Q1. What is accounting? Explain different types of accounting. What are the limitations of accounting?

Ans. Accounting - Accounting is the process of recording financial transactions pertaining to a business. The accounting process includes summarizing, analyzing and reporting these transactions to oversight agencies, regulators and tax collection entities. The financial statements used in accounting are a concise summary of financial transactions over an accounting period, summarizing a company's operations, financial position and cash flows.

Types of Accounting

Financial Accounting

Financial accounting refers to the processes used to generate interim and annual financial statements. The results of all financial transactions that occur during an accounting period are summarized into the balance sheet, income statement and cash flow statement. The financial statements of most companies are audited annually by an external CPA firm. For some, such as publicly traded companies, audits are a legal requirement. [6] However, lenders also typically require the results of an external audit annually as part of their debt covenants. Therefore, most companies will have annual audits for one reason or another.

Managerial Accounting

Managerial accounting uses much of the same data as financial accounting, but it organizes and utilizes information in different ways. Namely, in managerial accounting, an accountant generates monthly or quarterly reports that a business's management team can use to make decisions about how the business operates. Managerial accounting also encompasses many other facets of accounting, including budgeting, forecasting and various financial analysis tools. Essentially, any information that may be useful to management falls underneath this umbrella.

Cost Accounting

Just as managerial accounting helps businesses make decisions about management, cost accounting helps businesses make decisions about costing. Essentially, cost accounting considers all of the costs related to producing a product. Analysts, managers, business owners and accountants use this information to determine what their products should cost. In cost accounting, money is cast as an economic factor in production, whereas in financial accounting, money is considered to be a measure of a company's economic performance.

Limitations of Accounting

Besides studying accounting, it is also important to understand the limitations of accounting. These limitations have been discussed below:

- **Historical Costs -** To measure the values, accounting considers historical costs. However, this process does not allow considering important areas of accounting like inflation, price changes and similar things as such. Further, this reduces the importance of accounting information and records. Hence, historical costs are considered to be one of the important limitations of accounting.
- **Estimates -** Another important limitation of accounting is an estimation. The reason behind is that not all accounting can be done establishing the exact amount and hence it is essential to estimate. But the drawback in such a scenario is that the accountant makes the estimation based on his or her judgment. This estimation is extremely subjective as they are based on the assumption of future events. Such estimation results in doubtful debts and often at times leads to depreciation.
- **Verifiability -** The correctness of the financial statement or for that matter an audit, cannot be guaranteed. The verification of the statements depends only on the judgment and ability of the auditor and hence creates plenty of limitations in accounting.
- **Measurability -** Events or things that do not have monetary value cannot be measured in accounting. Such events or things include management, reputation, loyalty and dedication which cannot be expressed in money and therefore has no place in accounting. These important qualities are responsible for the growth of the organization but they cannot be measured and put in financial statements. Thus it becomes one of the important limitations of financial accounting.
- **No Future Assessments -** The financial statements prepared are based on the date or the period of preparation. But when it reaches the authorities of the company to assess the future position of the firm it does not have any clarification as it does not provide the record of the present. All businesses are dynamic and change is inevitable. To understand more about this limitation, the student can refer to the limitations of accounting class 11.
- **Errors and Frauds -** These two limitations are the most common ones in accounting. Error is ought to happen as the financial statements are prepared by humans and not machines and fraudulency occurs whenever there is the involvement of manipulation or similar other external or internal factors. These factors are very hard to recognize

and rectify at the same time. Thus, this limitation is highly dangerous for any business or firm.

- **Accounting Policies -** Though mentioned last, this is one of the most common problems that is faced by all organizations across the world. The reason is that every accounting department follows the different form of accounting policies. While Indians follow the global accounting standards, Americans follow the GAAP. However, if a multinational company operates in more than one country it is prone to create confusion and conflict. This is the reason why there is a sheer need for uniform accounting policies to eradicate this limitation from accounting. The student will be able to learn more about the accounting by referring to the right tutorial site which can help them develop a clear understanding of the chapter.

Q2. What do you understand by final accounts? What are the objectives of their preparation?

Ans. Final Accounts – Definition

- The accounts which are prepared at the final stage of the accounting cycle to know the profit or loss and financial position of a business concern are called **Final Accounts**.

Explanation

Every businessman enters into business activities to earn profit. It is the accounting that shows profit or loss of a business concern. The role of accounting is to compile the financial record of a business in such a manner that yields the profit or loss of the business. We have already learned that all the transactions of a business are in the first instance recorded in the books of the original entry. Then these transactions are posted into ledgers in classified form.

These transactions are then summarized and arithmetical accuracy is checked by means of a "Trial Balance". After the preparation of "Trial Balance", the next step is the preparation of "Final Accounts". The accounting cycle begins with the recording of transactions in the books of original entry and ends with the preparation of "Final Accounts". As these accounts are prepared at the final stage of the accounting cycle that's why these are called "Final Accounts". These accounts consist of the followings:

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

Trading Account

The **trading account** shows the result of buying and selling of goods, It is prepared to determine the gross profit or the gross loss of a trader. It is prepared at the stage of **final accounts** preparation.

The following items usually appear on the debit and credit side of Trading Account.

On the debit side:

1. Stock in hand at the beginning. (Opening Stock)
2. Net Purchases made during the year (Total Purchases less Purchases Returns).
3. All Direct Expenses

On the credit side:

1. Net Sales (Total Sales less Sales Returns)
2. The value of the closing stock of goods.

Profit and loss account – Definition

- The account that shows annual net profit or net loss of a business is called **Profit and Loss Account**. It is prepared to determine the net profit or net loss of a trader. P&L account is a component of **final accounts**.

Explanation

The purpose of preparing the profit and loss account is to ascertain the net income (performance result) of the enterprise for the year/period, which is the most significant information to be reported for decision making. Net income or net profit is calculated by charging all operating expenses and by considering other incomes

earned in the form of commission, interest, rent, discount, fees, etc.
In fact, profit and loss account is prepared by following the ‘accrual system of accounting’. where gross profit and other operating incomes are credited and all operating expenses are debited. The resultant effect is either net profit or net loss. If the total amount of gross profit and other operating incomes are more than the operating expenses, the difference is treated as net income or net profit. Alternatively, if the total amount of gross profit and other operating incomes is less than the operating expenses, then the difference is treated as net loss.
The following items usually appear on the debit and credit side of a Profit and Loss Account.

On the debit side:
1. Gross Loss (Transferred from Trading Account)
2. All Indirect Expenses

On the credit side:
1. Gross Profit (Transferred from Trading Account)
2. All Indirect Revenues

Net Profit or Net Loss
Net Profit or Net Loss is the difference between the total revenue of a certain period and the total expenses of the same period. Net profit is made when the total revenues exceed the total expenses. If the total of revenues is less than the total expenses, the net loss is incurred. The balance of Profit and Loss Account which represents either net profit or net loss is transferred to the capital account.

Balance Sheet – Definition
A **balance sheet** is a list of assets and claims over a business at some specific point of time and is prepared from an adjusted trial balance. It shows the financial position of the business by detailing the sources of funds and the utilization of these funds. A balance sheet shows the assets and liabilities grouped, properly classified and arranged in a specific manner. The balance sheet is a component of **final accounts**.

Explanation
The balance sheet reflects the fundamental accounting model which describes the financial position of a firm in terms of equality between its assets on one side and its liabilities plus owner’s equities on the other (A = L + OE).
Hence, the balance sheet is a widely used term but is somewhat less descriptive than the more appropriate designation, statement of financial position. Assets are economic resources and benefits owned by an entity, valued generally at acquisition cost less accumulated write-offs.
Liabilities are the debts of the entity and other claims against its assets which may oblige the firm to provide goods are services. Usually, Liabilities are measured at their current cash equivalent or the maturity value of debt.
Owner’s equities are the residual amounts, A – L = OE, but bear little resemblance to the current market value of an entity.

Objectives of preparation of Final Accounts
The objectives of preparing final accounts are:-

1. To ascertain the results of transactions:
Final Accounts are prepared to know the profit earned or loss sustained by the business in a particular period of time. In order to determine the profit and loss of business, trading and profit and loss account or Income Statement is prepared.
2. To know the financial position of the business:
Besides the determination of profit and loss, the financial position of the business is measured through final accounts. The financial position of the business is shown with the help of a balance sheet.

Trial Balance: The basis of Final Accounts
The basis of Final Accounts is the Trial Balance. The trial balance includes all the balances of ledger accounts. It includes the account balances of expenses, revenue, assets, liabilities, capital and drawings. A trial balance has two columns, debit and credit. Debit balances usually represent expenses, assets drawings and these appear in the debit column of trial balance.
Credit balances generally represent revenue, capital and liabilities and these appear in credit column of trial balance. From trial balance Expenses and revenues are transferred to Trading and Profit and Loss Account while assets, liabilities and drawings are transferred to Balance Sheet.

Q4. What is capital budgeting. Explain its importance and difficulty
Ans. Capital budgeting is the process a business undertakes to evaluate potential major projects or investments. Construction of a new plant or a big investment in an outside venture are examples of projects that would require capital budgeting before they are approved or rejected. As part of capital budgeting, a company might assess a prospective project's lifetime cash inflows and outflows to determine whether the potential returns that would be generated meet a sufficient target benchmark. The capital budgeting process is also known as investment appraisal.

KEY TAKEAWAYS

- Capital budgeting is used by companies to evaluate major projects and investments, such as new plants or equipment.
- The process involves analyzing a project's cash inflows and outflows to determine whether the expected return meets a set benchmark.
- The major methods of capital budgeting include discounted cash flow, payback, and throughput analyses.

Importance of Capital Budgeting

Importance of Capital Budgeting

1. Long-term Goals
2. Involvement of a Large Number of Funds
3. Irreversible Decision
4. Monitoring & Controlling the Expenditure
5. Transfer of Information
6. Difficulties of Investment Decision
7. Maximization of Wealth

Long-term Goals
For the growth & prosperity of the business, long-term goals are very important for any organization. A wrong decision can be disastrous for the long-term survival of the firm. Capital budgeting has its effect in a long time span. It also affects companies future cost & growth.

Involvement of a Large Number of Funds
Capital Investment requires a large number of funds. As the companies have limited resources, the company has to make a wise & correct investment decision. The wrong decision would harm the sustainability of the business. The large investment includes the purchase of an asset, rebuilding or replacing existing equipment.

Irreversible Decision
The capital Investment decisions are generally irreversible as it requires large amounts of funds. It is difficult to find the market for that asset. The only way remains with the company is to scrap the asset & incur heavy losses.

Monitoring & Controlling the Expenditure
Capital budget carefully identifies the necessary expenditure and R&D required for an investment project. Since a good project can turn bad if expenditures aren't carefully controlled or monitored, this step is a crucial benefit of the capital budgeting process.

Transfer of Information
The time that project starts off as an idea, it is accepted or rejected; numerous decisions have to be made at a various level of authority. The capital budgeting process facilitates the transfer of information to appropriate decision makers within a company.

Difficulties of Investment Decision
The long-term investment decisions are difficult because it extends several years beyond the current period. Uncertainty indicates a higher degree of risk. Management loses his flexibility and liquidity of funds in making investment decisions so it must consider each proposal very thoroughly.
Maximization of Wealth
Long-term investment decision of the organization helps in safeguarding the interest of the shareholder in the organization. If the organization has invested in a planned manner, the shareholder would also be keen to invest in that organization. This helps in the maximization of wealth of the organization. Any expansion is fundamentally related to further sales and future profitability of the firm and assets acquisition decisions are based on capital budgeting.

Other Important Aspect of Capital Budgeting
Capital budgeting involves two important decisions at once: a financial decision and an investment decision. By taking the project, the business has agreed to make a financial commitment to a project, and that involves own set of risk. Project delay, cost overruns & regulatory restriction that can all delay & increase the cost of the project.

Difficulties of Capital Budgeting

Capital budgeting consists in planning the development of available capital for the purpose of maximizing long-term profitability (return on investment) of the firm". Capital budgeting involves mainly three problems:

1. Demand for capital.
2. Supply of capital.
3. Rationing of capital.

1. Demand for capital:

The starting point for capital budgeting is a survey of the need of capital for the company. The discovery and development of good investment proposals require efforts and as such an imaginative search for such opportunities is very important part of the programmed. The activities of research and the industrial engineering group in reducing costs and improving products also results from research and competition in the equipment industries that are keen to promote their sales by creating obsolescence. Survey of explicit capital requirements generally, confined to one year or two years at the most. The capital projects of distant future cannot be visualized accurately. Further, when projects are foreseeable it is, hardly possible to visualize their earnings, for those depend upon unknown technical advances, market developments and changes in relative prices.

2. Supply of capital:

This is a problem to find out where from the money will came. The distinction between internal and external sources of funds must be made.

The chief internal sources are-

I. Depreciation charge, and
II. Retained earnings.

The external sources arc mainly the issue of shares and debentures to the public. It is very important to correctly forecast.

(i) how much cash will be generated internally and
(ii) to decide how much cash is to be paid out of dividend and
(iii) also to decide how much of the remainder may be tied up in long-term projects.

The capital expenditure in some firm are confined completely to the amount available internally. The amount that can be expected from accumulated depreciation and retained earnings are the most important part of capital expenditure budgeting. Generally these estimates are confined to one year or two years. Such projection's are not matter of forecasting the level of prices and costs; they also involve management decision on the adequacy of depreciation charges, the level of dividend and the necessary degree of liquidity. Thus, as a source of capital funds, plough back policy forms an integral part of capital budgeting. The problem of how much to plough back can be guided by a number of principles. Regarding the external sources much depends upon the state of capital market and sound financial position and goodwill of the company

3. Capital rationing:

Capital is a scarce resource and is therefore, it has a cost. The return on investment must be more than the cost of capital. Only that investment should be considered for acceptance which yields a rate of return in excess of cost of capital. The cost of capital sets the minimum rate that the investment must promise to return. This is in fact, a way to determine the cutoff point in capital budgeting. The basic aim of capital to maximize the firm long run profit potentials. All profitable investments cannot be accepted because the firm has limited supply of capital. In such a situation, it has to choose out the project which is the most profitable. To conclude, capital budgeting consists of (i) determining the cost of capital (ii) determining the rate of return on different investment proposals under consideration; and (iii) ranking the proposals on the basis of their profitability

Q1. What do you understand by balance sheet? Discuss its advantages.

Ans. What Is a Balance Sheet?

A balance sheet is a financial statement that reports a company's assets, liabilities and shareholders' equity at a specific point in time, and provides a basis for computing rates of return and evaluating its capital structure. It is a financial statement that provides a snapshot of what a company owns and owes, as well as the amount invested by shareholders.

The balance sheet is used alongside other important financial statements such as the income statement and statement of cash flows in conducting fundamental analysis or calculating financial ratios.

KEY TAKEAWAYS

- A balance sheet is a financial statement that reports a company's assets, liabilities and shareholders' equity.
- The balance sheet is one of the three (income statement and statement of cash flows being the other two) core financial statements used to evaluate a business.
- The balance sheet is a snapshot, representing the state of a company's finances (what it owns and owes) as of the date of publication.
- Fundamental analysts use balance sheets, in conjunction with other financial statements, to calculate financial ratios.

Formula Used for a Balance Sheet

The balance sheet adheres to the following accounting equation, where assets on one side, and liabilities plus shareholders' equity on the other, balance out:

Assets=Liabilities + Shareholders' Equity

This formula is intuitive: a company has to pay for all the things it owns (assets) by either borrowing money (taking on liabilities) or taking it from investors (issuing shareholders' equity).

Advantages of Balance Sheet

1. **Helps To Obtain The Financial Position**

   Balance sheet helps to ascertain the financial position of the company by disclosing the information about assets, capital and liabilities. Current financial position of the business can be obtained with the help of data and information about assets and liabilities by preparing balance sheet.
2. **Helps To Calculate Financial Ratios**

   Balance items or data are very essential to calculate different financial ratios like liquidity ratio, current ratio and acid-test ratio. Financial ratios help to measure profitability, liquidity and sustainability of the company.

3. **Helps To Disclose The Solvency**
   Balance sheet provides detailed information about assets and liabilities for a particular accounting period. It helps to understand the solvency position of the company.
4. **Helps To Borrow Loans**
   Balance sheet provides information about financial health of the company. It discloses the solvency position and net worth of the business. These information are helpful to borrow loans from banks, other financial institutions or outsiders.
5. **Provides Information About Debtors And Creditors**
   Balance sheet provides up to date financial aspects of the business. It provides full information about trade debtors and trade creditors at a given period.
6. **Helps To Ascertain The Owners' Equity**
   Another key benefit of balance sheet is that it provides information regarding owners' equity and capital at a given period.
7. **Helps In Decision Making**
   Balance sheet helps to compare current financial status of the company with the financial position of previous period. So, the current progress can be ascertained and future plans and decisions can be make properly.

Q2. What do you mean by journal? Give rules and advantages of journalizing.
Ans. **Definition:** A journal or book of original entry is the place where journal entries are recorded before they are posted to the ledger accounts. A journal is a record of all the transactions a company has recorded.
In the process of accounting and book-keeping, a journal is a record of financial transactions where transactions of a business are ordered by date. A journal is defined as the book of original entry while the definition is more appropriate when the transactions were written in a journal prior to manually posting them to their respective accounts. There are a variety of journals like the sales journal, purchases journal, cash receipts journal, cash disbursements journal, and a general journal.

Advantages of the Journal
Journalizing the business transaction is done by the majority business. Journal helps a business to keep a systematic record of their financial events. To know the advantages of maintain the same, we can sum it in the following points:

- Journal records all the financial transactions of a business in one place on the time and date basis.
- The transactions are recorded, in support with a bill, to check the authenticity of each of these journal entries with their bills.
- There is a less chance to avoid transactions as in a journal we record each and every transaction on a date basis.
- The accountant writes each journal entry's narration below every journal entry, so that another auditor can audit it without any confusion.
- In a journal, we record these transactions which help in deep analysis of the two accounts on the basis of a double entry system, and this prevents a minimum chance of mistake in the journal.
- Journal posts the transactions in their respective ledger accounts. Without making this journal, an accountant will be unable to make the ledger accounts.
- In case of a mistake in the ledger accounts, this can be easily rectified with the help of a journal or by passing a rectified journal entry in the journal.
- All the opening journal entries, closing journal entries and all other transactions which cannot be recorded in any other subsidiary books, can be recorded in the journal proper.
- Even in accounting software, journals are required. Accounting software can make an auto system of posting the journal entries to the ledger by their automatic processing system.
- There is a single column of ledger folio, which is very helpful for checking the reference of each account's posting with its own original journal entry.

Rules Of Journalizing Or Rules Of Debit And Credit
Under the double entry system, every financial transactions of a business has a double effect. That is, each transaction involves at least two accounts. One aspect of the transaction is debited in an account and the other credited in another account. The debiting and crediting of the accounts are done on the basis of certain rules. These rules are called rules of journalizing i.e debit and credit. There are two alternative bases for the rules of debit and credit such as follows.

1. Rules Of Debit And Credit Based On The Types Of Account

2. Rules Of Debit And credit Based On The Accounting Equation

1. Rules Of Debit And Credit Based On The Types Of Account

Under double-entry system an account is classified into three types. They are personal account, real account and nominal account. For each of these types of account, there are three separate rules of debiting and crediting the financial transactions. The rules of debit and credit under different types of account are as follows.

A. Personal Account

Personal account is a account of a person. A person can be a natural person such as people like us, an artificial person such as firms, organizations and institutions and a representative person such as debtors and creditors. Since a person, be it a natural, artificial or representative, can be the receiver of benefits or giver of benefits, the rule of debiting and crediting the account of the person is as follows:
* **Debit the receiver of benefits**
* **Credit the giver of benefits**
This rule states that whenever a person receives benefits is debited by the amount of the benefit received. On the contrary, whenever the person gives the benefits is credited by the amount of benefits given. For example, if cash is paid to Michael (Michael is a natural person), his account (Michael's account) is debited since he is the receiver of the benefit (cash). If cash is received from City Enterprises (City Enterprises is an artificial person), its account (City enterprises account) is credited because it is the giver of benefits (cash).

B. Real Account

Real account is a record of an asset. An asset can be current asset such as cash, a fixed asset such as building and intangible asset such as goodwill. Since an asset, is a current, fixed or an intangible asset , can either come in the business through its purchase or go out of the business through its sales, the rule of debiting and crediting the real (asset) account is as follows:
* **Debit what comes in**
* **Credit what goes out**
This rule states that whenever some benefit in the form of asset come into the business through its purchase, its (asset) account is debited. Conversely, whenever some benefit in the form of asset goes out of the business through its sales, its (asset) account is credited. For example, if cash is invested in the business, cash (current asset) account is debited by the amount of cash. If furniture is purchased for cash, furniture (fixed asset) account is debited because it comes into and cash (current asset) account is credited because it goes out from the business in Exchange for furniture.

C. Nominal Account

Nominal account is a record of expense or loss or income or gain. An expense or loss is the sacrifice of benefits in exchange for service used and an income or gain is the benefit earned in exchange for service rendered. Since the business makes expenses and earns incomes, the rule of debiting and crediting the expense and income (nominal) account is as follows:
* **Debit all expenses and losses**
* **Credit all incomes and gains**
This rule states that whenever some benefit is sacrificed in exchange for service used (expense made or loss suffered), its (expense) account is debited. On other hand, whenever some benefit is earned in exchange for service rendered, its (income or gain) account is credited. For example, when salary is paid, an expense is made by the business, therefore salary account is debited. On the other hand , when interest is received, an income is earned by the business, hence, interest received account is credited.

2. Rules Of Debit And Credit Based On The Accounting Equation

Accounting equation is a statement of equality between the three basic elements of accounting. They are assets, capital and liabilities. Each and every financial transaction affects the three basic elements. However, the total of all assets is always equal to the total of capital and liabilities at any point in time. The rules of debiting and crediting an account based on the accounting equation can be summarized in the following way.

S.N..............Effect of Transactions.......................................Debit or Credit
1..................Increase in assets and expenses/losses...........Debit
2..................Decrease in assets and expenses/losses...........Credit
3..................Increase in capital,liabilities,income/gains........Credit
4..................Decrease in capital,liabilities,income/gains........debit

Q3. What do you understand by ledger? Explain the rules of posting with example.

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

- Asset accounts include fixed assets, prepaid expenses, accounts receivable and cash
- Liability accounts which include notes payable, lines of credit, accounts payable and debt
- Stockholders' equity accounts
- Revenue accounts
- Expense accounts
- Revenue and loss accounts such as interest, investment, disposal of an asset

These transactions are recorded throughout the year by debiting and crediting these accounts. The transactions are caused by normal business activities such as billing customers or through adjusting entries. The ledger account may be in the form of a written record if accounting is done by hand or in the form of electronic records when accounting software packages are used.

RULES FOR POSTING IN TO LEDGER

1. Entries must be posted from the day books or journal only.
2. Posting of the entries must be date wise.
3. Date of entry in day books must be the date of entry in ledger.
4. All amounts shown in debit side in journal must be posted in debit side of a particular account. In **'particulars'** column of ledger, the name of the other account as shown in journal, relating to same entry, must be written and the account head must start with 'To'.
5. All amounts shown in credit side in journal must be posted in credit side of a particular account. In **'particulars'** column of ledger, the name of the other account as shown in journal, relating to same entry, must be written and the account head must start with 'By'.
6. After the entry, page number of journal from where the entry is posted, must be written in L/F column of account and the page number of ledger account must be written in L/F column of journal or day book.
7. Then the balancing of the ledger should be done. Balancing is may be done as running or can be done after doing the totals of debit and credit side. If the total of debit side is more than credit side then the balance should be shown as debit balance in balance column and if the total of credit side is more than the total of debit side then balance should be shown as credit balance in balance column. If the totals of debit and credit sides are equal then the balance should be shown as 'nil' in balance column.