.

Mr. Bharath's Capital	108090	Stock on 1-4-09	46800
Sales	289600	Sales returns	8600
Purchases	243000	Purchases returns	5800
Carriage & freight	18600	Rent and Taxes	5700
Salaries and wages	9550	Sundry Debtors	24000
Sundry Creditors	14800	Bank Loan @ 6%	20000
Bank interest paid	900	Printing &Advertising	14600
Income from investments	250	Cash at Bank	8200
Discount allowed	7340	Discount received	3690
Investments	5000	Furniture & Fittings	1800
General expenses	3600	Audit Fees	500
Insurance	800	Travelling expenses	2310

Postage and telegram	800	Cash in Hand	380
Bank Deposit @ 5%	30000	Drawings	10000
Bad debts	500	Bank Interest received	500
Reserve for bad debts	250		

Additional information:

a. Stock in hand as on 31-03-2006 was Rs. 78,600

b. Depreciate Furniture and Fittings by 10%

c. Salaries outstanding Rs.450 and Carriage outstanding Rs.100

d. Insurance prepaid Rs.200

e. Create reserve for bad debts @ 5% on Debtors

f. Goods worth Rs.2500 were destroyed by fire, but the Insurance Company admitted the claim for Rs.1800 only.

3. From the following Trial Balance prepare Trading and Profit and Loss Account and Balance Sheet for the year ended 31st March 2008

	Debit	Credit
Capital	—	5,00,000
Drawings	1,00,000	—
Purchases	7,40,000	—
Sales	—	11,28,000
Opening Stock	1,80,000	—
Returns	25,000	15,000
Wages	60,000	—
Salaries	55,000	—
Rent and Insurance	14,000	—
General expenses	46,000	—
Debtors and Creditors	2,00,000	1,70,000
Bills Receivable and Payable	80,000	1,50,000
Bad Debts	12,000	—
Discount allowed	3,200	—
Plant and Machinery	3,00,000	—
Furniture	50,000	—
Cash	97,800	—
	19,63,000	**19,63,000**

Adjustments:

a. Outstanding Salaries Rs.5,000.

b. Insurance prepaid Rs.2,000

c. Provision for doubtful debts to be maintained at 5%

d. 10% depreciation to be provided on plant and machinery.

e. Closing stock was valued at Rs.1,60,000