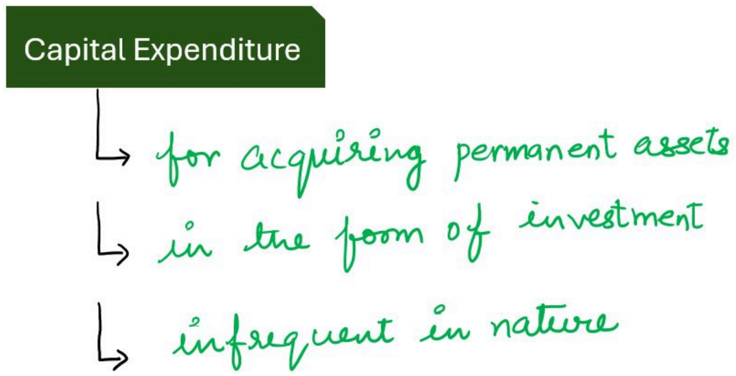
Auditing Course Material

Part 16 of 61 (Chapters 1501-1600)

8. Expenditure

Capital expenditure refers to the spending on acquiring, improving, or extending permanent assets that are expected to provide benefits to a business beyond the current accounting period. These expenditures are incurred to enhance the earning capacity of the business by increasing its productivity, efficiency, or revenue-generating potential. Capital expenditure is intended for long-term use in the business and is considered an investment in the company's future growth and profitability.



Capital expenditure is non-recurring or infrequent in nature, as it involves significant investments that are made periodically or on an as-needed basis. Once incurred, capital expenditure is not expected to recur in subsequent accounting periods, although ongoing maintenance and repairs may be required to preserve the assets' value.

Some of the examples of capital expenditures which result in the acquisition, enhancement, or improvement of assets with lasting benefits to the business are as follows.

Additions to Buildings: When a business makes additions to its buildings, such as constructing new wings or expanding existing structures, the costs incurred are considered capital expenditures. These additions increase the overall value and utility of the buildings, providing long-term benefits to the business.

Renovation of Old Machinery: Expenses related to the renovation or refurbishment of old machinery are treated as capital expenditures. By investing in the renovation of machinery, the business extends its useful life, improves its performance, and maintains or enhances its productivity, thus justifying the capitalization of these costs.

Reconditioning Second-hand Machinery: If a business purchases second-hand machinery and incurs significant expenses on reconditioning or refurbishing it to bring it to a usable condition, the costs of reconditioning are capitalized. Despite being incurred on a used asset, these expenditures contribute to increasing the asset's value and functionality.

Structural Improvements or Alterations: Expenditures on structural improvements or alterations to existing fixed assets, such as buildings or machinery, that enhance their revenue-earning capacity are classified as capital expenditures. These improvements increase the efficiency, capacity, or functionality of the assets, leading to higher revenue generation potential.

Development of Mines and Plantations: Costs incurred during the early stages of developing mines or land for plantations until they become operational are treated as capital expenditures. These costs include expenses related to land preparation, clearing, planting, infrastructure development, and other activities necessary to establish productive operations.

Legal Charges for Asset Protection: Legal charges incurred in connection with acquiring or defending suits to protect fixed assets, rights, or interests of the business are included in capital expenditures. These charges are necessary to safeguard the business's ownership or control over its assets and are considered part of the cost of acquiring or maintaining those assets.

8. Expenditure

Revenue expenditure refers to ongoing operating expenses incurred by a business in its regular course of operations to maintain its day-to-day activities and generate revenue. Unlike capital expenditures, which involve investments in assets with long-term benefits, revenue expenditures are incurred for short-term needs and do not result in the acquisition or enhancement of assets. These expenditures are essential for sustaining the business's operations and facilitating revenue generation in the current accounting period.

Following are the key characteristics and examples of revenue expenditures:

1. Ongoing Operating Expenses

Revenue expenditures encompass expenses required to meet the ongoing operational costs of running a business. These expenses are incurred regularly to support the business's day-to-day activities and are necessary for its continued operation. Examples include:

- Wages and salaries paid to employees
- Rent or lease payments for office space or facilities
- Postage and stationery expenses
- Insurance premiums for business coverage
- Utility bills such as electricity, water, and gas
- Marketing and advertising expenses
- Administrative and general expenses.

2. Purchase of Goods or Raw Materials

Expenditures incurred for buying goods for resale or raw materials for manufacturing products are classified as revenue expenditures. These expenses are directly related to the production or procurement of goods and services for sale to customers.

3. Maintenance of Fixed Assets

Costs incurred for maintaining and repairing fixed assets to keep them in working condition are considered revenue expenditures. This includes expenses for routine repairs, replacements, and renewals of buildings, machinery, equipment, and vehicles. While these expenses help preserve the usefulness of assets, they do not significantly increase their value or extend their useful life.

4. Depreciation on Fixed Assets

Depreciation expense, which represents the allocation of the cost of fixed assets over their estimated useful lives, is treated as a revenue expenditure. Although depreciation reduces the value of fixed assets over time, it is recognized as an operating expense on the income statement rather than as a capital expenditure.

5. Interest on Loans

Interest payments made on loans borrowed to finance the business's operations are considered revenue expenditures. These expenses represent the cost of borrowing capital to support ongoing activities and are deductible for tax purposes.

6. Legal Charges

Legal charges incurred during the regular course of business, such as legal expenses related to debt collection or defense against lawsuits, are classified as revenue expenditures. These expenses are necessary for protecting the business's interests and resolving legal issues but do not result in the acquisition of assets.

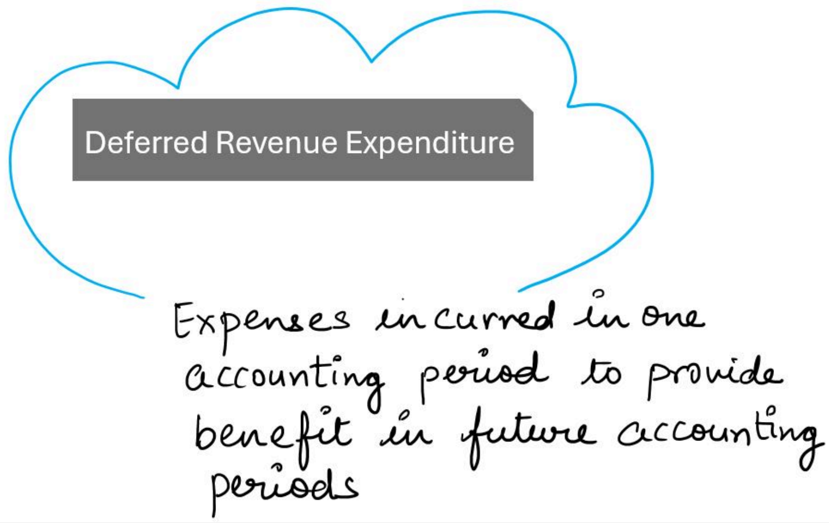
8. Expenditure

Deferred revenue expenditure refers to an expense incurred during a particular accounting period, which is revenue in nature but provides benefits over multiple future accounting periods.

Unlike regular revenue expenditures, where the benefits are typically realized immediately, deferred revenue expenditure involves costs that provide ongoing benefits beyond the period in which they are incurred. This type of expenditure does not result in the creation of an asset or reduction of a liability on the balance sheet.

Deferred revenue expenditure is categorized as a revenue expense because it relates to the day-to-day operations of the business and is incurred to generate revenue. However, its benefits are spread over an extended period rather than being fully realized in the period in which the expenditure is incurred.

In certain cases where the expenditure is unusually heavy and the benefit is likely to be available over more than one accounting year, it may be appropriate to capitalize the expenditure. This means that only a portion of the total amount spent is charged to the Profit and Loss Account for the current year, and the balance is shown as an asset on the balance sheet. The asset is then written off over subsequent accounting periods.



Following are the examples of Deferred Revenue Expenditure:

Expenditure on an advertising campaign to introduce a new product: While the campaign may incur significant costs upfront, its benefits in terms of increased sales and brand awareness are expected to be realized over multiple years.

Preliminary expenses incurred during the formation of a new company: These expenses include legal fees, registration fees, and promotional costs. While they are necessary for establishing the business, their benefits extend beyond the current accounting period.

Brokerage charges and underwriting commission paid in connection with the issue of shares and debentures: These expenses facilitate the raising of capital but provide ongoing benefits over multiple years.

Costs associated with relocating plant and machinery to a new site: This may involve dismantling, removing, and re-erecting the equipment, with the benefits of the relocation being spread over several years.

Treatment of Experiments

The cost of experiments that ultimately result in the acquisition of a patent is treated as a capital expenditure because it leads to the creation of an intangible asset. However, if the experiments are unsuccessful and do not result in the acquisition of a patent, the costs incurred are treated as deferred revenue expenditure and written off within two to three years.

9. Expense

Expenses refer to the costs incurred by a business in its day-to-day operations with the primary aim of earning revenue. These costs are essential for conducting business activities, producing goods or services, and facilitating sales and distribution. Expenses are incurred to maintain and support the business's operations and are subtracted from revenue to determine the net income or profit of the business.

Expenses are directly related to the business's revenue-earning activities and are incurred in the process of generating sales and revenue. They are necessary for the business to produce goods, market them to customers, and deliver them to the market.

Some of the common examples of expenses in relation to a business entity are as follows.

Cost of Goods Sold (COGS): Expenses related to the production or purchase of goods for sale, including the cost of raw materials, direct labor, and manufacturing overhead.

Operating Expenses: Expenses incurred in the day-to-day operations of the business, such as wages, salaries, rent, utilities, insurance, advertising, marketing, transportation, and administrative expenses.

Selling and Distribution Expenses: Expenses related to the selling and distribution of goods or services, including sales commissions, advertising, transportation, and storage costs.

Expense Vs. Expenditure

In accounting, the terms "expense" and "expenditure" are often used interchangeably, but there is a subtle difference in their meanings and contexts.

While an expense refers to the costs incurred by a business during its normal operating activities to generate revenue. Expenditure, on the other hand, is a broader term that encompasses any outflow of funds or incurring of liabilities by a business, whether it relates to revenue-generating activities or not. In other words, expenditure includes not only expenses but also capital expenditures, which are investments in assets with long-term benefits, and other types of payments or obligations.

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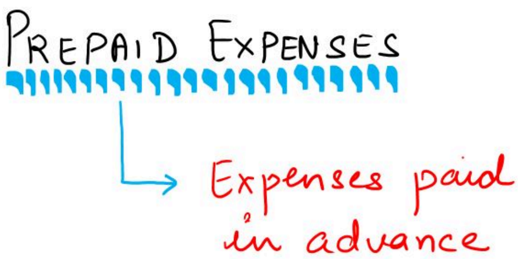
9. Expense

Prepaid expenses refer to costs that have been paid for in advance but have not yet been used or consumed. These expenses represent future benefits that the business has already paid for, and they are recorded as assets on the balance sheet until they are utilized. Prepaid expenses are typically shown on the assets side of the balance sheet because they represent resources owned by the business that will provide future economic benefits.



For example, ABC Pvt. Ltd. pays Rs. 6,000 annually for office rent. The company makes the payment on April 1st for the entire year in advance. The amount paid is initially recorded as a prepaid rent expense on the balance sheet. Each month, Rs. 500 (6,000 / 12 months) is recognized as rent expense on the income statement until the end of the rental period.

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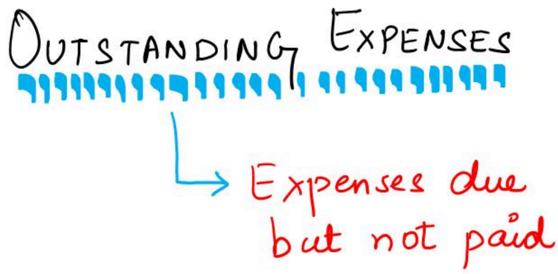
9. Expense

Outstanding expenses refer to costs that have been incurred during the current accounting period but have not yet been paid by the end of the period. These expenses represent liabilities owed by the business to its creditors or suppliers for goods or services received but not yet settled.



Outstanding expenses are recorded on the balance sheet as liabilities because they represent obligations to make future payments.

For example, at the end of the month, ABC Company has incurred Rs. 10,000 in salaries for its employees but has not yet paid them. This unpaid amount represents outstanding expenses for the current accounting period.

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10. Purchases

Purchases refer to the acquisition of goods by a business for the purpose of resale or for use in the production process.

In other words, the term "purchases" specifically refers to the buying of goods that a business intends to resell as part of its regular operations. It is used only for items that are considered inventory or stock. For example, in a clothing store, the purchase of clothes to sell to customers would be recorded as "purchases." It does not apply to the buying of fixed assets like machinery or office supplies, which are not for resale but for business use.

In trading concerns, purchases represent the acquisition of final goods that will be sold to customers without further processing. In contrast, in manufacturing concerns, purchases refer to the acquisition of raw materials or components that will undergo further processing or manufacturing to produce finished goods. These goods are typically acquired from suppliers or vendors.

$$\text{Total Purchases} = \text{Cash Purchases} + \text{Credit Purchases}$$

Purchases can be classified into two main types, i.e., cash purchases and credit purchases. Cash purchases involve the immediate payment of cash at the time of acquiring the goods, while credit purchases allow the business to acquire goods on credit terms, with payment to be made at a later date according to agreed-upon terms.

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10. Purchases

Purchases return involves the process of returning goods to the original supplier or vendor from whom they were initially acquired. The goods are sent back to the seller's premises due to reasons such as overstocking, damaged goods, quality issues, incorrect shipment, or dissatisfaction with the products received.

Purchases return reduces the quantity and value of inventory on hand, as the returned goods are no longer held in inventory.

Purchases return is also referred to as return outward because it involves the return of goods from the buyer's premises to the seller's premises, thus representing an outward flow of goods from the buyer's perspective.

Net purchases represent the total amount of goods acquired by a business after subtracting the value of purchases returned to the supplier. It is calculated by deducting the value of purchases return from the total purchases made during a specific period, providing a clearer picture of the net amount of goods retained by the business.

The formula to calculate Net Purchases is:

$$\text{Net Purchases} = \text{Total Purchases} - \text{Purchase Return}$$

Let's say a grocery store buys Rs.10,000 worth of inventory during a month. However, during that same month, grocery store returns Rs.1,000 worth of goods due to various reasons like defects or unsuitability.

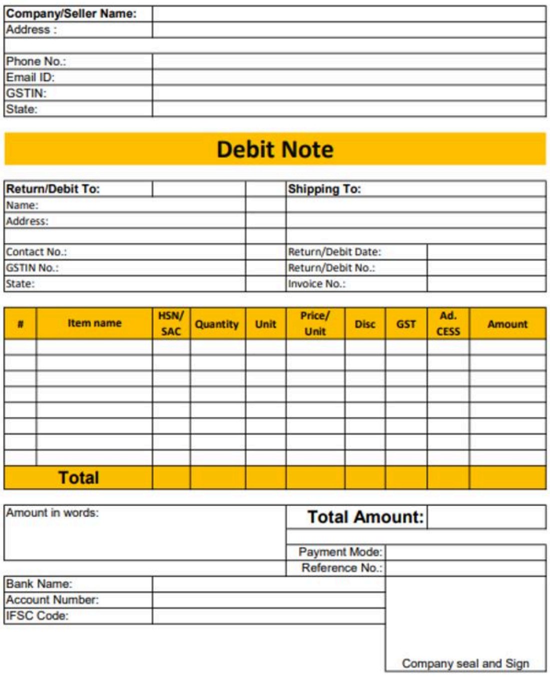
To calculate the net purchases for that month, you would subtract the value of returns from the total purchases:

$$\begin{aligned}\text{Net Purchases} &= \text{Total Purchases} - \text{Purchase Returns} \\ &= \text{Rs. } 10{,}000 - \text{Rs. } 1{,}000 \\ &= \text{Rs. } 9{,}000\end{aligned}$$

So, the net purchases for that month would be Rs. 9,000, which reflects the actual amount of goods the store kept after accounting for returns.

10. Purchases

A debit note is a document issued by a buyer to inform the seller about the return of goods and to request a refund or credit for the amount and quantity being returned. It serves as an intimation to the seller regarding the debit made in their account, with details of the reasons for the return included.



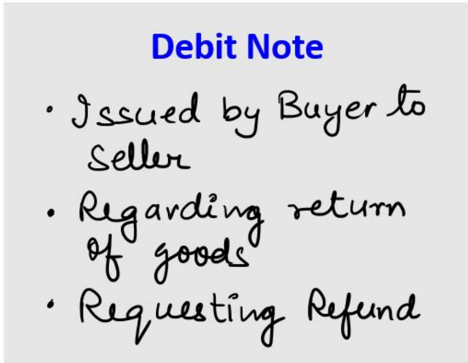
Company/Seller Name:	
Address :	
Phone No.:	
Email ID:	
GSTIN:	
State:	

Debit Note

Return/Debit To:		**Shipping To:**	
Name:			
Address:			
Contact No.:		Return/Debit Date:	
GSTIN No.:		Return/Debit No.:	
State:		Invoice No.:	

#	Item name	HSN/ SAC	Quantity	Unit	Price/ Unit	Disc	GST	Ad. CESS	Amount
Total									

Amount in words:	**Total Amount:**
	Payment Mode:
	Reference No.:
Bank Name:	
Account Number:	
IFSC Code:	
	Company seal and Sign



Typically, the buyer sends the debit note to the seller along with the returned goods, outlining the specific items being returned and the corresponding amount to be refunded or credited. The information provided in the debit note is used to update the purchase returns book, to reflect the return of goods and the associated financial adjustments.

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11. Sales

Sales represent the total revenues generated by a business from the sale of goods or services to its customers. This includes both cash sales, where payment is received immediately at the time of the transaction, and credit sales, where payment is deferred to a later date according to agreed-upon terms.

Total Sales = Cash Sales + Credit Sales

It is important to note that sales pertain exclusively to goods or services with a regular nature, typically constituting the core activities of the business. Sales do not encompass the sale of assets, such as property, equipment, or investments, which are treated separately in the financial statements.

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11. Sales

It is that part of sales, which is returned to us by the purchasers. This return may also be due to excessive, unnecessary and defective supply of goods or violation of terms of agreement.

Sales returns are known as "returns inward" because they represent goods that are returned to the seller, thus reversing the outward flow of goods from the seller to the buyer during the original sales transaction.

Net sales are the total revenue from sales minus the value of sales returns, representing the actual amount of revenue retained by the business after deducting returns.

The formula for calculating Net Sales is:

$$\text{Net Sales} = \text{Total Sales} - \text{Sales Return}$$

Let's consider a clothing store that generated Rs. 50,000 in revenue from sales during a month. However, during the same period, customers returned clothing items worth Rs. 5,000 due to reasons like size issues or dissatisfaction.

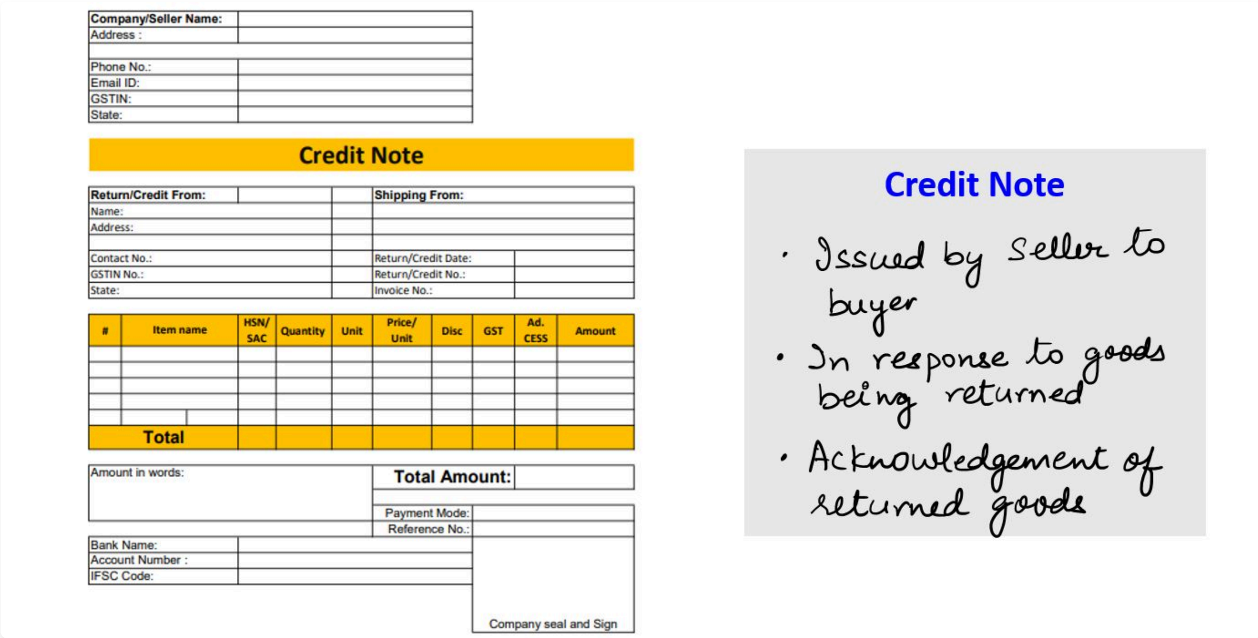
To calculate the net sales for that month, you would subtract the value of returns from the total revenue:

$$\begin{aligned}\text{Net Sales} &= \text{Total Sales} - \text{Sales Returns} \\ &= \text{Rs. } 50{,}000 - \text{Rs. } 5{,}000 \\ &= \text{Rs. } 45{,}000\end{aligned}$$

So, the net sales for that month would be Rs. 45,000, which represents the actual revenue retained by the clothing store after deducting returns. This figure provides a clearer picture of the business's performance in terms of revenue generation.

11. Sales

A credit note is a document issued by a seller to a buyer in response to goods being returned, indicating that the amount for the returned goods will be credited to the buyer. It serves as a formal notification to the buyer, informing them of the credit made in their account and the reasons for the return.


Company/Seller Name:
Address :
Phone No.:
Email ID:
GSTIN:
State:

Credit Note

Return/Credit From:		Shipping From:	
Name:			
Address:			
Contact No.:		Return/Credit Date:	
GSTIN No.:		Return/Credit No.:	
State:		Invoice No.:	

#	Item name	HSN/ SAC	Quantity	Unit	Price/ Unit	Disc	GST	Ad. CESS	Amount
Total									

Amount in words:
Total Amount:
Payment Mode:
Reference No.:
Bank Name:
Account Number :
IFSC Code:
Company seal and Sign

Typically, the seller sends the credit note to the buyer along with the acknowledgment of the returned goods. The information provided in the credit note is used to update the sales return book, facilitating accurate record-keeping and financial adjustments in cases of returned goods.

12. Revenue from Operations

'Revenue from operations' is a financial term that refers to the income generated by a company from its core business activities. These activities include selling goods or services, and revenue from operations excludes income from non-operating sources such as investments or asset sales.

STATEMENT OF PROFIT AND LOSS

FOR THE YEAR ENDED 31ST MARCH, 2023

		Note	For the year ended 31st March, 2023 (₹ in lakhs)	For the year ended 31st March, 2022 (₹ in lakhs)
I	Revenue from Operations	29	18,404.73	9,420.87
II	Other Income	30	285.52	230.23
III	Total Income (I + II)		18,690.25	9,651.10
IV	Expenses			
	Employee Benefits Expense	31	4,236.58	3,143.52
	Finance Costs	32	3.35	10.20
	Depreciation and Amortisation Expense		597.69	626.92
	Other Expenses	33	12,021.33	6,940.11
	Total Expenses (IV)		16,858.95	10,720.75
V	Profit / (Loss) before Tax (III- IV)		1,831.30	(1,069.65)
VI	Tax Expense:			
	Current Tax	34	-	-
	Deferred Tax	34	(1,007.29)	-
	Total Tax Expense (VI)		(1,007.29)	-
VII	Profit / (Loss) for the year (V - VI)		2,838.59	(1,069.65)
VIII	Other Comprehensive Income Items that will not to be reclassified to Profit or Loss			
	Re-measurement of Defined Benefit Plans		(59.01)	51.92
	Income Tax relating to Re-measurement of Defined Benefit Plans		14.85	-
	Other Comprehensive Income for the year (VIII)		(44.16)	51.92
IX	Total Comprehensive Income for the year (VII + VIII)		2,794.43	(1,017.73)
X	Earnings Per Share (Face Value of ₹ 10/- each)			
	Basic (₹)	35 (i)	35.51	(13.38)
	Diluted (₹)	35 (i)	35.51	(13.38)

REVENUE FROM OPERATIONS =

Revenue from Sale of Products/service

+

Other operating Revenue

Different business models generate revenue in various ways depending on their nature and operational strategies. Some examples of how different business models generate revenue are as follows:

1. **Sales of Goods:** This is revenue generated from the sale of products manufactured or acquired for resale. For example, a retail store earns revenue from selling clothing, electronics, or groceries.

2. **Rendering of Services:** This is revenue earned from providing services to customers. This can include consulting services, software subscriptions, healthcare services, and legal services.

3. **Rental Income:** This is revenue generated from renting out properties or equipment. This could be rental income from real estate properties, machinery, vehicles, or other assets.

4. **Interest Income:** This is revenue earned from interest on loans, bonds, or other interest-bearing instruments. Banks and financial institutions often earn significant revenue from interest on loans they provide.

5. **Commission Income:** This is revenue earned from commissions on sales or transactions. This can be seen in industries like real estate, insurance, and retail, where agents or brokers earn commissions on successful deals.

6. **Royalty Income:** This is revenue earned from licensing intellectual property such as patents, trademarks, copyrights, or franchise agreements. For example, a software company earns royalty income from licensing its software to other businesses.

7. **Subscription Revenue:** This is revenue earned from subscription-based models, such as subscription boxes, streaming services, software as a service (SaaS), or membership-based businesses.

8. **Advertising Revenue:** This is revenue earned from advertising services. This can include display ads, sponsored content, pay-per-click advertising, and other forms of digital or traditional advertising.

Sales vis-a-vis Revenue from Operations

Schedule III (Division II) to the Companies Act, 2013, requires that revenue from operations is to be separately disclosed in the notes, showing revenue from Sale of products (including Excise Duty), Sale of services, and other operating revenues. This means that revenue from operations is different from the term 'Sales', because revenue from operations may include other operating revenues.

Detailed Note 29
(To P&L given above)

		For the year ended 31st March, 2023 (₹ in lakhs)	For the year ended 31st March, 2022 (₹ in lakhs)
29	**Revenue from Operations**		
	Sale of Services	18,114.78	8,826.58
	Other Operating Revenue	289.95	594.29
	Total	18,404.73	9,420.87
30	**Other Income**		
	Interest Income on Bank Deposits - Carried at Amortised Cost	15.03	79.84
	Interest Income on Income Tax Refunds	80.96	-
	Gain / (Loss) on Sale of Property, Plant and Equipment - Net	64.26	-
	Other Non Operating Income	-	16.30
	Net Gain / (Loss) arising on Financial Assets mandatorily measured at FVTPL*	125.27	134.09
	Net unrealised gain on investments carried at fair value through profit or loss	-	-
	Total	285.52	230.23

* Includes ₹ 98.98 lakhs (2022 - ₹95.27 lakhs) being net gain / (loss) on sale of investments.

It is important to understand what is meant by the term "other operating revenues" and which items should be classified under this head vis-à-vis under the head "Other Income".

The term 'other operating revenue' includes revenue arising from a company's operating activities, i.e., either its principal or ancillary revenue generating activities, but which is not revenue arising from sale of products or rendering of services. Whether a particular income constitutes "other operating revenue" or "other income" is to be decided based on the facts of each case and detailed understanding of the company's activities.

For example, when companies engaged in exporting activities receive export incentives from the government or other entities as a reward for their export efforts, these incentives can be classified as other operating revenue.

13. Cost

Cost represents the financial resources that have been utilized or expended in relation to a particular item or activity. This expenditure could include various components such as the purchase price of materials, labor costs, overhead expenses, and any other associated expenses.

Costs are specifically linked to the production, acquisition, or provision of a particular item or service. They are directly attributable to the specific article or activity being considered. For example, the cost of manufacturing a product would include expenses related to raw materials, labor, and manufacturing overhead.

For example, let us assume that the cost towards direct materials amounts to Rs. 9800, direct labor stands at Rs. 1000, and manufacturing overhead accounts for Rs. 90. Consequently, the total cost per smartphone for any manufacturing company would be Rs. 10,890.

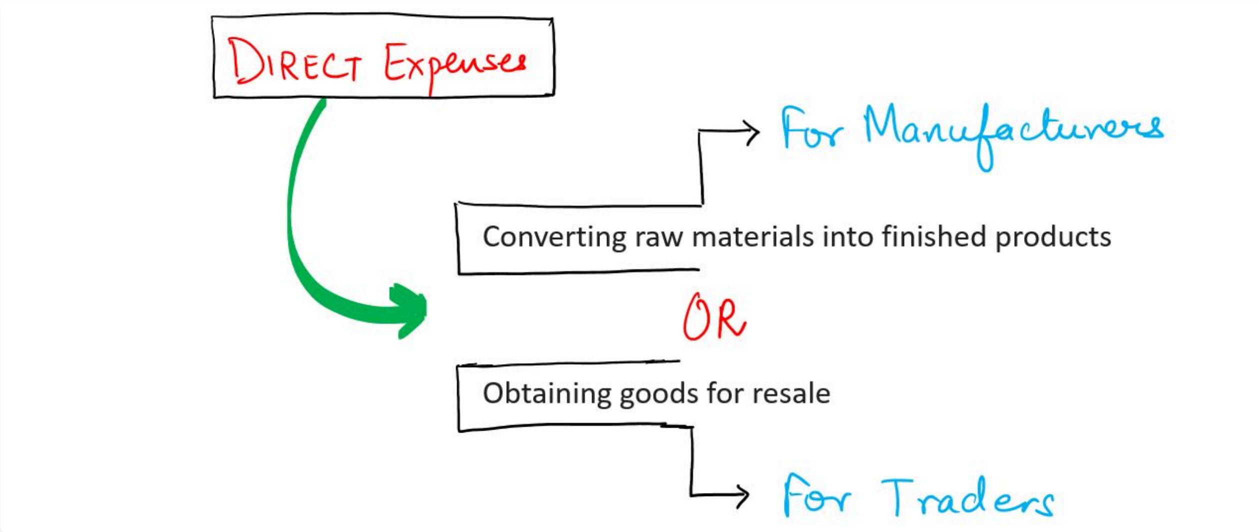
Direct material cost refers to the expenses directly associated with the materials used in the production of a product. For instance, in manufacturing a chair, the cost of wood, screws, and upholstery fabric would be considered direct material costs.

Direct labour cost refers to the wages and salaries paid to employees who directly work on producing a product or providing a service. For example, in a construction project, the wages paid to carpenters, electricians, and plumbers would be considered direct labor costs.

Manufacturing overhead cost encompasses all indirect expenses associated with the manufacturing process that cannot be easily attributed to specific units of production. These costs are essential for production to occur efficiently, but they are not directly tied to the creation of individual products. These include expenses such as factory rent, utilities like electricity and water, depreciation of machinery, indirect labor wages for supervisors and maintenance staff, factory supplies such as lubricants and safety equipment, insurance premiums for the manufacturing facility, property taxes, and costs associated with maintenance and repairs of equipment.

13. Cost

Direct expenses are costs that are specifically and solely associated with the production or purchase of goods, or with bringing those goods to the point of sale.



Direct expenses are those costs that can be directly attributed to the manufacturing process if the business is involved in production, or to the purchase of goods if the business operates as a retailer or wholesaler. These expenses are incurred in the process of converting raw materials into finished products or obtaining goods for resale.

Direct expenses typically include items such as raw materials used in manufacturing, direct labor costs for workers directly involved in production, freight and shipping charges for bringing raw materials to the production facility or finished goods to the point of sale, and direct expenses associated with production facilities such as rent and utilities for manufacturing plants or warehouses.

Direct expenses are distinct from indirect expenses, which are costs that cannot be directly linked to the production or purchase of goods. Indirect expenses may include items like administrative salaries, rent for office space, utilities for administrative buildings, and advertising expenses.

13. Cost

Operating expenses are the costs that a business incurs as part of its regular business activities, excluding the cost of goods sold (COGS). These expenses are necessary for the day-to-day operation of the business and are essential for generating revenue.

Some common types of operating expenses are as follows:

Office & Administrative Expenses: These expenses are associated with the general administrative functions of a business, including costs related to office facilities, administrative staff salaries, office supplies, utilities, rent for office space, insurance, and other administrative overhead costs. These expenses are incurred to support the overall operation of the business and ensure its smooth functioning.

Selling & Distribution Expenses: These expenses are related to the sales and distribution activities of a business, including costs associated with advertising, marketing, sales commissions, transportation, packaging, warehousing, and distribution of products or services. These expenses are incurred to promote the products or services, reach customers, and facilitate the sale and delivery of goods or services to customers.

Operating expenses are recorded on the income statement and are subtracted from the gross revenue to calculate the operating income (or operating profit) of the business.

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13. Cost

Non-operating expenses are expenses incurred by a business that are unrelated to its core operations or primary business activities. These expenses do not directly contribute to generating revenue and are often one-time or infrequent costs.

Some common types of non-operating expenses are as follows.

Loss on Sale of Fixed Assets: This occurs when a business sells its fixed assets (such as equipment, machinery, or property) at a loss compared to their book value.

Interest Charges or Other Costs of Borrowing: These expenses include interest payments on loans, finance charges, and other costs associated with borrowing capital.

Loss Due to Theft: This represents losses incurred due to theft, fraud, or other criminal activities.

Taxes: Non-operating expenses may include taxes that are not directly related to the business's core operations, such as property taxes or income taxes on investment income.

Non-operating expenses are also recorded on the income statement but are typically reported separately from operating expenses. They are deducted from the operating income to calculate the net income of the business.

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13. Cost

Cost of goods sold (COGS) represents the total cost incurred by a business to produce or purchase the goods that have been sold to customers during a specific accounting period. It includes all direct costs associated with the production or acquisition of goods sold by the business.

The cost of goods sold (COGS) can be calculated using the following formula:

$$\text{COGS} = \text{Opening Stock} + \text{Net Purchases} + \text{Direct Expenses} - \text{Closing Stock}$$

Let us understand with the help of an example. Suppose a retail store sells shoes, with following relevant figures for the year:

Opening Stock of Shoes: Rs. 50,000
Purchases of Shoes during the year: Rs. 150,000
Direct Expenses related to shoe sales (e.g., transportation, storage costs): Rs. 10,000
Closing Stock of Shoes at the end of the year: Rs. 30,000

The COGS will be calculated as under:

$$\begin{aligned} \text{COGS} = {} & \text{Opening Stock} \\ & + \text{Purchases} \\ & + \text{Direct Expenses} \\ & - \text{Closing Stock} \end{aligned} \quad \text{OR} \quad \begin{array}{r} 50{,}000 \\ +\ 150{,}000 \\ +\ 10{,}000 \\ -\ 30{,}000 \\ \hline \underline{\underline{180{,}000}} \end{array}$$

So, according to this calculation, the Cost of Goods Sold (COGS) for the year is Rs.180,000.

Components of COGS

Components of COGS are as follows.

Opening Inventory
This represents the value of inventory held by the business at the beginning of the accounting period. It includes the cost of goods that were not sold in the previous period and are carried forward as inventory.

Net Purchases
Net purchases refer to the total cost of goods purchased or manufactured by the business during the accounting period. It includes the cost of raw materials, components, and finished goods purchased for resale, net of any discounts, returns, or allowances.

Direct Expenses
Direct expenses are costs directly associated with the production or purchase of goods sold by the business. These may include direct labor costs, direct material costs, and other direct production costs.

Closing Inventory
Closing inventory represents the value of inventory remaining unsold at the end of the accounting period. It includes the cost of goods that have not yet been sold and are still held by the business as inventory.

14. Income

Income refers to the total amount of money earned by a business entity from both its operating and non-operating activities during a specific accounting period. It encompasses all sources of revenue generated by the business, including revenue from selling goods or services, as well as income from investments, interest, dividends, and other non-operating activities.

In essence, income represents the net result of the business's revenue-generating activities after deducting all expenses incurred in the process. It is the surplus or profit earned by the business during the accounting period.

Income provides a comprehensive measure of the financial performance of a business, capturing both the revenue generated from its primary operations and any additional income earned from non-operating activities.

Income is broader than the term "profit" because it encompasses not only the profit generated from operating activities but also profits derived from non-operating sources, such as investments, interest income, rental income, and other ancillary activities.

Income represents the excess of revenue over expenses incurred by the business. It reflects the amount remaining after deducting all operating and non-operating expenses from the total revenue earned during the accounting period.

Let us understand the concept of 'income' with the following example.

Let's say, goods costing Rs. 18,000 are sold for Rs. 25,000 by a firm. The firm also earned interest of Rs. 4,000 on fixed deposit in bank.

In this case, the cost of goods sold, that is Rs. 18,000 is an expense, the sale of goods, that is Rs. 25,000 is revenue. Bank interest of Rs. 4,000 falls into the category of other income. Thus,

$$
\begin{aligned}
\text{Income} &= \text{Revenue} + \text{Other Income} - \text{Expense} \\
&= 25{,}000 + 4{,}000 - 18{,}000 \\
&= \text{Rs. } 11{,}000
\end{aligned}
$$

15. Profit

Profit refers to the financial gain or surplus earned by a business firm from its operating activities, which primarily include the sale of goods or rendering of services. It represents the difference between the revenue generated from the sale of goods or services and the total costs incurred in producing or providing those goods or services.

Profit is derived from the core operating activities of the business, which involve selling goods or services to customers.

Profit is calculated by subtracting the total cost of goods sold (COGS) from the revenue generated from the sale of those goods. For example, if goods costing Rs. 18,000 are sold for Rs. 25,000, the profit would be calculated as follows:

$$\text{PROFIT} = \text{REVENUE} - \text{COGS}$$

$$25,\cancel{000} - 18,\cancel{000}$$

$$= \text{Rs. } 7,\cancel{000}$$

There are different types of profit, including gross profit, operating profit, and net profit. Gross profit represents the surplus after deducting the direct costs of producing goods from the revenue. Operating profit further deducts operating expenses, such as salaries, rent, and utilities, from the gross profit. Net profit is the final surplus after subtracting all expenses, including taxes and interest, from the operating profit.

15. Profit

Gross profit refers to the surplus income remaining after deducting the direct costs associated with producing or acquiring the goods sold or services rendered by a company. It represents the difference between the revenue generated from sales or services and the direct costs directly attributable to producing those goods or services.

In simple words, Gross profit represents the income earned by a company after paying off the direct expenses directly related to the production or acquisition of the goods sold or services rendered. These direct expenses typically include the cost of raw materials, direct labor, and manufacturing overhead.

The formula for calculating Gross Profit is:

$$\text{Gross Profit} = \text{Net Sales} - \text{Cost of Goods Sold}$$

For example, if a company generates Rs. 1,00,000 in revenue from sales and incurs Rs. 60,000 in direct costs, the gross profit would be:

$$\begin{aligned}\text{Gross Profit} &= 1{,}00{,}000 - 60{,}000 \\ &= \text{Rs. } 40{,}000\end{aligned}$$

Gross profit serves as an indicator of a company's operational efficiency in producing or acquiring goods and services. A higher gross profit margin indicates that the company is effectively controlling its direct expenses and generating a larger surplus from its sales or services.

Note that **Gross loss** is the negative difference between total sales revenue and the cost of goods sold, excluding other expenses.

15. Profit

Operating profit is the income that a company earns from its normal business operations before deducting interest and taxes. It reflects the profitability of the company's primary business activities, excluding income and expenses from non-operating activities, such as investments, financing, or one-time gains or losses.

Operating profit is calculated by subtracting operating expenses from gross profit. The formula for operating profit is as follows:

Operating Profit = Gross Profit − Operating Expenses

OR

Operating Profit = Net Sales − COGS − Operating Expenses

OR

Operating Profit = Net Profit + Non operating Expenses − Non-Operating Incomes

OR

Operating Profit = Net Sales − Operating Cost

where, Operating Cost = COGS + Operating Expenses

Gross Profit is the difference between net sales revenue and the cost of goods sold (COGS). It represents the profit earned from the sale of goods or services before deducting operating expenses.

Operating Expenses are the costs incurred by a business in its day-to-day operations, including selling, general, and administrative expenses (SG&A), research and development expenses, and other operating costs.

Let us understand this with the help of an example.

Suppose a bakery operates and sells various baked goods with following relevant figures for the year:

- Revenue from Sales: Rs. 200,000
- Cost of Goods Sold (COGS): Rs. 100,000
- Operating Expenses (including salaries, rent, utilities, marketing, etc.): Rs. 60,000

Thus, Operating Profit will calculated as follows.

Gross Profit = Sales − COGS

= 2,00,000 − 1,00,000

= Rs. 1,00,000

Now, Operating Profit = Gross Profit − Operating Expenses

= 1,00,000 − 60,000

= Rs. 40,000

15. Profit

Net profit, also known as net income or net earnings, refers to the total profit earned by a company after deducting all direct and indirect expenses from its total revenue. It represents the surplus remaining after subtracting all expenses, including both operating and non-operating expenses, from the company's total revenue.

Net profit provides a comprehensive measure of a company's profitability by taking into account all expenses incurred in generating revenue, both direct and indirect. It reflects the true earnings of the company after considering all costs associated with its operations.

Net profit is calculated by subtracting all expenses, including the cost of goods sold (COGS), operating expenses, interest expenses, taxes, depreciation, and other non-operating expenses, from the total revenue generated by the company.

The formula for calculating net profit is:

$$\text{Net Profit} = \underbrace{\text{Gross Profit} - \text{operating Expenses}}_{\text{Operating Profit}} - \text{Non-operating Expenses} + \text{Non-Operating Incomes}$$

OR

$$\text{Net Profit} = \text{Operating Profit} - \text{Non-operating Expenses} + \text{Non-operating Incomes}$$

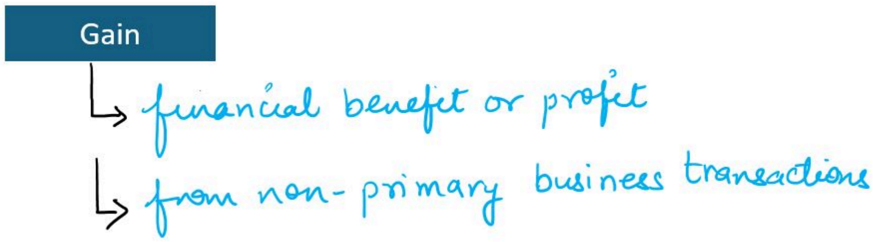
For example, if a company generates Rs. 5,00,000 in total revenue and incurs Rs. 400,000 in total expenses, including COGS, operating expenses, interest, and taxes, the net profit would be Rs. 100,000 (Rs. 5,00,000 - Rs. 4,00,000).

Note that, in case total expenses are more than the revenue and other Income, it is **Net Loss.**

Net Profit increases capital and Net Loss decreases it. As net profit accumulates over time, it increases the company's capital reserves, strengthening its financial position and providing resources for future growth and investment opportunities. On the other hand, Net losses deplete the company's capital base, reducing its financial resources and impairing its ability to invest in growth opportunities.

16. Gain

Gain refers to the increase in owner's equity resulting from transactions that are not directly related to the primary operating activities of the business but are incidental or peripheral to it. It represents the financial benefit or profit that arises from transactions outside of the ordinary course of business operations.



A common example of a gain is the gain on the sale of fixed assets. When a business sells a piece of machinery, equipment, or property at a price higher than its carrying value (book value), the difference between the sale proceeds and the asset's book value represents a gain.

Gains are considered non-operating in nature because they do not arise from the primary revenue-generating activities of the business. Instead, they represent windfalls or unexpected financial benefits that arise from asset sales or other incidental transactions.

While gains may contribute to an increase in owner's equity, they are distinct from profits in that gains are specifically related to transactions involving the sale or disposal of assets. Profits, on the other hand, stem from the core operating activities of the business, such as sales revenue *minus* expenses.

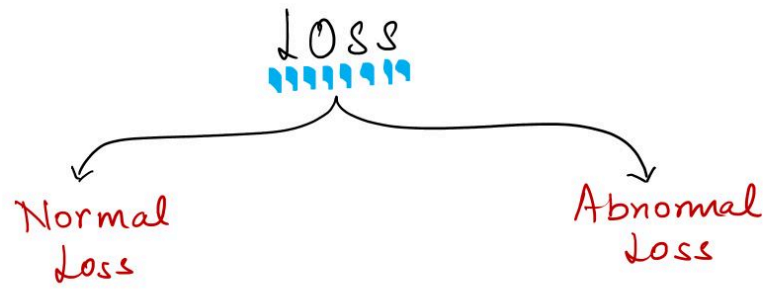
17. Loss

Losses refer to the financial shortfall or negative outcome experienced by a business when its expenses for a period exceed its revenues and other sources of income.

Losses are regarded as unwanted burdens that businesses are compelled to bear when their expenses surpass their revenues and other sources of income.

Losses occur when a business's total expenses, including operating expenses, interest expenses, taxes, depreciation, and other costs, exceed its total revenues generated from sales, services, and other income sources.

For example, during the first quarter, XYZ Corporation incurred Rs. 80,000 in expenses but only generated Rs. 60,000 in revenue. As a result, the company experienced a loss of Rs. 20,000 for the period, decreasing its owner's equity.

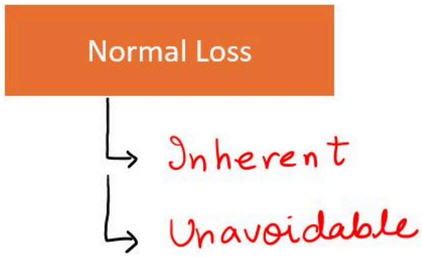


Losses can be classified into different categories based on their nature and origin. One common classification is normal loss and abnormal loss. Normal losses are inherent to the regular operations of the business and are considered part of the expected operating expenses. Abnormal losses, on the other hand, arise from unforeseen events or extraordinary circumstances that are not part of the usual business operations.

Normal Losses and Abnormal losses are discussed in detail next.

17. Loss

Normal loss, also known as inherent loss, refers to the loss that occurs as a result of the inherent nature of the product or the production process. It is a loss that is considered unavoidable and is expected to occur in the ordinary course of business operations.



Common examples of normal loss include:

- **Evaporation loss:** Loss of moisture or volatile components during processing or storage.
- **Shrinkage:** Reduction in volume or weight of raw materials or products during processing.
- **Leakage:** Loss of materials due to leaks or spills during handling or transportation.
- **Shortage:** Shortfall in production output due to factors such as defects or inefficiencies in the manufacturing process.

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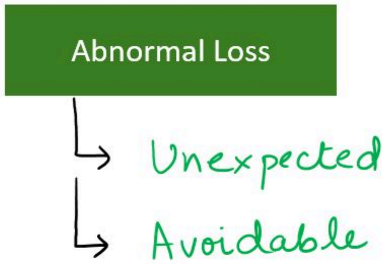
17. Loss

Abnormal loss refers to the loss that occurs unexpectedly or as a result of abnormal circumstances that are not inherent to the normal course of business operations.

Unlike normal losses, which are considered unavoidable and inherent to the production process, abnormal losses are avoidable and can be prevented with proper care, control, and management practices.



Common examples of abnormal losses include:

- **Loss by theft or burglary:** Unauthorized removal of assets or inventory by theft or burglary.
- **Loss by fire:** Destruction of assets or inventory due to accidental fires or arson.
- **Accidents in transit:** Damage or loss of goods during transportation due to accidents, collisions, or mishandling.
- **Loss due to unskilled labor force:** Damage or spoilage of products due to errors or mishandling by unskilled or inexperienced workers.

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18. Assets

Assets are essentially resources or valuable possessions owned by an individual, company, or organization.

Assets are items of value used by the business in its operations. For example, Super Bazar owns a fleet of trucks, which is used by it for delivering foodstuffs; the trucks, thus, provide economic benefit to the enterprise. This item will be shown on the asset side of the balance sheet of Super Bazaar.

Assets encompass anything tangible or intangible that holds value and can potentially generate future benefits.

Tangible assets include physical items like property, equipment, inventory, and cash. Intangible assets, on the other hand, lack a physical presence but still hold significant value. These might include intellectual property such as patents, trademarks, copyrights, and goodwill.

Assets under **Schedule III of the Companies Act 2013**, is classified into (i) Current Assets and (ii) Non-current Assets. They are defined as follows.

(i) **Current Assets** – An asset is a current asset if it satisfies *any one* of the following criteria:
(a) it is expected to be realised in or is intended for sale or consumption in the company's normal operating cycle; or
(b) it is held primarily for the purpose of being traded; or
(c) it is expected to be realised within 12 months after the reporting date; or
(d) it is Cash or Cash Equivalent unless it is restricted from being exchanged or used to settle a liability for at least 12 months after the reporting date.

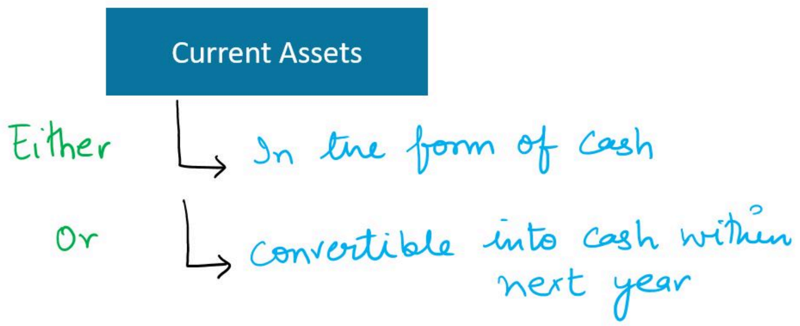
(ii) **Non-current Assets** - These are those assets which are not current assets.

Operating Cycle means the time between the acquisition of an asset for processing and its conversion into Cash and Cash Equivalents. If the operating cycle cannot be identified, it is taken to be a period of 12 months.

The key characteristic of assets is their capacity to provide economic benefits in the future. For instance, a company's machinery is an asset because it can be used to manufacture products that will generate revenue. Similarly, investments in stocks or bonds are assets because they can appreciate in value or provide dividends over time.

18. Assets

Current assets are a specific category of assets on a company's balance sheet that includes resources expected to be converted into cash or used up within a relatively short period, typically within one year. They represent assets that are either already in the form of cash or will be converted into cash or used up in the normal course of business operations within the next year.



Examples of current assets include:

Cash and Cash Equivalents: This includes physical currency, bank account balances, and short-term investments that are highly liquid and can be readily converted into cash.

Marketable Securities: These are investments in stocks, bonds, or other financial instruments that are easily traded on the market and can be converted into cash quickly.

Accounts Receivable: Thi refer to Amounts owed to the company by its customers for goods or services provided on credit. These are expected to be collected within a short period, typically within a few months.

Inventory: Inventory refer to Goods held for sale in the ordinary course of business. Inventory includes raw materials, work-in-progress, and finished goods that are expected to be sold or used up within the next year.

Prepaid Expenses: These include payments made in advance for goods or services that will be used or consumed in the future, such as prepaid rent, insurance premiums, or prepaid subscriptions.

Conditions for an asset to be classified as current asset

Further, an asset can be classified as current asset, if it satisfies any of the following conditions:

1. Expected realization in the operating cycle
The operating cycle of a company refers to the time it takes to convert cash into inventory, sell the inventory, and receive cash from customers. If an asset is expected to be converted into cash or used up in the company's normal operating cycle, typically within one year, it is classified as a current asset. For example, inventory held for sale or raw materials used in the production process would fall under this category.

2. Held primarily for trading purposes
Assets acquired with the primary intention of being traded for profit in the short term are classified as current assets. This includes securities such as stocks, bonds, or other financial instruments bought and sold for short-term gains.

3. Realization within 12 months
Any asset that is expected to be converted into cash or used up within 12 months after the reporting date is considered a current asset. This includes items like accounts receivable (amounts owed by customers), prepaid expenses (payments made in advance for goods or services), or short-term investments that mature within the next year.

4. Cash or cash equivalent
Cash equivalents are highly liquid assets that are easily convertible into cash and have a short maturity period, typically three months or less from the date of acquisition. They are considered to be as good as cash because they can be quickly converted into cash without significant risk of loss in value. Cash equivalents include bank accounts and some types of marketable securities such as commercial paper and short-term government bonds.

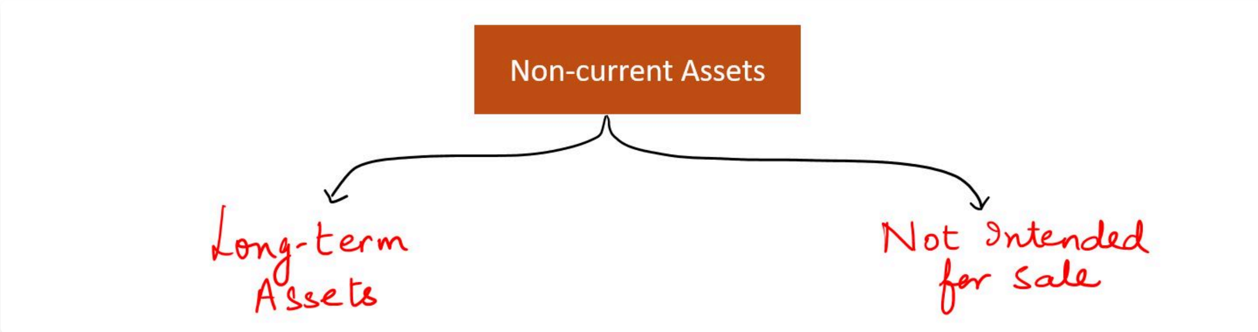
18. Assets

Non-current assets, also known as long-term assets or fixed assets, are resources owned by a company that are not intended for sale in the normal course of business. Instead, they are expected to provide economic benefits to the company over an extended period, typically exceeding one year. These assets are essential for the company's operations and are not held for the purpose of resale.

Non-current assets are categorized into 2 types:

1. **Tangible Assets**: These are physical items that can be touched and seen. Examples include buildings, machinery, vehicles, and equipment. They have a physical presence and are used in the day-to-day operations of the business.

2. **Intangible Assets**: These are non-physical assets that do not have a physical presence but have value. Examples include patents, trademarks, copyrights, and goodwill. They represent rights or advantages that can benefit the business over time but cannot be physically touched or seen.



Some of the common examples of non-current assets are as follows.

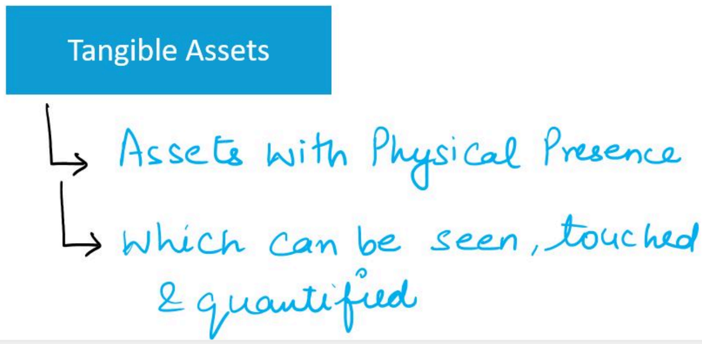
Property, Plant, and Equipment (PP&E): PP&E includes tangible assets such as land, buildings, machinery, equipment, vehicles, and furniture that are used in the production process or for administrative purposes. These assets are essential for the company's core operations and are expected to be utilized for many years.

Intangible Assets: Intangible assets lack physical substance but have value due to their intellectual or legal rights. Examples include patents, trademarks, copyrights, goodwill, and software. Intangible assets are often acquired through purchases, mergers, or internal development and contribute to the company's competitive advantage and future cash flows.

Investments: Non-current investments represent long-term holdings in other companies, subsidiaries, or joint ventures where the investing company has significant influence but does not control the operations. These investments may include equity securities, bonds, or other financial instruments held for strategic or financial purposes.

18. Assets

Tangible assets are assets that have a physical presence and can be seen, touched, and quantified. These assets are distinct from intangible assets, which lack physical substance and include items like intellectual property, patents, and trademarks.



Examples of tangible assets include:

- Real estate properties such as land, buildings, and warehouses
- Machinery and equipment used in manufacturing or production
- Vehicles used for transportation or delivery
- Furniture and fixtures in office spaces or retail stores.

Here are some key characteristics of tangible assets:

Physical Existence: Tangible assets have a physical form and can be observed and assessed using the senses. Examples include land, buildings, machinery, equipment, vehicles, furniture, inventory, and raw materials. These assets occupy space and have a measurable quantity or dimension.

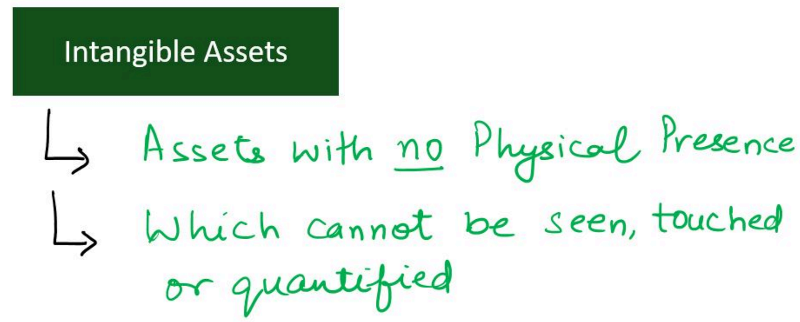
Visible and Touchable: Tangible assets can be visually inspected and physically touched. They provide a tangible representation of value and can be readily identified and assessed for their condition, quality, and usability. This tangible nature makes them easier to value and manage compared to intangible assets, which may be more abstract and difficult to quantify.

Used for Operations: Tangible assets are typically used in the day-to-day operations of a business to produce goods or services, store inventory, or facilitate administrative functions. For example, machinery and equipment are used in manufacturing processes, while buildings provide office space or production facilities. These assets contribute directly to the company's ability to generate revenue and achieve its objectives.

Subject to Depreciation: Tangible assets are subject to depreciation, which reflects the gradual loss in their value over time due to wear and tear, obsolescence, or physical deterioration. Depreciation expense is recognized on the company's financial statements to allocate the cost of the asset over its estimated useful life.

18. Assets

Intangible assets are assets that lack physical substance and cannot be seen or touched. While they do not have a tangible form, they hold economic value and contribute to a company's competitive advantage, revenue generation, and overall worth.



Examples of intangible assets include:

- Intellectual property rights such as patents, trademarks, copyrights, and trade secrets
- Brand names, logos, and slogans that distinguish products or services in the marketplace
- Goodwill arising from the acquisition of a business, representing the premium paid above the fair value of identifiable tangible and intangible assets

Here are some key characteristics of intangible assets:

Lack of Physical Substance: Intangible assets exist in the form of ideas, rights, or legal claims and do not have a physical manifestation. They cannot be touched, felt, or observed directly. Examples include intellectual property, brand reputation, customer relationships, and software.

Value Creation: Intangible assets play a crucial role in creating value for a company by enhancing its competitive position, brand recognition, and marketability. For example, a strong brand reputation can command higher prices for products or services and foster customer loyalty, leading to increased revenues and profitability.

Long-term Benefits: Intangible assets provide long-term benefits to a company, often extending beyond the current accounting period. While they may not generate immediate revenue, they contribute to future cash flows and sustainable growth. Examples include patents, trademarks, and copyrights, which provide exclusive rights to use or exploit intellectual property over a specified period.

Recognition and Valuation: Intangible assets are recognized on the company's balance sheet if they meet specific criteria for recognition, such as being separable, identifiable, and having measurable future economic benefits.

18. Assets

Wasting assets are those with a limited useful life that depreciate over time as they are used. These assets gradually lose their value or become obsolete as they are consumed, depleted, or wear out through regular use. These assets typically have a finite lifespan and are expected to be used up or disposed of within a specific timeframe.

This lifespan can vary depending on the nature of the asset and how it is utilized. Examples of wasting assets include natural resources, such as oil reserves or timber stands, which are depleted as they are extracted or harvested.

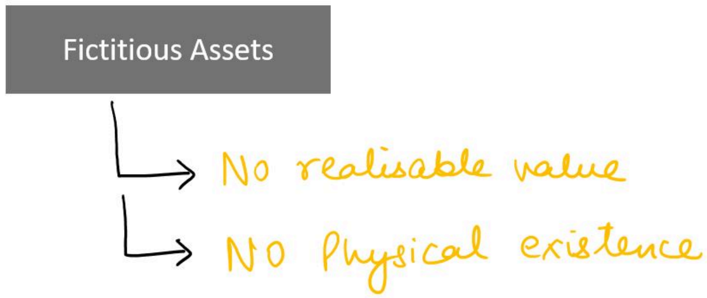
Wasting assets are subject to depreciation, which is the gradual decrease in their value over time due to wear and tear, obsolescence, or depletion.

Ultimately, wasting assets reach a point where they are no longer economically viable or useful. This could be due to complete depletion, physical deterioration, technological advancements rendering them obsolete, or changes in market demand. Once an asset becomes useless, it may need to be disposed of or replaced.

18. Assets

Fictitious assets refer to assets that don't have a tangible or physical existence but are still recorded on a company's balance sheet. These assets are not expected to provide any future benefit to the company, and their inclusion on the balance sheet is primarily for accounting purposes.

In other words, fictitious assets are items that look like assets on the balance sheet but cannot be turned into cash or used to generate income. They are often expenses or costs that have been paid in advance and don't have any real value in terms of cash



Few examples of fictitious assets are as follows.

Preliminary Expenses: These are expenses incurred during the setup phase of a business, such as incorporation costs, legal fees, or expenses related to market research. While these expenses are essential for starting a business, they don't represent tangible assets and can't be easily converted into cash. As a result, they are categorized as fictitious assets and are usually amortized over a period of time.

Discount on Issuance of Shares: When a company issues shares at a price higher than their face value, the excess amount is termed as a premium or discount. If the company issues shares at a discount, the difference between the face value and the issue price is recorded as a fictitious asset on the balance sheet. This amount is amortized over a period, usually against the company's profits.

Losses on Issue of Debentures: If a company incurs losses while issuing debentures, such as expenses related to their issuance or discounts offered to investors, these losses are treated as fictitious assets. They are shown on the balance sheet as a deferred expense and gradually charged off to the profit and loss account over the tenure of the debentures.

In each of these cases, the assets don't represent physical resources or future economic benefits in the same way as tangible assets like property or equipment. Instead, they represent expenditures or financial transactions that have already occurred but don't fit the definition of traditional assets.

19. Liabilities

Liabilities represent the amount of money or resources that a business owes to individuals, organizations, or other entities outside of the business. These external parties are often referred to as creditors or suppliers.

Liabilities may take various forms, including:

- **Accounts Payable:** Amounts owed to suppliers or vendors for goods or services purchased on credit.
- **Loans Payable:** Money borrowed from banks or financial institutions, which must be repaid with interest.
- **Accrued Expenses:** Expenses that have been incurred but not yet paid, such as salaries, rent, or utilities.
- **Notes Payable:** Promissory notes or written agreements to repay borrowed funds.
- **Deferred Revenue:** Payments received in advance for goods or services that have not yet been provided.
- **Other Liabilities:** Other financial obligations such as taxes payable, interest payable, or warranties and provisions.

Liabilities represent legally binding obligations that the business must fulfill according to contractual agreements, regulations, or customary business practices. Failure to meet these obligations can result in legal action, penalties, or damage to the business's reputation.

Liabilities represent sources of funding or financing for the business's operations and investments, alongside equity (owner's investment) and retained earnings.

> Liability under **Schedule III of the Companies Act 2013**, is classified into (i) Current Liabilities and (ii) Non-current Liabilities. They are defined as follows.
>
> (i) **Current Liabilities** - A liability is a current liability if it satisfies *any one* of the following criteria:
> (a) it is expected to be settled in the company's normal operating cycle; or
> (b) it is held primarily for the purpose of being traded; or
> (c) it is due to be settled within 12 months after the reporting date; or
> (d) the company does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date.
>
> (ii) **Non-current Liabilities** - These are those liabilities which are not current liabilities.
>
> **Operating Cycle** means the time between the acquisition of an asset for processing and its conversion into Cash and Cash Equivalents. If the operating cycle cannot be identified, it is taken to be a period of 12 months.

Liabilities can also be classified as current liabilities, non-current liabilities and contingent liabilities.

These are discussed next.

19. Liabilities

Current Liabilities, also referred to as short-term liabilities, are financial obligations or debts that a business must repay within a relatively short period, typically within one year or the operating cycle of the business, whichever is longer. These liabilities are due and payable in the near term, usually within 12 months from the date of the balance sheet.

Current liabilities encompass various types of obligations that require repayment or settlement within a short timeframe. Common examples include Accounts Payable, Short-term Loans, Accrued Expenses etc.

The defining characteristic of current liabilities is that they are due for repayment or settlement within a relatively short timeframe, typically within the next 12 months. This short-term nature distinguishes them from long-term liabilities, which have longer repayment periods extending beyond one year.

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19. Liabilities

Non-current Liabilities, also known as long-term liabilities, are financial obligations or debts that a business owes and are not due for repayment within the next 12 months or the operating cycle, whichever is longer. These liabilities have longer repayment periods, typically extending beyond one year from the date of the balance sheet.

Non-current liabilities encompass various types of long-term financial obligations that extend beyond the immediate future. Common examples include Long-term Loans, Bonds Payable, Deferred Tax Liabilities (i.e., tax obligations that will become due in future periods as a result of temporary differences between accounting and tax rules, etc.

The defining characteristic of non-current liabilities is that they are not due for repayment within the next 12 months or the operating cycle of the business, whichever is longer. Instead, they represent longer-term financial commitments that will be settled over an extended period.

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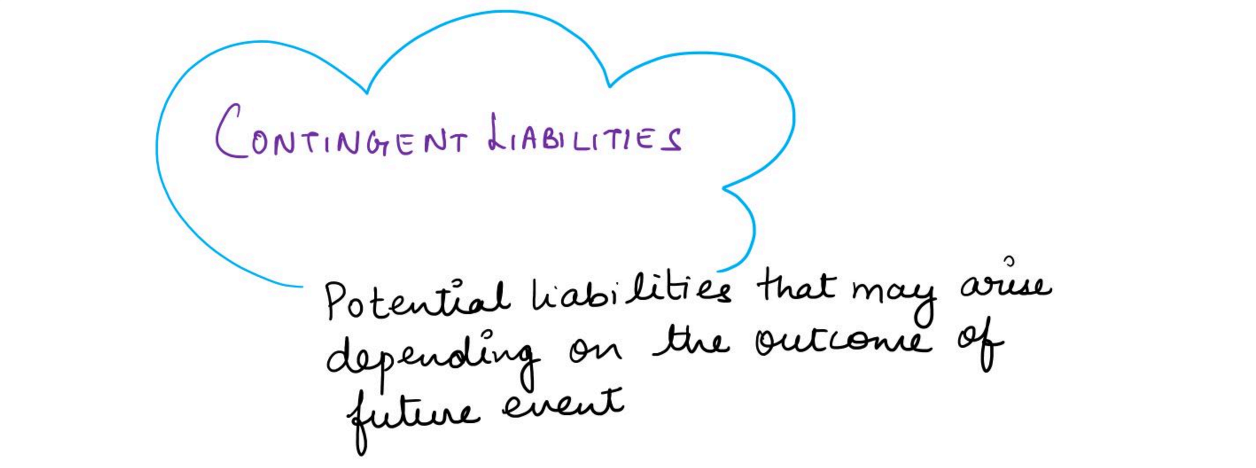
19. Liabilities

Contingent Liabilities are potential obligations or liabilities that may arise depending on the outcome of a future event. Unlike actual liabilities, which represent existing financial obligations, contingent liabilities are uncertain and contingent upon the occurrence or non-occurrence of specific future events.



Contingent liabilities arise from possible future events that are not entirely within the control of the company. These events may include legal disputes, pending lawsuits, warranty claims, product recalls, environmental liabilities, or guarantees provided to third parties.

The defining characteristic of contingent liabilities is their uncertainty. They represent potential financial obligations that may or may not materialize, depending on the outcome of the future event. As a result, they do not meet the criteria for recognition as actual liabilities on the balance sheet.

For example, Company XYZ is facing a lawsuit filed by a former employee who alleges wrongful termination and seeks damages for lost wages and emotional distress. The lawsuit is currently pending, and the outcome is uncertain. The lawsuit represents a contingent liability for Company XYZ because the financial obligation (potential payment of damages) depends on the outcome of the lawsuit. If the court rules in favor of the former employee, Company XYZ may be required to pay damages. However, if the court rules in favor of Company XYZ, the liability may not materialize.

Despite not being recognized as actual liabilities, contingent liabilities must be disclosed in the financial statements, typically in the *footnotes* accompanying the balance sheet. This disclosure provides transparency to investors, creditors, and other stakeholders regarding the potential risks and uncertainties facing the company.

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20. Net Worth

It represents the excess of total assets over total liabilities of a business. Technically, this amount is made available to be distributed to the owners in the event of closure of the business after payment of all liabilities. That is why it is also termed as Owner's Equity. A profit-making business will result in an increase in the owner's equity, whereas losses will reduce it.

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21. Book Value

Book value refers to the monetary amount at which an asset is recorded in the books of account. It is calculated by subtracting the accumulated depreciation from the original cost of the asset.

Book Value = Cost - Depreciation

For example, if a company purchases a piece of equipment for Rs. 10,000 and it depreciates by Rs. 2,000 over time, the book value of the equipment would be Rs. 8,000 (Rs. 10,000 - Rs. 2,000).

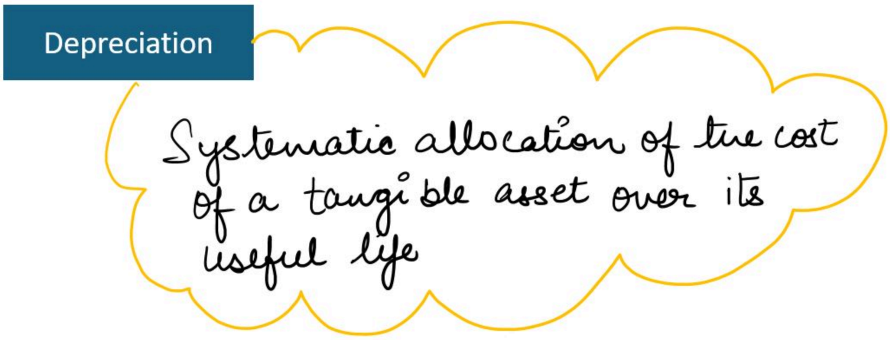
Book value represents the historical cost of the asset adjusted for its depreciation, rather than its current market value.

22. Depreciation

Let us understand the concept of 'Depreciation' by way of an illustration.

Imagine you buy a car. When you drive it, it gradually wears out over time. Depreciation is like acknowledging this wear and tear in your accounting books. Instead of saying the car loses all its value the moment you drive it off the lot, you spread out its cost over the years you expect it to be useful. This way, each year, a portion of the car's original value is recorded as an expense, reflecting its decreasing value as it gets older.

The term 'Depreciation' refers to the systematic allocation of the cost of a tangible asset over its useful life. This allocation is done to reflect the gradual reduction in the asset's value due to factors such as wear and tear, obsolescence, or time.



Depreciation is recorded as an expense in the income statement, reducing the asset's carrying value on the balance sheet over time. It is a non-cash expense, meaning no actual cash outflow occurs when depreciation is recorded; rather, it represents the gradual consumption of an asset's value during its usage in the business.

For example, imagine a company purchases a delivery truck for Rs. 50,000. The company estimates that the truck will be useful for delivering goods for 5 years before it becomes obsolete or needs replacement.

Using the straight-line depreciation method, the company spreads the cost of the truck evenly over its useful life.

So, each year, the company records Rs. 10,000 (Rs. 50,000 divided by 5 years) as depreciation expense on its income statement. This indicates that the truck's value decreases by Rs. 10,000 each year due to wear and tear, even though no cash actually leaves the company.

After the first year, the truck's carrying value on the balance sheet reduces from Rs. 50,000 to Rs. 40,000 (Rs. 50,000 - Rs. 10,000). This process continues each year until the truck's carrying value becomes zero at the end of its useful life.

23. Capital Reserve

Capital Reserve is a type of reserve that is created by a company out of its profits derived from sources other than its regular business operations. Unlike revenue reserves, which are created from profits generated from day-to-day business activities, capital reserves are created from profits earned through non-operating activities, such as the sale of fixed assets, revaluation of assets, or proceeds from the issuance of shares at a premium.

The primary purpose of creating a capital reserve is to set aside funds that can be used to finance long-term projects, investments, or capital expenditures in the future. By accumulating capital reserves, a company ensures that it has adequate resources to fund future growth initiatives without relying solely on external financing sources or diluting existing shareholders' equity.

Note that Capital reserves are not available for distribution as dividends to shareholders because they represent profits derived from non-operating activities and are reserved for specific purposes, such as future capital investments or write-offs of capital expenses. Only revenue reserves, which are generated from regular business operations, are available for dividend distribution.

24. General Reserve

A general reserve, also known as a general reserve fund or general reserve account, is a financial provision created by a company by retaining a portion of its profits for future needs or contingencies.

Unlike specific reserves, which are created for specific purposes such as expansion, research and development, or dividend equalization, a general reserve is established without any particular or earmarked purpose.

25. Investments

In accounting, the term 'investment' refers to the purchase of assets with the goal of generating income, capital appreciation, or both, over time. Investments can take various forms and are classified based on their nature, purpose, and holding period.

Some common types of investments are as follows.

Financial Investments
These include investments in financial instruments such as stocks, bonds, mutual funds, exchange-traded funds (ETFs), and other securities traded in financial markets. Financial investments are typically made with the expectation of earning returns through dividends, interest, or capital appreciation.

Real Estate Investments
Real estate investments involve the purchase of properties such as land, residential or commercial buildings, and other real estate assets. Investors may generate income through rental payments, lease agreements, or property appreciation.

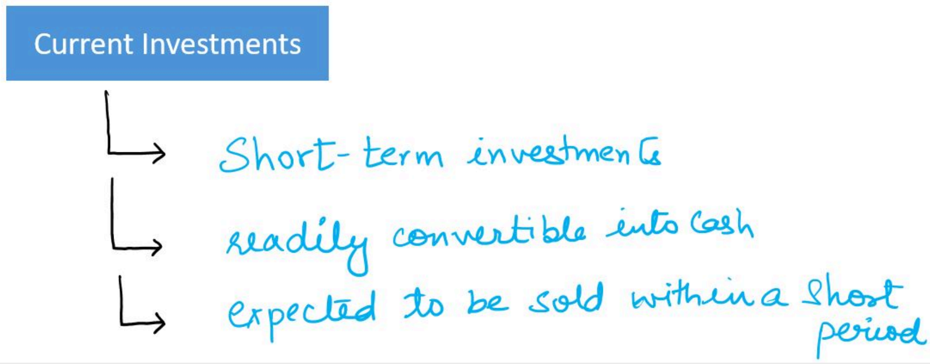
Business Investments
Business investments involve acquiring ownership stakes in other companies or businesses. This can include investments in equity securities (such as shares or stocks) of publicly traded or privately held companies, as well as investments in partnerships or joint ventures.

Fixed Asset Investments
Fixed asset investments refer to investments in long-term physical assets used in business operations, such as machinery, equipment, vehicles, and infrastructure. These investments are typically recorded on the balance sheet as property, plant, and equipment (PP&E) and are depreciated over their useful lives.

Intangible Asset Investments
Intangible asset investments include investments in non-physical assets such as patents, copyrights, trademarks, goodwill, and other intellectual property rights. These investments are recorded on the balance sheet and may be amortized or assessed for impairment over time.

25. Investments

Current investments, also known as short-term investments, are financial assets that are readily convertible into cash and are expected to be sold, redeemed, or otherwise disposed of within a short period, usually, not more than one year from the date of acquisition.



These investments are classified as current assets on the balance sheet because they are expected to be converted into cash or used to fund current operations within the short term.

Few examples of Current Investments are as follows.

Commercial Paper: Commercial paper is a type of short-term debt instrument issued by corporations to raise funds for short-term financing needs, such as meeting working capital requirements or financing inventory purchases.

Treasury Bills (T-Bills): Treasury bills are short-term government securities with maturities ranging from a few days to one year. T-Bills are considered highly liquid, making them attractive to investors seeking safety and liquidity.

Certificates of Deposit (CDs): Certificates of deposit are time deposits offered by banks and financial institutions with fixed terms ranging from a few weeks to several months or one year.

25. Investments

Non-current investments, also known as long-term investments, are financial assets that are not intended to be sold or otherwise disposed of in the near future, typically beyond the current accounting period. These investments are held for strategic purposes such as generating income, earning dividends, or capital appreciation over an extended period, generally exceeding one year from the date of acquisition.

Non-current investments are classified as non-current assets on the balance sheet because they are not expected to be converted into cash or used to fund current operations within the short term.

Examples of Non-Current Investments are as follows.

Fixed Deposits: Fixed deposits (FDs) are financial instruments offered by banks and financial institutions where investors deposit funds for a fixed period, usually ranging from several months to several years.

Equity Investments: Equity investments represent ownership stakes in other companies or entities. These investments can include shares or stocks of publicly traded companies, as well as equity interests in privately held companies, partnerships, or joint ventures.

Bonds and Debentures: Bonds and debentures are debt securities issued by governments, corporations, or other entities to raise funds for financing projects or operations. These investments have fixed maturity dates ranging from several years to decades and offer periodic interest payments to investors.

26. Goodwill

Let us the understand the meaning of Goodwill with the help of an illustration.

Imagine you're opening a lemonade stand. Now, let's say your lemonade stand becomes really popular because you always use fresh ingredients, your service is friendly, and your stand has a nice, welcoming atmosphere. People start coming to your stand not just for the lemonade but because they know they'll have a great experience there.

Now, if you decide to sell your lemonade stand, you might find that buyers are willing to pay more than just the value of the stand and the equipment. That extra amount they're willing to pay is what we call goodwill. It's basically the value of your business's reputation, customer loyalty, and the goodwill you've built up over time.

So, in accounting terms, goodwill is like an invisible asset on your balance sheet. It represents the extra value your business has beyond its physical assets, like the stand and equipment. It's a way of recognizing the value of your hard work, good service, and positive reputation in generating extra profit for the business.

Mathematically, the formula for calculating goodwill is:

$$\text{Goodwill} = \text{Purchase Consideration} - \text{Net Assets}$$

where,

$$\text{Net Assets} = \text{All Assets} - [\text{Fictitious Assets} + \text{Existing Goodwill} + \text{Non-trade Investments}] - \text{Liabilities}$$

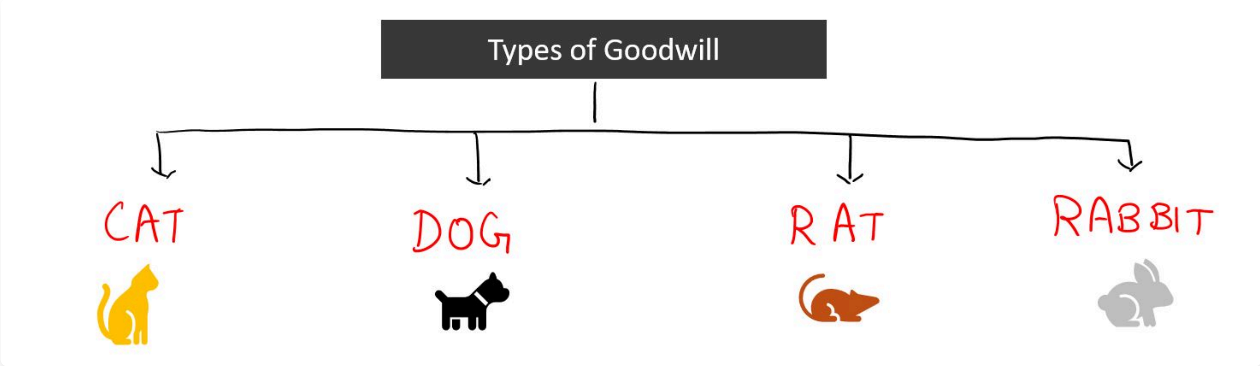
To illustrate, let's say Company A acquires Company B for Rs. 10 Lakh. After conducting a thorough assessment, Company A determines that Company B's net assets (assets minus liabilities) are valued at Rs. 7 Lakh. To calculate goodwill, we would subtract the net assets of Company B from the purchase consideration:

$$\begin{aligned}\text{Goodwill} &= \text{Purchase Consideration} - \text{Net Assets} \\ &= \text{Rs. } 10 \text{ Lakh} - \text{Rs. } 7 \text{ Lakh} \\ &= \text{Rs. } 3 \text{ Lakh}\end{aligned}$$

So, in this example, the goodwill arising from the acquisition of Company B by Company A is Rs. 3 Lakh. This represents the premium paid by Company A above the fair value of Company B's identifiable net assets.

Note that Goodwill is recorded on the books when one company buys another and pays more than the fair value of the identifiable assets acquired minus any liabilities assumed. This helps ensure a true and fair representation of the value of the purchase and the financial health of the acquiring company.

26. Goodwill



The Goodwill can be classified as follows:

Cat Goodwill

A special feature of a cat is that it remains at one place and does not change its living place from time to time. Goodwill of some businesses is like cat because it depends on the place of business and it does not change due to change in ownership.

Dog Goodwill

A special feature of dogs is that they are attached to the persons. Dog has more affection for its owner than the place. The faithful dog is attached to the person rather than to the place, therefore, he will follow the outgoing owner if he does not go too far. There are some businesses whose goodwill depends on the owner.

Rat Goodwill

A special feature of a rat is that it moves from place to place. The rat has no attachments and is purely casual. If the goodwill of a business often changes, it is known as Rat Goodwill. Such goodwill is valueless.

Rabbit Goodwill

A special feature of rabbit is that it remains confine to a patch and do not like to venture far away. Similarly, the rabbit consumers will only pick a product, if it is available in their acceptable radius.

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27. Goods

Goods refer to items purchased by a business for the purpose of sale at a profit, for further processing, or for use in the manufacturing of other goods. These commodities constitute the core products or inventory that the business deals with.

For example, furniture would be considered goods for a business specializing in buying or selling furniture, as it forms the primary inventory for that business. However, for a business dealing in stationery or a different line of products, furniture would be classified as an asset rather than goods, as it is not the primary product sold or processed by that business.

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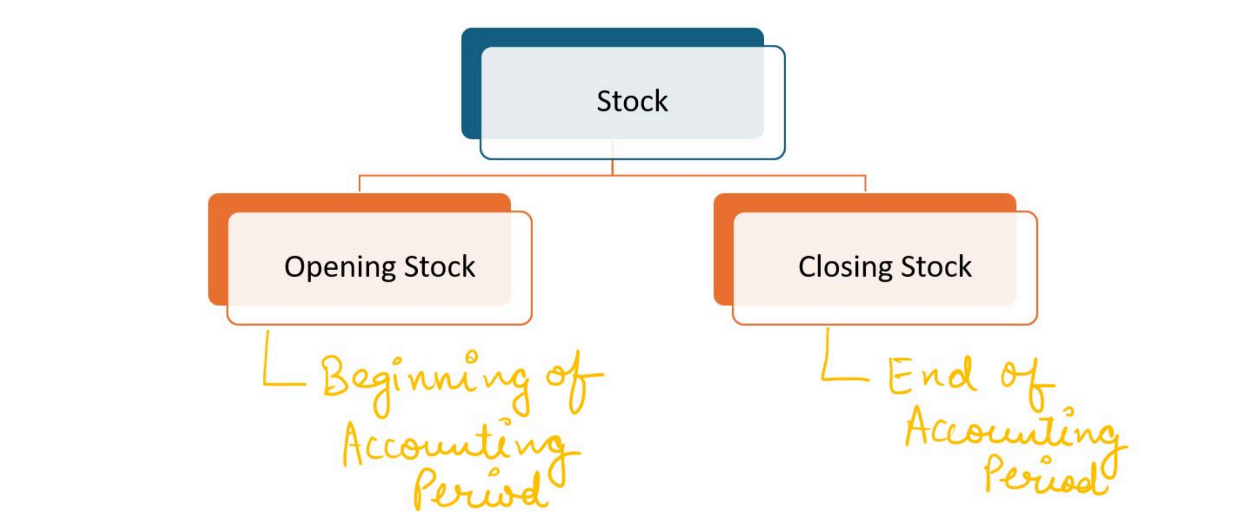
28. Stock or Inventory

Stock, also known as inventory, represents the current assets held by an enterprise for sale in the normal course of business operations or for use in the production of goods intended for sale. It includes raw materials, work-in-progress, and finished goods.



Stock can be categorized into two main types, i.e., opening stock and closing stock.

Opening Stock is the stock-in-hand in the beginning of the accounting year. In other words, it is stock-in-hand at the end of the previous accounting year.

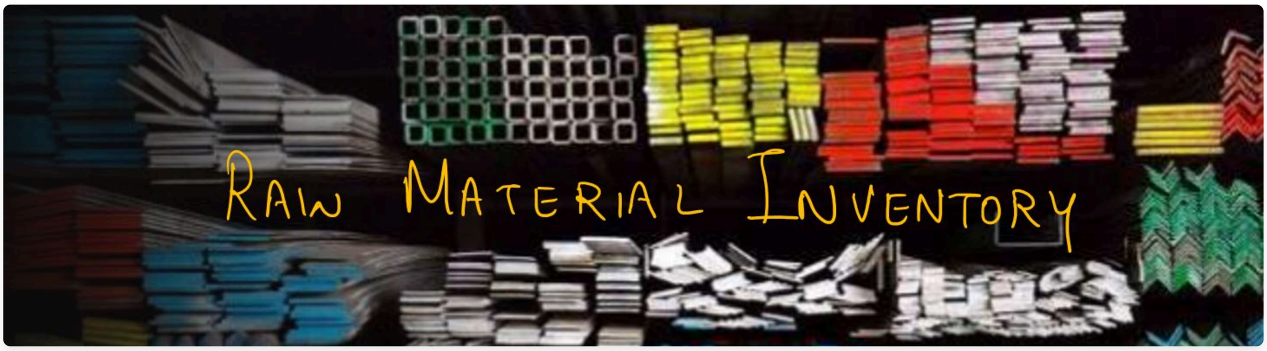
Closing Stock is the stock-in-hand at the end of the current accounting period.

Stock or Inventory may be of the following kinds:

1. Stock of Goods
2. Stock of Raw Material
3. Work-in-Progress

These are discussed next.

28. Stock or Inventory



Stock or inventory of raw material refers to the quantity of unprocessed materials held by a business for use in the manufacturing process. These raw materials are essential inputs required to produce finished goods.

For example, stock of lumber held by a furniture manufacturing company is the unprocessed material used to craft furniture pieces such as tables, chairs, and cabinets. It represents the essential input required for the production process, and its valuation would be determined based on the lower of cost or net realizable value, ensuring accurate financial reporting and asset valuation.

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28. Stock or Inventory

Work-in-progress (WIP) refers to inventory items that are in the process of being transformed from raw materials into finished goods but are not yet complete. These are partly finished goods that are undergoing various stages of production within the manufacturing process.

The valuation of work-in-progress includes the aggregate costs incurred during the production process, which typically consist of the cost of raw materials used, the cost of labor, and other production costs such as overhead expenses (e.g., power, fuel, utilities).

By valuing work-in-progress at its aggregate cost, businesses can accurately track the value of inventory as it progresses through the production cycle and determine its contribution to the overall cost of goods sold.

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28. Stock or Inventory

Stock of Finished Goods refers to the inventory of products that have been fully manufactured or processed and are ready for sale but remain unsold at the end of the accounting period.

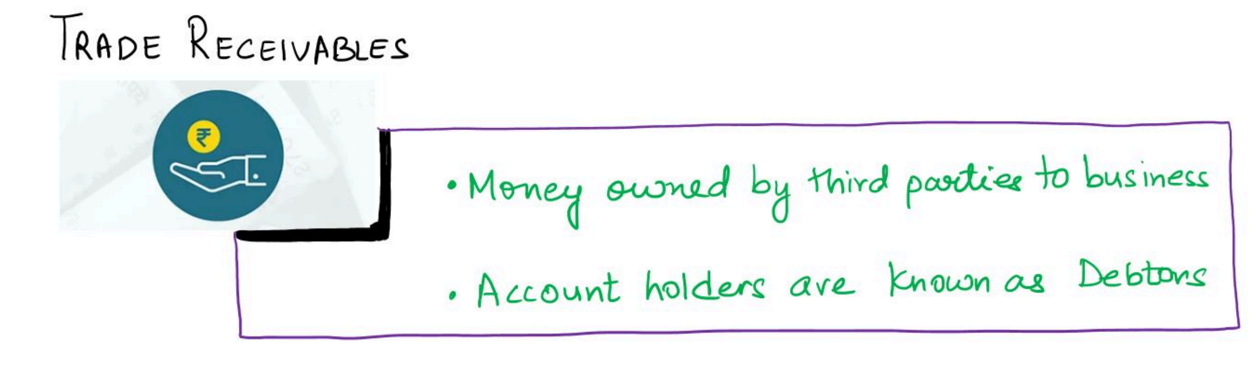
In the context of a trading concern, stock of finished goods comprises unsold merchandise or products that the business purchases for resale to customers. For a manufacturing concern, inventory includes processed goods that have been manufactured or assembled by the business and are intended for sale to customers.

The primary purpose of maintaining stock or inventory is to meet customer demand and facilitate sales. By having sufficient quantities of goods on hand, businesses can fulfill orders promptly, minimize stockouts, and ensure smooth operations.

Stock or inventory is recorded as an asset on the balance sheet of a business and is typically valued at the lower of cost or market value.

29. Trade Receivables

Trade receivables, as defined by the Companies Act of 2013, represent the money owed to a business for goods sold or services rendered in the ordinary course of its operations. In simpler terms, it is the amount a company expects to receive from its customers for products sold or services provided on credit.



When a business sells goods or services on credit, the customers who owe money to the business are referred to as **debtors**. In some cases, these debtors may accept bills of exchange drawn by the business, which then become part of **bills receivable**.

Thus, Bills Receivable refers to the written promises that a business expects to receive payment for at a future date. It represents the amount of money owed to the business by its customers, usually in the form of promissory notes or bills of exchange. For example, if a customer buys goods on credit and agrees to pay by a certain date, the document representing that agreement is a bill receivable.

The total sum of all outstanding amounts owed by customers, whether in the form of debtors or bills receivable, is collectively termed as receivables.

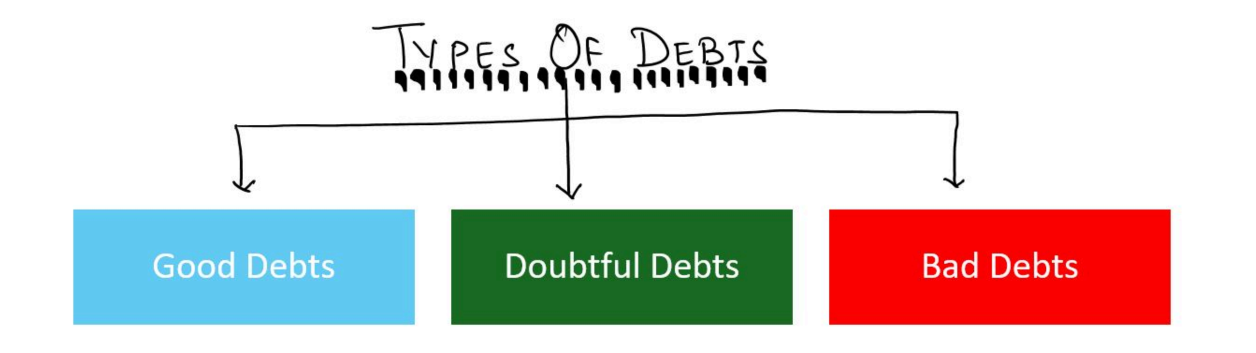
Note that a bill of exchange is a financial instrument used in trade transactions. It is essentially a written order by one party (the drawer) to another party (the drawee) to pay a certain sum of money to a third party (the payee) at a specified future date. The bill of exchange contains details such as the amount of money to be paid, the date on which the payment is due (known as the maturity date), and any conditions or instructions regarding the payment.

Since receivables are assets that are expected to be converted into cash within a year, they are categorized as current assets on the balance sheet. This means they are listed under assets and are shown as part of the company's total assets. The presence of receivables on the balance sheet indicates the amount of money the company expects to receive from its customers in the near future.

29. Trade Receivables

Debtors, also known as accounts receivable or trade debtors, represent the total amount of money owed to a business by its customers for goods sold on credit, services rendered, or other contractual obligations. In essence, debtors are individuals or entities who have purchased goods or services from the business but have yet to make full payment.

For example, if a customer named Mahesh buys goods worth Rs. 20,000 on credit, he becomes a debtor of the business until he settles the full payment. These outstanding amounts owed by customers are typically listed as assets on the balance sheet under the category of debtors.



Types of Debts

Debtors can be further categorized based on the likelihood of recovery:

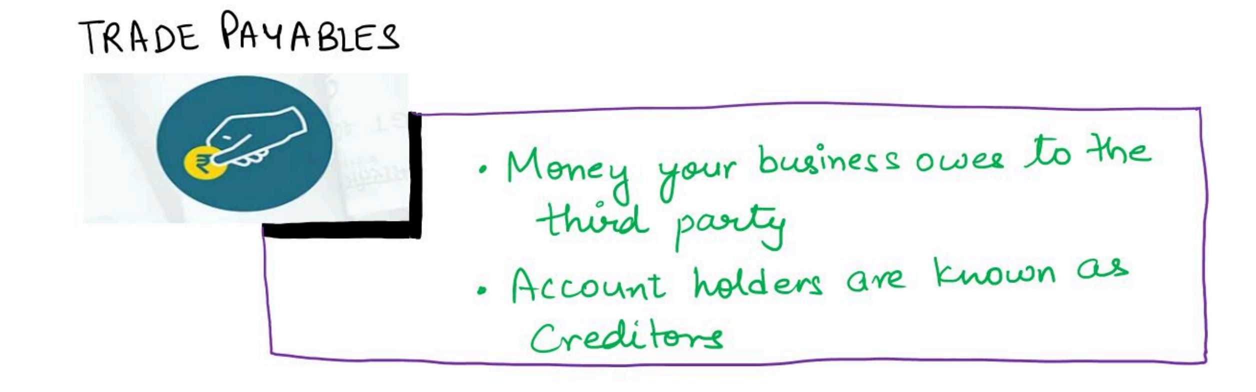
1. Good Debts
These are debts that are highly likely to be realized. Customers who have a strong history of timely payments and financial stability typically fall into this category.

2. Doubtful Debts
These are debts where there is uncertainty regarding their realization. This uncertainty may arise due to various factors such as financial difficulties faced by the debtor or a history of delayed payments.

3. Bad Debts
These are debts that are unlikely or impossible to be recovered. This could be due to customers defaulting on payments, declaring bankruptcy, or other reasons indicating non-recovery.

30. Trade Payables

Trade payables, as defined by the Companies Act of 2013, represent the total amount of money that a business owes to its suppliers or vendors for goods purchased and services received in the ordinary course of its operations.



In simpler terms, it is the amount a company is obligated to pay to external parties for products bought or services utilized on credit terms.

When a business purchases goods or services on credit, the entities from which the purchases are made are termed as **creditors**. In some instances, the business may accept bills of exchange drawn by certain creditors, which then become part of bills payable. The collective sum of all outstanding amounts owed to creditors, whether in the form of direct credit purchases or bills payable, is known as **trade payables**.

Thus, **Bills Payable** refers to the written promises the business must pay to its creditors at a future date. It represents the amount the business owes to others, such as suppliers or lenders. For instance, if a business purchases goods on credit and agrees to pay by a certain date, the document representing that obligation is a bill payable.

Trade payables are listed on the liabilities side of the balance sheet, indicating the obligations the company has to external parties. This shows the total amount the business needs to pay to its suppliers or vendors in the near future.

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30. Trade Payables

Creditors are individuals or entities to whom a business owes money for goods purchased or services received on credit terms. When a business buys goods or services but hasn't yet paid for them, the entities from which the purchases were made become creditors.

When a business purchases goods or services but defers the payment for a later date, it's essentially buying on credit. This means the business is promising to pay the amount owed at a future time.

The entities from which the business made purchases and to whom it owes money are termed as creditors. These could be suppliers, vendors, service providers, or any other parties that extended credit to the business.

Creditors are listed as liabilities on the balance sheet since they represent obligations that the business needs to settle in the future.

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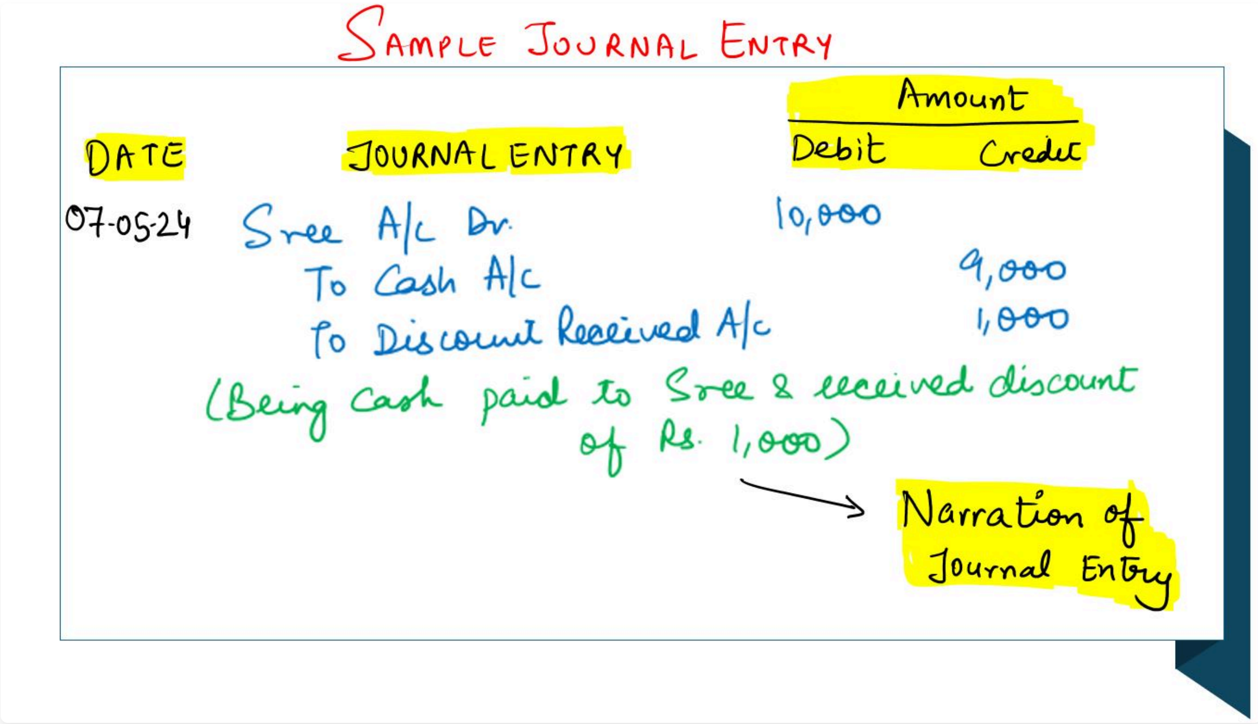
31. Entry or Journal Entry

When a business transaction or event occurs, it needs to be documented and recorded in the company's accounting records. The process of recording this information is called making an entry.



Each entry includes details such as the date of the transaction, the accounts involved, the amounts debited and credited, and a brief description of the transaction. These entries are usually made in a journal or an accounting software system.

32. Books of Account

In accounting, 'books of accounts' refer to the formal records where financial transactions of a business are systematically and chronologically recorded. These records serve as the foundation for preparing financial statements and analyzing the financial health of the business.

> As per Companies Act, 2013, the Books of account includes records maintained in respect of—
> (i) all sums of money received and expended by a company and matters in relation to which the receipts and expenditure take place;
> (ii) all sales and purchases of goods and services by the company;
> (iii) the assets and liabilities of the company; and
> (iv) the items of cost for certain class of companies engaged in the production of prescribed goods or providing prescribed services.

The term 'books of accounts' can encompass various types of ledgers and subsidiary records, including:

General Ledger

This is the primary ledger where all financial transactions are recorded. It typically includes accounts such as assets, liabilities, equity, revenue, and expenses. Entries in the general ledger are usually summarized from subsidiary ledgers or journals.

Subsidiary Ledgers

These are detailed records for specific accounts, such as accounts receivable, accounts payable, inventory, and fixed assets. Subsidiary ledgers provide more detailed information than the general ledger, allowing for better tracking and management of individual transactions.

Journals

Journals are used to initially record financial transactions before they are transferred to the general ledger. Common types of journals include the sales journal, purchases journal, cash receipts journal, and cash disbursements journal.

Trial Balance

A trial balance is a statement that lists all the accounts from the general ledger along with their respective debit or credit balances. It helps ensure that total debits equal total credits, providing a preliminary check on the accuracy of the recorded transactions.

Financial Statements

While not technically part of the books of accounts, financial statements like the balance sheet, income statement, and cash flow statement are prepared using the information recorded in the books of accounts. These statements provide a snapshot of the financial position and performance of the business.

33. Capital Loss

A capital loss occurs when the value of a capital asset decreases, leading to a loss in its overall worth.

Capital assets include investments such as stocks, bonds, real estate properties, and other assets held for long-term use or investment purposes.

The value of capital assets can fluctuate due to various factors, including market conditions, economic trends, and changes in demand or supply. When the value of a capital asset decreases from its original purchase price, it incurs a capital loss.

However, this loss is not considered realized until the asset is sold for a price lower than its original purchase price. Until the asset is sold, the decrease in value is often referred to as an unrealized loss or paper loss.

For example, suppose an investor purchases shares of a company for Rs. 1,000. If the market value of the shares subsequently declines to Rs. 800, the investor has experienced a capital loss of Rs. 200. However, this loss is not realized until the investor decides to sell the shares at the decreased market value of Rs. 800.

1. Introduction

Accounting serves as the language of business, allowing organizations to communicate their financial health and performance to various stakeholders. The financial statements prepared by accountants play a crucial role in conveying this information to stakeholders, aiding them in making informed decisions.

To ensure effective communication and comparability, it's essential that financial statements are prepared uniformly across different organizations. Imagine if every company had its own way of presenting financial information; it would be chaotic and difficult for stakeholders to understand and compare.

Consistency is also vital. Financial statements should maintain a consistent format and method of presentation over time. This consistency allows stakeholders to track changes in a company's financial position and performance accurately.

If accountants were to adopt their own individual methods and practices for recording financial transactions, it would lead to confusion and undermine the usefulness of financial statements. Standardized accounting principles and practices help mitigate this risk, ensuring that financial information is reliable, comparable, and useful for decision-making purposes.

To ensure consistency and reduce confusion, accountants follow a structured approach known as Generally Accepted Accounting Principles (GAAP).

Generally Accepted Accounting Principles (GAAP) refers to the rules or guidelines adopted for recording and reporting of business transactions, in order to bring uniformity in the preparation and the presentation of financial statements. **These rules, also referred to as concepts, conventions, postulates, or principles, assumptions or modifying principles are part of the conceptual framework within which accounting operates.** They help maintain uniformity and standardize financial reporting practices across different organizations and industries. So, when we talk about GAAP, we're essentially referring to the agreed-upon standards and procedures that guide how financial information is recorded, summarized, and communicated.

For example, one of the important rule is to record all transactions on the basis of historical cost, which is verifiable from the documents such as cash receipt for the money paid. This brings in objectivity in the process of recording and makes the accounting statements more acceptable to various users.

GAAPs, or Generally Accepted Accounting Principles, are like the backbone of the accounting world. They're essential for the entire accounting system to function smoothly. Think of them as the fundamental rules that shape how financial reports are created.

These principles act as guidelines, setting the boundaries and rules within which accounting reports are prepared. They're the foundation upon which the entire accounting system is built.

In addition to GAAPs, accountants also follow various accounting standards set by regulatory authorities. These standards help standardize accounting practices, ensuring consistency and reliability in financial reporting, especially in specific situations.

Together, these conceptual frameworks, including GAAPs and accounting standards, form the theoretical basis of accounting. Internationally, many countries adopt the International Financial Reporting Standards (IFRS) framework to achieve global standardization. However, countries may also have their own set of GAAPs and related frameworks. For instance, in India, companies are required to follow the Accounting Standards (AS) or Indian Accounting Standards (Ind-AS) frameworks as applicable.

2. Accounting concepts, conventions and assumptions

Accounting principles are the fundamental guidelines and rules that govern the practice of accounting. These principles provide a framework for recording, measuring, and reporting financial transactions consistently and accurately. They ensure that financial statements are prepared in a standardized manner, allowing for comparability and transparency across different companies and industries.

Accounting Concepts	Accounting Conventions	Fundamental Accounting Assumptions
1. Business Entity Concept	1. Convention of Conservatism	1. Going Concern Assumption
2. Dual Aspect Concept	2. Convention of Consistency	2. Consistency Assumption
3. Cost Concept	3. Convention of Full disclosure	3. Accrual Assumption
4. Money Measurement Concept	4. Convention of Materiality	
5. Accounting Period Concept		
6. Revenue Recognition or Realization Concept		
7. Matching Concept		
8. Verifiable Objective Concept		

The Generally Accepted Accounting Principles have evolved over a long period of time on the basis of past experiences, usages or customs, statements by individuals and professional bodies and regulations by government agencies and have general acceptability among most accounting professionals. However, the principles of accounting are not static in nature. These are constantly influenced by changes in the legal, social and economic environment as well as the needs of the users.

These principles are also referred as concepts and conventions.

Accounting concepts are fundamental ideas that guide the preparation and presentation of financial statements. These concepts provide a framework for recording and interpreting financial transactions.

For example, one of the accounting concept is Entity Concept, which suggests that the business should be treated as a separate entity from its owners. It means that business transactions are recorded separately from personal transactions of the owners.

Similarly, according to Dual Aspect Concept of accounting, every transaction has two aspects - a debit and a credit - which are recorded in at least two accounts, maintaining the balance in the accounting equation (Assets = Liabilities + Equity).

Accounting conventions are customs or traditions that have evolved over time and are generally accepted as appropriate for financial reporting. These conventions help in dealing with practical issues that arise in the preparation of financial statements.

For example, the Conservatism convention advises accountants to anticipate losses but not gains. In other words, assets and income should not be overstated, while liabilities and expenses should not be understated.

The Convention of Consistency suggests that accounting methods and practices should be consistent from one period to another, ensuring comparability between financial statements over time.

Apart from accounting concepts and accounting conventions, there are **fundamental accounting assumptions**, which are being followed as per Accounting Standard 1 on Disclosure of Accounting Policies.

The fundamental assumptions of accounting form the basis for how financial statements are created and shared. Although they're usually not directly mentioned, we assume that these principles are being followed in accounting practices. However, if any of these assumptions are ignored, it's important to disclose this to users of the financial statements to make them aware of any deviations from these fundamental principles.

Note that from the practicability view point, it is observed that the various terms such as principles, postulates, conventions, modifying principles, assumptions, etc. have been used inter-changeably.

Note that Accounting Assumptions are foundational rules assumed to be true for preparing financial statements, while **Accounting Conventions** are practices that guide the application of these assumptions in specific situations.

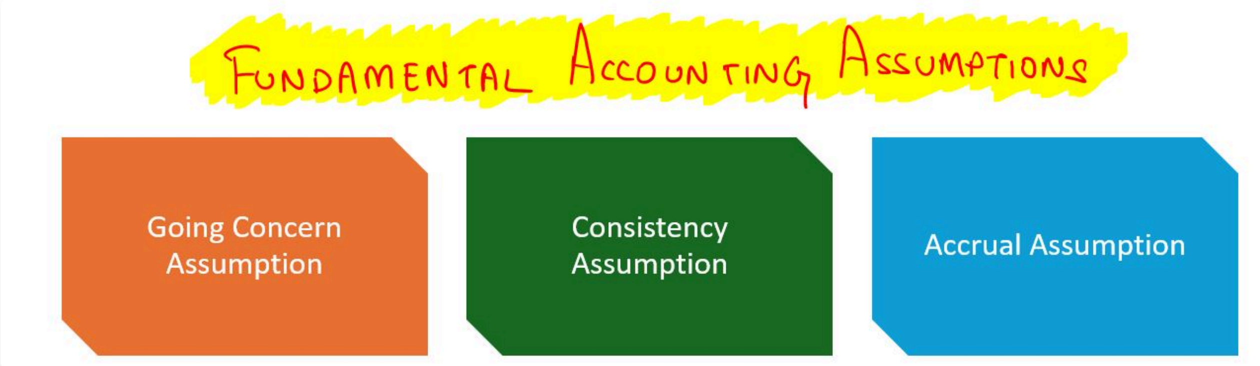
These accounting concepts, conventions and fundamental assumptions are discussed next.

3. Fundamental Accounting Assumptions

Fundamental Accounting Assumptions are those assumptions which are assumed to be followed even if nothing has been written about following such assumptions in preparation of the financial statements.

To understand, imagine you are building a house. Before you start, you have some basic assumptions: the ground is solid, the weather will be relatively stable, and the materials you are using are of good quality. These assumptions help you plan and build the house.

Similarly, in accounting, there are fundamental assumptions that everyone agrees on, even if they're not explicitly stated every time. These assumptions provide a foundation for preparing financial statements, just like the assumptions about the ground and weather provide a foundation for building a house.



According to Accounting Standard 1 on 'Disclosure of Accounting Policies, there are 3 fundamental accounting assumptions:

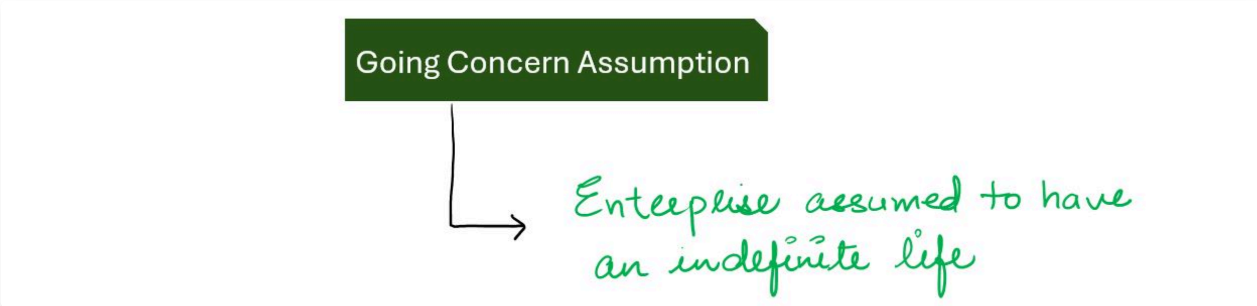
1. Going Concern Assumption
2. Consistency Assumption
3. Accrual Assumption

These are discussed next.

3. Fundamental Accounting Assumptions

According to Going concern assumption an enterprise has an indefinite life or existence. It is assumed that the business does not have an intention to liquidate or to scale down its operations significantly. The financial statements are usually prepared on the assumption that the enterprise is a going concern and will continue in operation for the foreseeable future.

This is an important assumption of accounting as it provides the very basis for showing the value of assets in the balance sheet.



An asset may be defined as a bundle of services. When we purchase an asset, for example, a personal computer, for a sum of Rs. 60,000, what we are buying really is the services of the computer that we shall be getting over its estimated life span, say 5 years. It will not be fair to charge the whole amount of Rs. 60,000, from the revenue of the year in which the asset is purchased. Instead, that part of the asset which has been consumed or used during a period should be charged from the revenue of that period.

The assumption regarding continuity of business allows us to charge from the revenues of a period only that part of the asset which has been consumed or used to earn that revenue in that period and carry forward the remaining amount to the next years, over the estimated life of the asset. Thus, we may charge Rs. 12,000 every year for 5 years from the profit and loss account. In case the continuity assumption is not there, the whole cost (Rs. 60,000 in the present example) will need to be charged from the revenue of the year in which the asset was purchased.

Applicability of Going Concern Assumption

The applicability of Going Concern Assumption is discussed below.

1. Distinguishing between Capital Expenditure and Revenue Expenditure

Capital Expenditure are expenditures incurred for acquiring or improving long-term assets, such as property, plant, and equipment, which are expected to benefit the business for multiple accounting periods. Under the going concern assumption, businesses can justify capital expenditures by considering the long-term benefits they provide to the ongoing operations of the entity.

Revenue Expenditure are expenditures incurred for maintaining the day-to-day operations of the business, such as salaries, utilities, and office supplies. These expenditures are typically treated as expenses in the period they are incurred since they are expected to generate benefits only in the current accounting period. The going concern assumption helps distinguish between these two types of expenditures by focusing on their impact on the ongoing operations of the entity over time.

2. Classifying Assets and Liabilities

Current Assets and Liabilities are assets and liabilities that are expected to be realized or settled within the normal operating cycle of the business, usually within one year. Examples of current assets include cash, accounts receivable, and inventory, while examples of current liabilities include accounts payable and short-term debt. The going concern assumption helps in classifying these items based on their expected timing of realization or settlement within the ongoing operations of the entity.

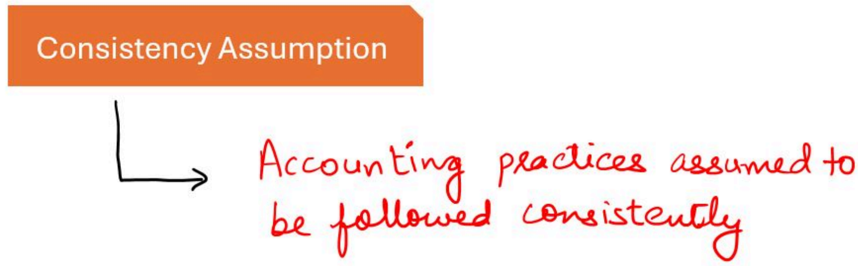
Non-Current Assets and Liabilities are assets and liabilities that are not expected to be realized or settled within the normal operating cycle of the business, typically beyond one year. Examples of non-current assets include long-term investments, property, plant, and equipment, while examples of non-current liabilities include long-term loans and deferred tax liabilities. The going concern assumption aids in classifying these items based on their long-term impact on the ongoing operations of the entity.

3. Fundamental Accounting Assumptions

The consistency assumption in accounting emphasizes that once accounting practices are chosen and adopted, they should be consistently applied from year to year. This ensures that the financial performance of the business can be meaningfully studied over several years, and it facilitates comparability of financial statements over a period of time as well as with the working of other enterprises. Thus, both **inter-firm** and **inter-period comparisons** are required to be made.

This can be possible only when accounting policies and practices followed by enterprises are uniform and are consistent over the period of time.

However, this assumption doesn't imply that accounting practices cannot be changed. When a change in accounting policy is deemed necessary, it should be fully disclosed in the financial statements. This disclosure includes explaining the reasons for the change and detailing its effects on the income statement and balance sheet. This transparency ensures that stakeholders are informed about the change and can properly assess its impact on the financial position and performance of the enterprise.



For example, ABC Corporation consistently uses the straight-line depreciation method to depreciate its assets every year. This ensures that the depreciation expense is spread evenly over the useful life of the assets, allowing for easy comparison of financial statements across different periods. If the company decides to switch to the double-declining balance method for more accurate depreciation calculations, it must disclose this change along with its impact on financial statements, maintaining transparency and adhering to the consistency assumption.

An enterprise may need to change its accounting policy under certain circumstances:

1. **To comply with Accounting Standards**: If there are changes in accounting standards issued by regulatory bodies, the enterprise may need to adjust its accounting practices to align with these standards.
2. **To comply with legal requirements**: Changes in laws or regulations may necessitate adjustments to accounting policies to ensure compliance with legal provisions.
3. T**o provide a true and fair view**: If circumstances change in such a way that the current accounting method no longer accurately reflects the financial position or performance of the enterprise, a new method may be adopted to provide a more accurate picture of its affairs.

Applicability of Consistency Assumption

The consistency assumption in accounting is applicable in various ways, but one significant aspect is its role in aiding management decision-making through the ability to compare financial information across different periods.

3. Fundamental Accounting Assumptions

As per this assumption, all revenues and costs are recognized when they are earned or incurred, i.e., the effects of transactions and events are recognised on mercantile basis (Accrual basis of accounting is also known as Mercantile system of accounting).

In other words, the **accrual concept** means that revenue is recorded when sales are made or services are provided, regardless of whether the cash has been received. Similarly, expenses are recorded in the period in which they contribute to generating revenue, even if the cash has not yet been paid.

This concept ensures that income and expenses are matched to the correct accounting period, which is why it's often referred to as the **matching concept**. It provides a more accurate picture of a company's financial performance by aligning revenues with the expenses incurred to earn them, rather than relying solely on the timing of cash flows.

Accrual Assumption

Revenues and Costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in financial statements of the periods to which they relate

Financial statements are prepared on accrual basis, i.e., it informs users not only of the past events involving the payment and receipt of cash but also of obligations to pay cash in future and of resources that represent cash to be received in future. It is immaterial, whether the cash is received or paid at the time of transaction or on a later date.

For example, a company provides services in December but receives payment in January; the revenue is recorded in December.

Similarly, in case of Expenses, a business uses electricity in December but pays the bill in January; the expense is recorded in December.

Applicability of Accrual Assumption

The accrual assumption in accounting is highly applicable and beneficial for several reasons:

Recording all Transactions: By recording all transactions relevant to an accounting period, regardless of whether they involve cash or credit, the accrual assumption ensures that financial statements accurately reflect the financial activities of the business during that period. This comprehensive recording provides a more complete picture of the company's financial performance and position.

Matching Revenue and Expenses: The accrual assumption allows for the accurate matching of revenue earned and expenses incurred with the accounting period to which they relate. This matching principle ensures that revenue is recognized when it is earned, regardless of when the cash is received, and expenses are recognized when they are incurred, regardless of when the cash is paid. As a result, financial statements reflect the true profitability and financial health of the business for the period.

Facilitating Measurement of Income and Identification of Assets and Liabilities: By accurately matching revenue and expenses to specific accounting periods, the accrual assumption facilitates the measurement of income and the identification of assets and liabilities. This helps stakeholders, such as investors and creditors, understand the financial performance and position of the business more accurately, enabling better decision-making.

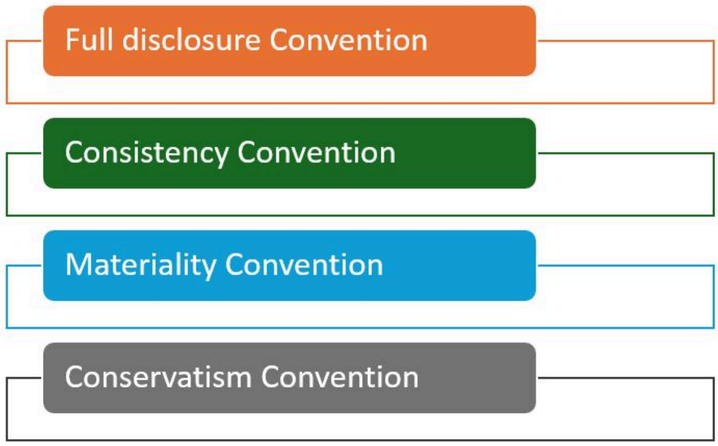
Foundation of Modern Accounting: The accrual assumption serves as the foundation on which the structure of present-day accounting has been developed. It forms the basis for accrual accounting, which is widely used by businesses worldwide. Accrual accounting provides a more accurate and comprehensive view of financial performance compared to cash-basis accounting, making it essential for modern accounting practices.

4. Accounting Conventions

Accounting conventions emerge from accounting practices that have been adopted and refined by organizations over time. These practices become widely accepted and ingrained in the accounting profession due to their effectiveness and reliability in preparing financial statements.

As organizations continue to use these accounting practices and principles, they become conventions that are commonly followed within the accounting community. Over time, these conventions become part of the accepted framework for preparing and presenting financial information.

There are following 4 accounting conventions.

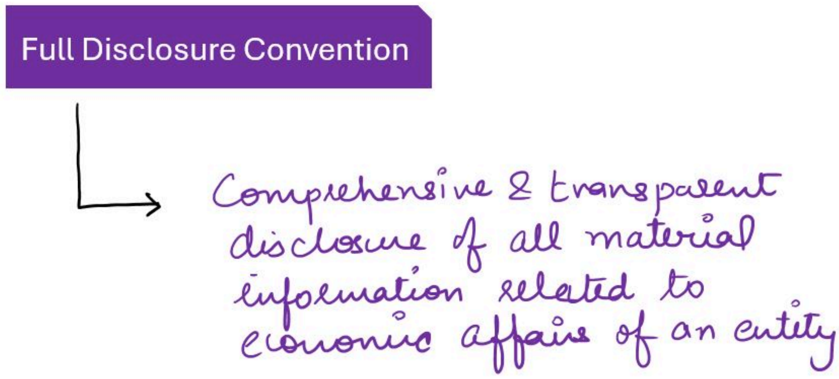


Once established, accounting conventions provide guidance for financial reporting by setting expectations for how financial information should be recorded, summarized, and presented. They help ensure consistency and comparability in financial reporting across different organizations and industries.

These accounting conventions are discussed next.

4. Accounting Conventions

The full disclosure principle in accounting emphasizes the comprehensive and transparent disclosure of all significant and material information related to the economic affairs of an entity in its financial statements and accompanying notes. This principle ensures that stakeholders have access to all relevant information necessary for making informed decisions.



Disclosure of information enhances transparency, fosters trust, and promotes confidence in the integrity of the financial reporting process.

Full disclosure is a principle commonly adopted by corporate organizations, particularly due to the separation between management and ownership. In line with this principle, the Companies Act mandates the format of balance sheets and profit and loss accounts. Additionally, it requires the disclosure of significant accounting policies and other pertinent information in footnotes, annexures, and similar formats. The inclusion of detailed notes alongside financial statements is a direct result of adhering to this principle.

Applicability of Full Disclosure Principle

The applicability of full disclosure principle is discussed below.

Contingent Liabilities

Any contingent liabilities, such as pending legal claims against the business with potentially significant financial implications, must be disclosed in the footnotes to the financial statements. This disclosure helps stakeholders understand the potential risks and obligations facing the entity.

Changes in Depreciation Methods

If there is a change in the method of providing depreciation for assets, it must be disclosed in the financial statements. This ensures transparency regarding changes in accounting policies that may affect the reported financial results and performance metrics.

Relevant Information for Investors

Any other relevant information that might impact investor decision-making, such as significant changes in business operations, financial condition, or future prospects, should also be disclosed. This could include changes in management, strategic initiatives, or significant events affecting the entity.

4. Accounting Conventions

This principle takes into consideration all prospective losses but not the prospective profit. It means profit should not be recorded until it is realised but all losses, even those which have remote possibility are to be recorded in the books. In simple words, an accountant should not anticipate income but should provide for all possible losses.

The objective of this principle is not to overstate the profit of the enterprise in any case and this Principle ensures that a realistic picture of the company is portrayed.

For example, when faced with multiple valuation options for an asset, accountants should choose the method that results in the lower value. This principle has led to the adoption of the "cost or market price, whichever is lower" rule for valuing current assets. Following this, lets say, closing stock with the firm has a book value of Rs. 1,20,000 and market value of Rs. 90,000, then closing stock will be recorded at Rs. 90,000.

This may be reflecting a generally pessimist attitude adopted by the accountants but is an important way of dealing with uncertainty and protecting the interests of creditors against an unwanted distribution of firm's assets. However, deliberate attempt to underestimate the value of assets should be discouraged as it will lead to hidden profits, called **secret reserves.**

Qualitatively, financial statements guided by the conservatism concept should possess 3 key characteristics:

1. Prudence: This involves exercising judgment about potential future losses that need safeguarding, as well as uncertain gains.

2. Neutrality: Financial statements should maintain an unbiased outlook, recognizing possible losses while excluding uncertain gains.

3. Faithful Representation: Alternative values should be faithfully represented in the financial statements.

For investors, conservatism is crucial as it helps them make informed investment decisions. Recognizing future profits prematurely might give a false impression of a thriving business, leading investors to inject more capital. However, if those profits fail to materialize, investors could suffer losses. Conversely, if an entity anticipates future losses, it's prudent to reflect them in the present financial statements, providing a cautionary signal for investors.

Applicability of Conservatism Convention

The conservatism convention has several applications that contribute to the reliability and prudence of financial reporting such as:

Asset Valuation: Conservatism influences the valuation of assets by advocating for the use of lower values when multiple valuation options exist. For example, when valuing inventory, the principle of conservatism suggests using the lower of cost or market value to ensure that assets are not overstated on the balance sheet.

Provision for Bad Debts: In the context of accounts receivable, conservatism prompts the establishment of provisions for bad debts to anticipate potential losses from customers who may default on their payments. This ensures that the reported accounts receivable balance reflects a more realistic expectation of future collections.

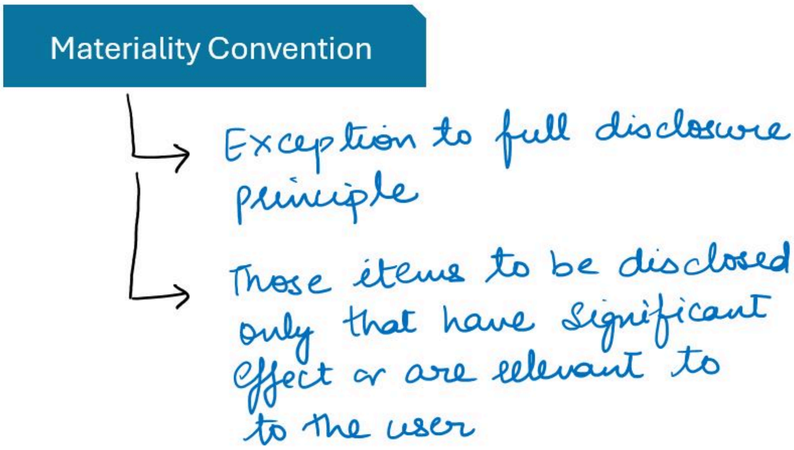
Impairment of Assets: Conservatism requires companies to assess the impairment of long-lived assets such as property, plant, and equipment, as well as intangible assets. If there are indicators of impairment, such as a decline in the asset's fair value or obsolescence, conservatism mandates recognizing the impairment loss to reflect the decreased value of the asset.

Revenue Recognition: Conservatism influences revenue recognition by discouraging premature recognition of revenue before it is earned or realizable. This prevents overstatement of income and ensures that revenue is recognized only when it is reliably measurable and earned.

Contingent Liabilities: Conservatism dictates the disclosure and recognition of contingent liabilities, such as pending lawsuits or legal claims against the company, even if the outcome is uncertain. By recognizing potential liabilities, companies provide investors and stakeholders with a more conservative view of the company's financial position and potential risks.

4. Accounting Conventions

The materiality principle states that financial information should only be disclosed if its omission or misstatement would influence the decisions of users relying on the financial statements.



The materiality principle allows for certain items to be excluded from disclosure in financial statements if their impact is deemed immaterial. This is an exception to the full disclosure principle, which generally requires all relevant information to be disclosed.

Materiality focuses on items with significant economic effect on the business. These are the items that have the potential to impact the decision-making of users, such as investors, creditors, and other stakeholders.

Determining materiality is subjective and requires the judgment, common sense, and discretion of the accountant preparing the financial statements. It depends on factors such as the amount involved, the size and nature of the business, the level of information provided, and the level of the decision-maker.

Examples of applying the materiality principle include expenses like stationery purchases, where even if not fully utilized within the accounting period, they are still recorded as an expense due to their materiality to the financial statements. Similarly, for small items like books or calculators, depreciation may be taken as 100% in the year of purchase to avoid the administrative burden of tracking these small assets over multiple years.

Materiality is not solely determined by the amount involved but also by the context of the business and the needs of the users. What may be material for one person making decisions may be immaterial to another.

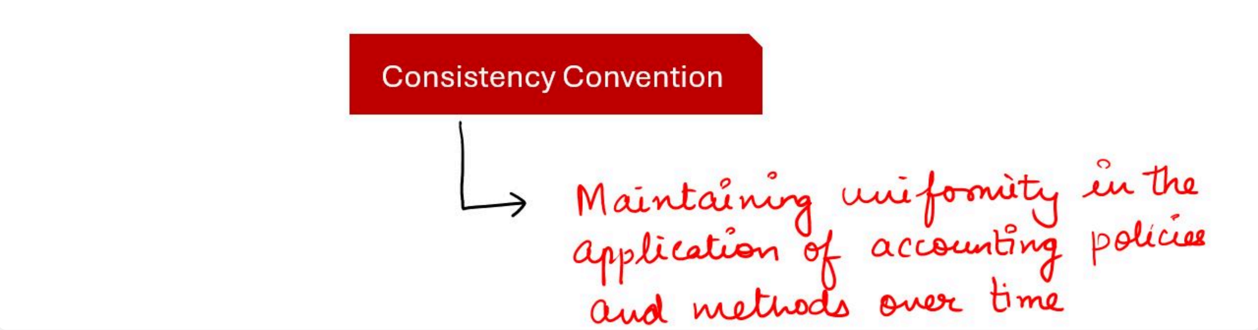
For example, imagine a retail chain where a small inventory discrepancy might not affect stakeholders' decisions due to its vast revenue streams. Contrastingly, a boutique fashion store might find the same discrepancy material as it significantly impacts its profitability and operational efficiency, crucial for its niche market. Thus, materiality is contextual, dependent not only on the amount but also on the business's scale and stakeholders' needs.

Applicability of Materiality Convention

The ultimate goal of considering materiality is to ensure that the omission or misstatement of information in the financial statements does not impair the decision-making process of users relying on those statements. By focusing on material items, financial statements remain relevant and useful for decision-making purposes.

4. Accounting Conventions

The concept of consistency means maintaining uniformity in the application of accounting policies and methods over time. This ensures that financial statements are comparable from one period to another, allowing stakeholders to analyze the company's performance and financial position accurately.



Consistency requires that the same accounting policies and methods are applied consistently from one accounting period to another. This includes methods of depreciation, inventory valuation, revenue recognition, etc.

Accounting policies should only be changed in exceptional circumstances. This means that changes should not be made frequently or arbitrarily but should be justified by significant reasons such as changes in accounting standards, regulatory requirements, or to provide more relevant and reliable information to users of financial statements.

However, Consistency does not mean inflexibility. If there are improved methods of accounting that provide more relevant and reliable information, they can be adopted. However, such changes should be carefully considered, well-documented, and explained in the financial statements to maintain transparency and allow stakeholders to understand the reasons behind the change.

Sometimes, even when consistent accounting policies are applied, there may appear to be inconsistencies. For example, if inventory valuation is based on the principle of "cost or market price, whichever is lower," the valuation may differ between periods depending on changes in market prices. However, this is not considered inconsistency; it's simply the application of the accounting principle.

Applicability of Consistency Convention

The applicability of consistency convention is discussed below.

Comparability of Financial Statements: One of the primary reasons for applying the consistency convention is to ensure the comparability of financial statements across different accounting periods. By consistently applying the same accounting methods and policies, users of financial statements can easily compare the performance and financial position of a company over time.

Enhanced Decision-Making: Consistency facilitates better decision-making by providing reliable and comparable financial information. When accounting policies and methods remain consistent, users can more accurately assess trends, identify patterns, and make informed decisions regarding investments, lending, or other financial matters.

Maintaining Trust and Credibility: Consistency helps to build trust and credibility in the financial reporting process. When stakeholders, such as investors, creditors, and regulatory authorities, see that accounting practices remain stable and consistent over time, they are more likely to have confidence in the accuracy and reliability of the financial information provided by the company.

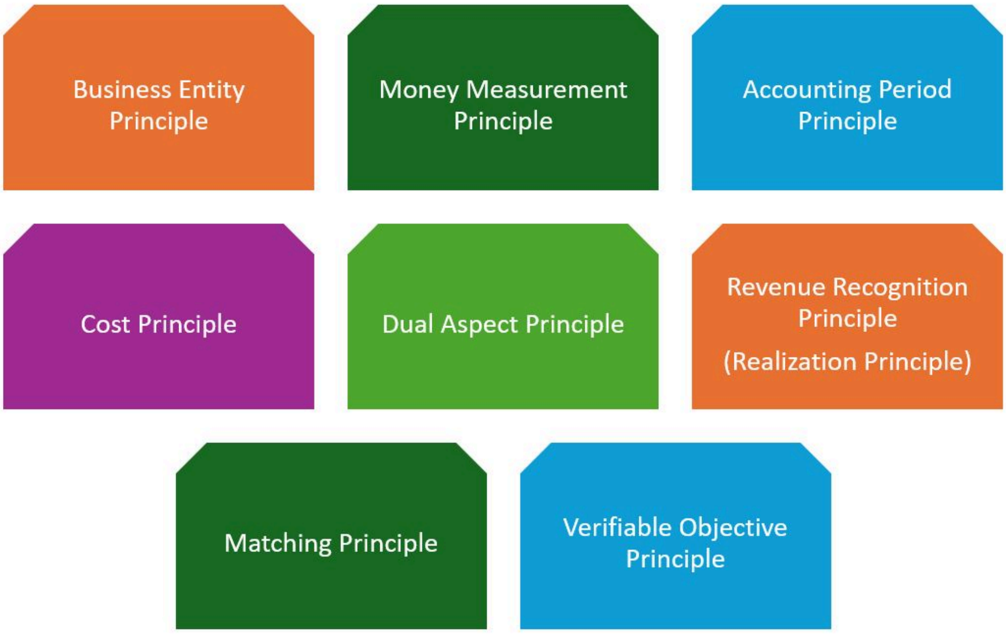
Preventing Manipulation of Financial Results: Consistency acts as a safeguard against the manipulation of financial results. If companies were allowed to change accounting methods or policies frequently, they could potentially manipulate their financial statements to portray a more favorable financial position or performance. By adhering to consistent accounting practices, companies mitigate the risk of such manipulation.

Facilitating Auditing and Compliance: Consistent application of accounting policies and methods makes auditing and regulatory compliance easier and more effective.

5. Accounting Principles

Accounting is the language of business, which communicates information among different users. In order to maintain uniformity and consistency in accounting records, certain rules or principles have been developed which are generally accepted by the accounting professionals. These rules are called by different names such as principles, concepts, conventions, postulates, assumptions and modifying principles.

Following are the common accounting concepts or principles.



Let us look at each of these accounting concepts or principles one by one.

5. Accounting Principles

The entity concept, also known as the separate entity principle, is a fundamental accounting principle that emphasizes the distinction between a business entity and its owner(s).

The entity concept asserts that a business entity is separate and distinct from its owner(s). This means that the business is treated as a separate legal entity, with its own rights, obligations, assets, and liabilities.

Under the entity concept, business transactions are recorded separately from personal transactions of the owner(s). Business transactions are recorded in the books of the business entity, while personal transactions of the owner(s) are recorded in their personal books of accounts. This separation ensures clarity and accuracy in financial reporting by keeping business affairs distinct from personal affairs.

The practice of distinguishing between business and personal affairs originated in the early days of double-entry bookkeeping. It helps to maintain the integrity of financial records by preventing the mingling of business and personal finances. This separation also aids in assessing the financial performance and position of the business entity independently of its owner(s).

The entity concept helps to ascertain the owner's capital investment in the business and their share of profits earned. Owners contribute capital to the business entity, and they are entitled to a return on their investment in the form of profits. Any profits apportioned to the owner(s) become a liability of the business entity, reflecting the owner's claim on the business's earnings.

Transactions that involve the owner(s) personally, such as personal expenses paid from personal funds, are not recorded in the books of the business entity. However, transactions that directly affect the business entity, such as withdrawals of funds by the owner(s), are recorded as transactions of the business. This ensures that financial statements accurately reflect the financial position and performance of the business entity.

For example, let's say Sameer owns a small bakery called "Sweet Delights." He decides to purchase a new oven for his home using his personal funds. Since this transaction involves Sameer's personal finances and is unrelated to the bakery's operations, it won't be recorded in Sweet Delights' accounting books.

However, if Sameer uses funds from Sweet Delights' bank account to purchase ingredients for the bakery, it constitutes a transaction directly related to the business operations. This transaction will be recorded in Sweet Delights' accounting records as a purchase of inventory or supplies, reflecting the bakery's financial activities separately from Sameer's personal finances.

5. Accounting Principles

The Money Measurement Principle asserts that only transactions and events which can be quantified in monetary terms are recorded in the books of accounts.

For example, while the appointment of a manager may not be recorded since its value is not easily quantifiable in monetary terms, the salary paid to the manager is recorded because it represents a monetary transaction.

This principle ensures that accounting data can be effectively aggregated, summarized, and compared. Transactions are recorded in the currency of the country where the books of account are prepared, serving as a unit of measurement for business activities. However, there are limitations to this principle as it overlooks qualitative aspects such as the efficiency of human resources or customer satisfaction.

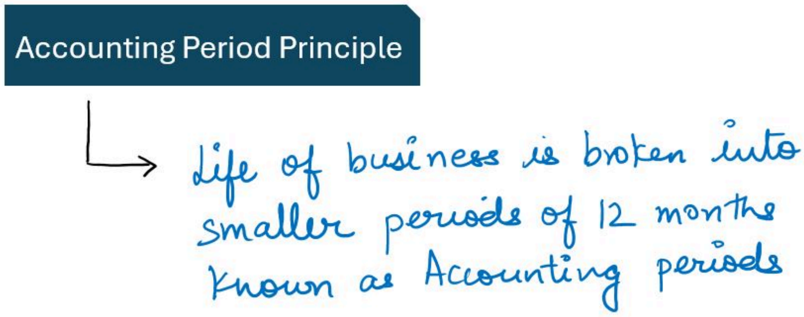
Moreover, the value of money fluctuates over time, which isn't always reflected in the accounting records, potentially distorting the true financial position of a business. For example, if a company purchased land for Rs. 1,00,000 several years ago, but due to inflation, the value of money has decreased. Despite the land retaining its utility and potential for development, its market value may have increased to Rs. 5,00,000. However, the accounting records still show the original purchase price, potentially understating the true value of the asset and distorting the company's financial position.

Despite its limitations, the Money Measurement Principle allows for the uniform expression of business transactions in monetary terms, facilitating the recording of diverse items in accounting records.

Note that the foundational principles of entity and money measurement serve as the cornerstone upon which other procedural concepts in accounting depend.

5. Accounting Principles

The Periodicity Concept addresses the challenge posed by the indefinite lifespan assumption of the going concern concept. While businesses are assumed to have an indefinite existence, it's impractical to measure their performance and financial position only at the end of their lifecycle.



Thus, according to this principle, the life of an enterprise is divided into smaller periods so that its performance can be measured at regular intervals.

Accounting period is defined as the interval of time, at the end of which the Profit and Loss account and the Balance Sheet are prepared, so that the performance is measured at regular intervals and decisions can be taken at the appropriate time. Accounting period is usually a period of one year. However, it may also be 6 months or 9 months or 15 months. We generally follow from 1st April of a year to 31st March of the immediately following year.

This Principle is also called as **periodicity principle** or the **principle of definite accounting period**.

Periodicity Principle facilitates in:

Allocation of Expenses between Capital and Revenue: The periodicity concept requires businesses to allocate expenses between capital and revenue. Capital expenditures are those that benefit the business over multiple accounting periods, such as investments in assets like machinery or buildings. A portion of capital expenditure consumed during the current year is charged to the Income Statement as an expense, reflecting the portion used up during the period. The remaining unconsumed portion is shown as an asset in the Balance Sheet, recognizing its enduring value beyond the current accounting period.

Comparison of Financial Statements: By dividing the business's financial activities into distinct time periods, the periodicity concept enables stakeholders to compare financial statements across different periods. This comparison allows for the identification of trends, patterns, and fluctuations in the business's performance and financial position over time, aiding in informed decision-making.

Timely Decision-Making: The preparation of financial statements at regular intervals, typically annually, ensures that management has timely access to key financial information. With access to these financial statements, management can promptly assess the business's performance and financial health, enabling them to make timely decisions and take corrective measures when necessary. This proactive approach helps in steering the business towards its objectives and mitigating potential risks.

Matching Periodic Revenues with Expenses: The periodicity concept facilitates the matching of periodic revenues with expenses to determine the accurate results of business operations. By recording expenses in the period they are incurred and matching them against the revenues generated during the same period, the concept ensures that the financial statements reflect the true profitability of the business for each accounting period. This matching principle enhances the reliability and relevance of financial information for stakeholders, aiding in their understanding of the business's performance.

5. Accounting Principles

According to this principle, every business transaction has two aspects, debit and credit of equal amount. In other words, for every debit, there is a credit of equal amount in one or more accounts and vice-versa. The system of recording transactions based on this principle is known as “Double Entry System”.

Dual Aspect Principle

↳ Every transaction entered into has two aspects 'debit' and 'credit' of equal amounts

For example, Ram starts a business with cash Rs. 1,00,000. There are two aspects of this transaction, a debit and credit on one hand, the business has an asset of 1,00,000. While, on the other hand, it has a liability towards Ram of 1,00,000 (capital of Ram).

Thus, this concept states that every transaction has a dual or two-fold effect and should therefore be recorded at two places. In other words, at least two accounts will be involved in recording a transaction.

Thus, we can say,

$$\text{Capital (equities)} = \text{Cash (Asset)}$$

$$1{,}00{,}000 = 1{,}00{,}000$$

The applicability of Dual Aspect Principle is discussed below.

Balance Sheet Equality: The Dual Aspect Principle ensures that the total assets of a business are always equal to the total of its liabilities and equity. In other words, the resources owned by the business (assets) must be financed by either borrowing (liabilities) or owner's investment (equity). This principle ensures that the financial position of the business is accurately represented on the Balance Sheet at all times.

$$\text{ASSETS} = \text{LIABILITIES} + \text{CAPITAL}$$

Arithmetical Accuracy of Financial Statements: By adhering to the Dual Aspect Principle, financial statements achieve arithmetical accuracy. Every transaction is recorded in such a way that the total debits equal the total credits, maintaining the balance between the two sides of the accounting equation. This balance ensures that the financial statements are mathematically precise and free from computational errors, providing users with reliable and trustworthy information about the financial position and performance of the business.

Note that this concept is the core of double entry book-keeping. Every transaction or event has two aspects:

(1) It increases one Asset and decreases other Asset;

For example, where a new machine is purchased paying Rs. 80,000 in cash, there is increase in machine value and decrease in cash balance by Rs. 50,000.

(2) It increases an Asset and simultaneously increases Liability;

For example, where a new machine is purchased for Rs. 80,000 on credit, cash is to be paid later on, there is increase in machine value and increase in Creditors by Rs. 80,000.

(3) It decreases one Asset, decreases a Liability.

For example, if Cash is paid to repay bank loan to the extent of Rs. 50,000, there is decrease in bank loan and decrease in cash by Rs. 50,000.

(4) It increases one Liability, decreases other Liability;

For example, where a bank loan of Rs. 50,000 is raised to pay off other loan, there is increase in bank loan and decrease in other loan by Rs. 50,000.

5. Accounting Principles

The Cost Principle dictates that items are recorded in the books of accounts at their original cost, which includes the cost of acquisition. This original cost forms the basis for all subsequent accounting transactions related to the asset. As the acquisition cost represents a past transaction, it is referred to as **historical cost**.

Accountants favor this principle for its objectivity, as historical cost reflects an actual expenditure of resources rather than a hypothetical or notional figure.

For instance, if a company purchases machinery for Rs. 1,50,000 in cash and spends an additional Rs. 20,000 on installation, the total cost recorded in the books will be Rs. 1,70,000. Depreciation will be calculated based on this cost. Even if the market value of the machinery increases to Rs. 2,00,000 due to inflation, the asset will still be recorded at its historical cost of Rs. 1,70,000, adjusted for depreciation.

However, an important **limitation of the historical cost basis** is that it does not show the true worth of the business and may lead to hidden profits. During the period of rising prices, the market value or the cost at (which the assets can be replaced are higher than the value at which these are shown in the book of accounts) leading to hidden profits.

Th applicability of Cost Principle is discussed below.

Reliability and Verifiability: The Cost Principle enhances the reliability and verifiability of accounting information, as the recorded cost of assets or liabilities is supported by evidence of their acquisition.

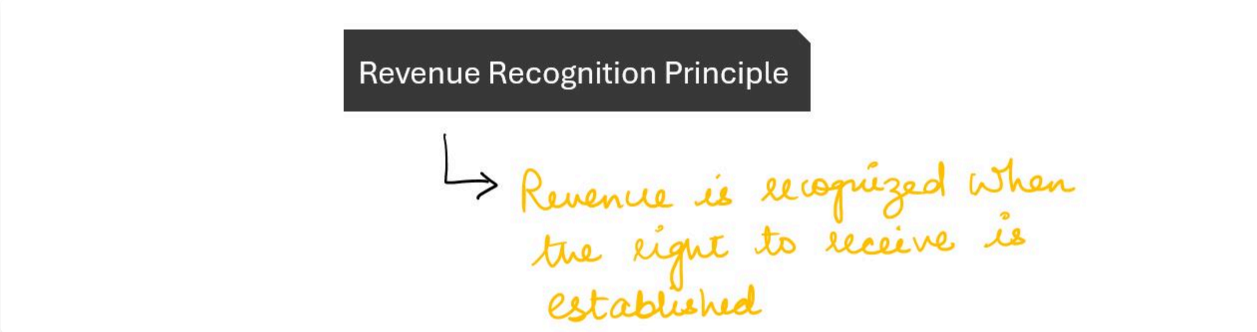
Preferability in Stable Economic Conditions: In stable economic conditions, the Cost Principle is preferred as it ensures consistency and comparability in financial statements over time.

Challenge in High Inflationary Conditions: However, in high inflationary conditions, the Cost Principle may not be preferable as it can lead to significant fluctuations in prices, hindering comparability and the ability of financial statements to present a true and fair view of business operations.

Assets without Acquisition Cost: Some assets, such as human assets, do not have an acquisition cost. In such cases, the application of the Cost Principle may be limited or inappropriate.

5. Accounting Principles

The concept of revenue recognition requires that the revenue for a business transaction should be included in the accounting records only when it is realised. Here arises two questions in mind. First, is termed as revenue and the other, when the revenue is realised.



Let us take the first one first. Revenue is the gross inflow of cash arising from (i) the sale of goods and services by an enterprise; and (ii) use by others of the enterprise's resources yielding interest, royalties and dividends.

Secondly, revenue is assumed to be realised when a legal right to receive it arises, i.e. the point of time when goods have been sold or service has been rendered.

Thus, credit sales are treated as revenue on the day sales are made and not when money is received from the buyer. As for the income such as rent, commission, interest, etc. these are recongnised on a time basis.

For example, rent for the month of March 2024, even if received in April 2024, will be taken into the profit and loss account of the financial year ending March 31, 2024 and not into financial year beginning with April 2024. Similarly, if interest for April 2024 is received in advance in March 2024, it will be taken to the profit and loss account of the financial year ending March 2025.

This principle closely aligns with the cost concept, where assets are initially recorded at their historical cost, regardless of any changes in market value. For example, if an asset is originally recorded at a historical cost of 5,00,000, even if its current market value rises to 15,00,000, this increase is not recognized in the books unless there is certainty that the asset will be sold or otherwise disposed of at the higher value.

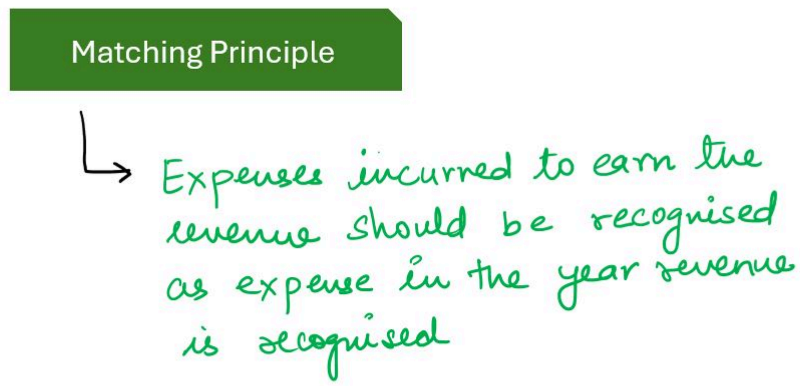
Accountants typically adopt a conservative approach when applying the realisation concept. They account for probable losses but do not recognize probable gains until they are realized. In other words, if there is an anticipation of a decrease in the value of an asset, it is accounted for, but any increase in value is ignored until it is actually realized. This conservative approach aims to provide a more prudent representation of the financial position of the business.

However, economists often criticize the realisation concept, arguing that it leads to value distortion and undermines the meaningfulness of accounting. They contend that by only recognizing gains when realized, the concept fails to provide a timely and accurate reflection of the true economic value of assets.

There are **some exceptions** to this general rule of revenue recognition. In case of contracts like construction work, which take long time, say 2-3 years to complete, proportionate amount of revenue, based on the part of contract completed by the end of the period is treated as realised. Similarly, when goods are sold on hire purchase, the amount collected in installments is treated as realised.

5. Accounting Principles

The matching principle is a fundamental concept in accounting that ensures expenses are recognized in the same period as the revenues they help generate.



The matching principle states that all expenses incurred by a business during an accounting period should be matched with the revenues recognized during the same period. This matching facilitates the accurate calculation of the profit or loss earned by the business in that period. It is based on the accrual principle, which focuses on recognizing revenues and expenses when they are incurred, regardless of the timing of cash flows.

Let's consider the example of a law firm that pays a fixed salary of Rs. 4,000 to each of its 6 consultants. Despite the fixed expense of Rs. 24,000 (Rs. 4,000 × 6), the matching principle ensures that this expense is allocated to the revenues generated in each specific year. For instance, if the firm earned revenues of Rs. 2,30,000 in 2023 and Rs. 1,80,000 in 2024, the profits for each year would be calculated by subtracting the fixed salary expense from the respective revenue figures. This results in profits of Rs. 2,06,000 (Rs. 2,30,000 - Rs. 24,000) for 2023 and Rs. 1,56,000 (Rs. 1,80,000 - Rs. 24,000) for 2024.

The applicability of Matching Principle is discussed below.

Prepaid Expenses: The matching principle acknowledges prepaid expenses. These are expenses paid in advance but not yet incurred. They are recognized as expenses only when they are actually incurred, aligning with the principle of matching expenses with the revenues they help generate.

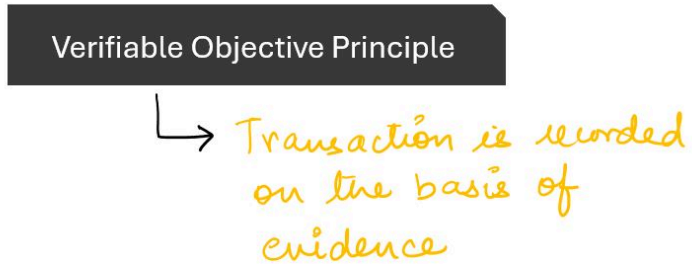
Unearned Income: Income received in advance, known as unearned income, is treated as a liability until the corresponding revenue is earned. This ensures that revenues are matched with the expenses incurred in generating them.

Recognition of Closing Stock: The matching principle also guides the recognition of closing stock. The cost of goods sold (COGS) is matched with the revenues generated from the sale of those goods, and the value of closing stock is considered at the end of the accounting period.

Depreciation Expense: Depreciation expense is charged on fixed assets to allocate their cost over their useful lives. This ensures that the cost of using assets is matched with the revenues they help generate, reflecting their contribution to the business's operations over time.

5. Accounting Principles

According to the verifiable objective concept, accounting measurements should be objective, meaning they are free from personal bias or judgment. Objective measurements are those that can be verified by independent parties and are based on reliable evidence.



All accounting transactions should be supported by verifiable evidence in the form of business documents. These documents serve as tangible proof that the transactions actually occurred and provide details such as the amount, terms, and parties involved. Examples of such documents include sales invoices, sales receipts, contracts, purchase orders, bank statements, and receipts.

By relying on verifiable evidence, financial information becomes more reliable and trustworthy. Independent parties, such as auditors or regulatory agencies, can verify the accuracy and completeness of the information, enhancing the credibility of the financial statements.

For example, when a sale occurs, it should be supported by verifiable evidence such as a sales invoice, sales receipt, or contract. These documents provide concrete evidence of the sale, including the amount, date, terms, and parties involved. Similarly, expenses should be supported by receipts, invoices, or other documentation that verifies the nature and amount of the expense.

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6. Difference between Assumptions and Conventions

Accounting Assumptions are generally based on fundamental legal or conceptual frameworks that form the foundation for financial reporting. These assumptions are accepted as standard principles across accounting practices and have legal relevance in ensuring consistency and reliability in financial statements.

Examples include the **Going Concern** assumption, which assumes the business will continue to operate in the foreseeable future, and the **Accrual Basis** assumption, which is legally required for many businesses to record transactions as they occur, not when cash is exchanged.

On the other hand, **Accounting Conventions** are not based on legal requirements but have developed over time through common practice and practical use. They help guide accountants in making decisions where there is no specific legal or standard rule.

For example, the **Conservatism** convention advises caution by preferring to recognize potential losses over gains, but it is not legally enforced—it's a widely accepted guideline to ensure prudent financial reporting. Similarly, conventions like **Materiality** and **Full Disclosure** are useful for decision-making but are more flexible and depend on the judgment of the accountant rather than strict legal obligations.

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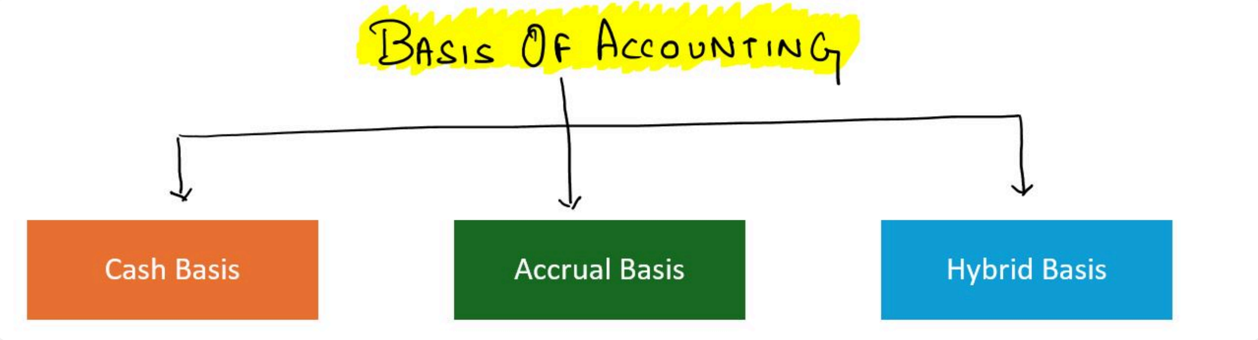
7. Basis of Accounting

The basis of accounting refers to the principles or methods used to determine when revenues and expenses are recognized in the financial statements of a business. It plays a crucial role in accurately measuring the profit earned and losses incurred by a business during an accounting period.

From the point of view of the timing of recognition of revenue and costs, the basis of recognition are as follows:



In cash basis accounting, revenues and expenses are recognized only when cash is received or paid out. Accrual basis accounting, on the other hand, recognizes revenues and expenses when they are earned or incurred, regardless of when cash is received or paid. Some businesses may use a combination of cash and accrual basis accounting, depending on the nature of their transactions and reporting requirements.

These are discussed in detail next.

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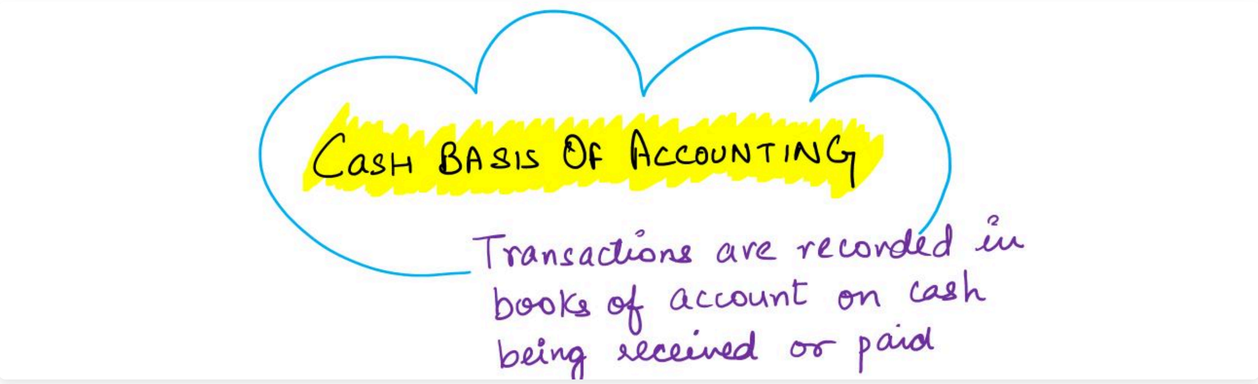
7. Basis of Accounting

In cash basis accounting, revenues and expenses are recognized only when cash is received or paid out. This means that revenue is recognized when cash is received from customers, and expenses are recognized when cash is paid to suppliers or for other expenses. No non-cash entry is recorded in the books under this approach.



Cash basis accounting is simple and easy to understand, but it may not accurately reflect the financial performance of a business, especially if there are significant transactions that involve credit.

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7. Basis of Accounting

During the Financial year 2023-24, Raman has cash sales of Rs. 4,00,000 and credit sales of 1,60,000. His expenses for the year were 2,70,000, out of which 80,000 is still to paid. Find out Raman's income for the year 2023-24 using Cash basis of Accounting.

Solution:

Revenue = Rs. 4,00,000

Less Expenses = Rs. 1,90,000 [Rs. 2,70,000 – Rs. 80,000]

Net Income = Rs. 2,10,000

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7. Basis of Accounting

Accrual basis accounting recognizes revenues and expenses when they are earned or incurred, regardless of when cash is received or paid. Under this method, revenue is recognized when it is earned, typically when goods are delivered or services are rendered, regardless of when payment is received. Similarly, expenses are recognized when they are incurred, such as when goods are purchased or services are received, regardless of when payment is made.

ACCRUAL BASIS OF ACCOUNTING

Transaction is recorded in the books of account when entered, whether cash is received / paid or not

Accrual basis accounting provides a more accurate picture of a business's financial performance because it matches revenues with the expenses incurred to generate them in the same accounting period.

Note that the Companies Act specifically requires the use of Accrual Basis of accounting.

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7. Basis of Accounting

During the Financial year 2023-24, Raman has cash sales of Rs. 4,00,000 and credit sales of 1,60,000. His expenses for the year were 2,70,000, out of which 80,000 is still to paid. Find out Raman's income for the year 2023-24 using accrual basis of Accounting.

Solution:

Total Sales = Rs. 5,60,000 [Rs. 4,00,000 + Rs. 1,60,000]

Less Total Expenses = Rs. 2,70,000

Net Income = Rs 2,90,000

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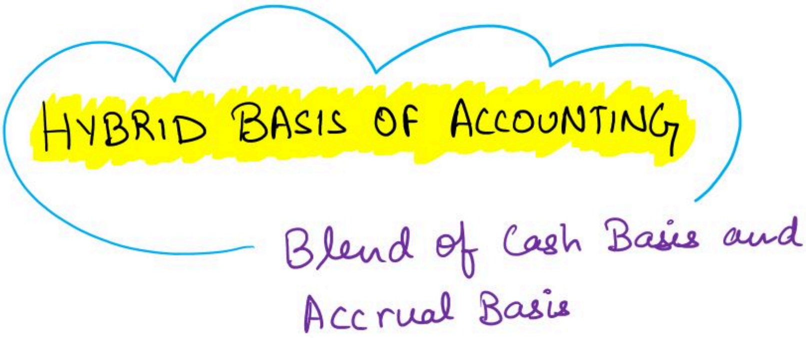
7. Basis of Accounting

Hybrid Basis, also known as the Modified Accrual System, represents a blend of the Cash Basis and Accrual Basis accounting methods. In this approach, revenues are recognized on a Cash Basis, while expenses are recognized on an Accrual Basis.



The hybrid basis combines elements of both the Realization Principle and the Accrual Principle. The Realization Principle, associated with Cash Basis accounting, focuses on recognizing revenue when it is realized through cash receipt. On the other hand, the Accrual Principle emphasizes recognizing revenue when it is earned and expenses when they are incurred, regardless of cash movements.

This method may be particularly suitable for small businesses or organizations with straightforward revenue streams but complex expense structures.

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7. Basis of Accounting

During the Financial year 2023-24, Raman has cash sales of Rs. 4,00,000 and credit sales of 1,60,000. His expenses for the year were 2,70,000, out of which 80,000 is still to paid. Find out Raman's income for the year 2023-24 using hybrid basis of Accounting.

Solution:

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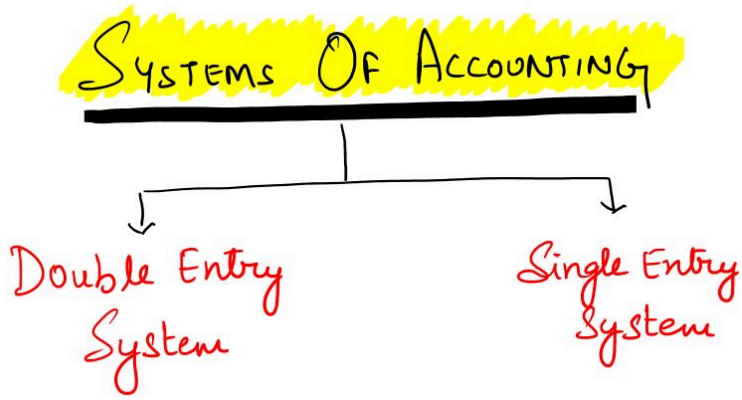
8. Systems of Accounting

The systems of recording transactions in the books of accounts can be classified in the following 2 types.



Double Entry System

It is based on the principle of Dual Aspect which states that every transaction has two effects, viz. receiving of a benefit and giving of a benefit. Thus, one account is debited and the other is credited.

Double entry system is a complete system as both the aspects of a transaction are recorded in the books of accounts. The system is accurate and more reliable, as the possibilities of frauds and misappropriations are minimized under this system of accounting. The arithmetic inaccuracies in records can mostly be checked by preparing the trial balance; A trial balance is a statement which shows a list of debit and credit balances taken out from ledger accounts to check the arithmetical accuracy. It is discussed in detail in later chapter).

Single Entry System

It is an accounting approach under which each accounting transaction is recorded with only a single entry, which is centred towards results of the business enterprise, which are shown in the statement of income of the company. In simple words, only one aspect of a transaction is recorded under single entry system. It is also known as incomplete or unscientific method for recording transactions. Instead of maintaining all the accounts, only personal accounts and cash book are maintained under this system. The system is, however, followed by small business firms, as it is very simple and flexible.

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9. Book-Keeping Vs Accounting

Bookkeeping and accounting are often used interchangeably, but they serve different functions within the realm of financial management.

While bookkeeping focuses on the systematic recording of financial transactions, accounting involves a broader range of activities, including interpretation, analysis, reporting, and decision-making based on financial data. Bookkeeping provides the foundation for accounting by ensuring that all financial transactions are accurately recorded, while accounting adds value by transforming raw financial data into meaningful information for stakeholders.

Book-keeping is primarily concerned with the systematic recording of financial transactions. It involves maintaining accurate records of financial transactions such as sales, purchases, receipts, and payments.

Bookkeepers typically record transactions in journals and ledgers, ensuring that all financial activities are properly documented. The main objective of bookkeeping is to create a chronological record of financial transactions, providing a basis for further analysis and reporting. Bookkeeping tasks include posting transactions, reconciling accounts, and producing financial statements.

Accounting, on the other hand, encompasses a broader set of activities beyond just recording transactions. It involves interpreting, classifying, analyzing, reporting, and summarizing financial data to provide meaningful insights into the financial health and performance of an organization.

Accountants use the recorded financial data from bookkeeping to prepare financial statements such as the balance sheet, income statement, and cash flow statement. They also analyze financial information to assess the financial position of the business, evaluate its performance, and make strategic decisions. Accounting involves applying principles and standards to ensure accuracy, consistency, and compliance with regulatory requirements.

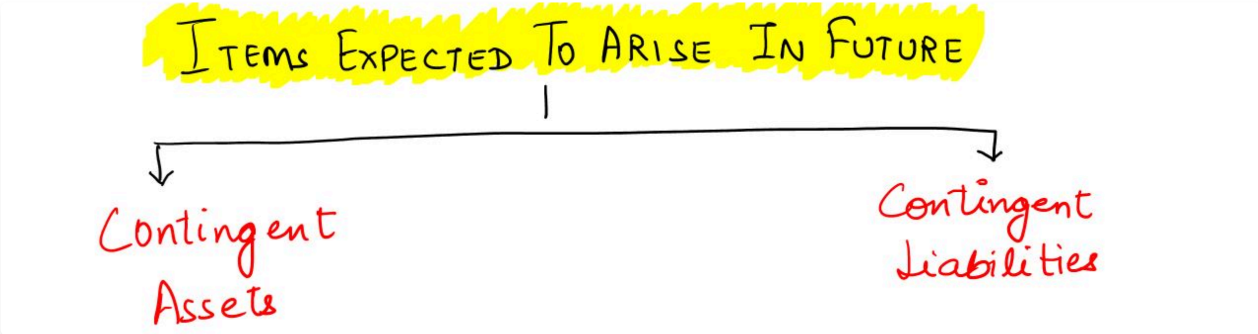
The underlying difference between Book-keeping and Accounting is given below.

Basis	**Book-keeping**	**Accounting**
Definition	Book-Keeping is mainly related to identifying, measuring and recording financial transactions.	Accounting is the process of summarizing, interpreting and communicating financial transactions which were classified in the ledger account.
Decision-Making	Management can't take a decision based on the data provided by book-keeping.	Depending on the data provided by the accountants, the management can take critical business decisions.
Objective	The objective of book-keeping is to keep the records of all financial transactions proper and systematic.	The objective of accounting is to gauge the financial situation and further communicate the information to the relevant authorities.
Preparation of Financial Statements	Financial Statements are not prepared as a part of this process.	Financial statements are prepared during the accounting process.
Skills Required	Book-keeping doesn't require any special skill sets.	Accounting requires special skills due to its analytical and complex nature.
Analysis	The process of book-keeping does not require any analysis.	Accounting uses book-keeping information to analyze and interpret the data and then compiles it into reports.

10. Contingent Assets and Contingent Liabilities

There are some items, which do not exist at the present for the enterprise but are expected to arise in future due to occurrence of some event.

These items can be classified as follows:



These are discussed next.

10. Contingent Assets and Contingent Liabilities

A contingent asset is like a "maybe" benefit for a company. It's something that might bring in money or value in the future, but whether it actually happens depends on certain uncertain events. For example, if a company is in a legal dispute and might receive compensation if they win, that potential compensation is a contingent asset. However, because it's not certain yet, we don't count it as a definite asset in the company's books until we're more sure it will actually happen.

Contingent Asset is defined as a possible asset that arises from past events and whose existence will be confirmed only after occurrence or non-occurrence of one or more uncertain future events, which is not wholly within the control of the enterprise. It arises from unplanned or unexpected events that give rise to the possibility of an inflow of economic benefits to the business entity.

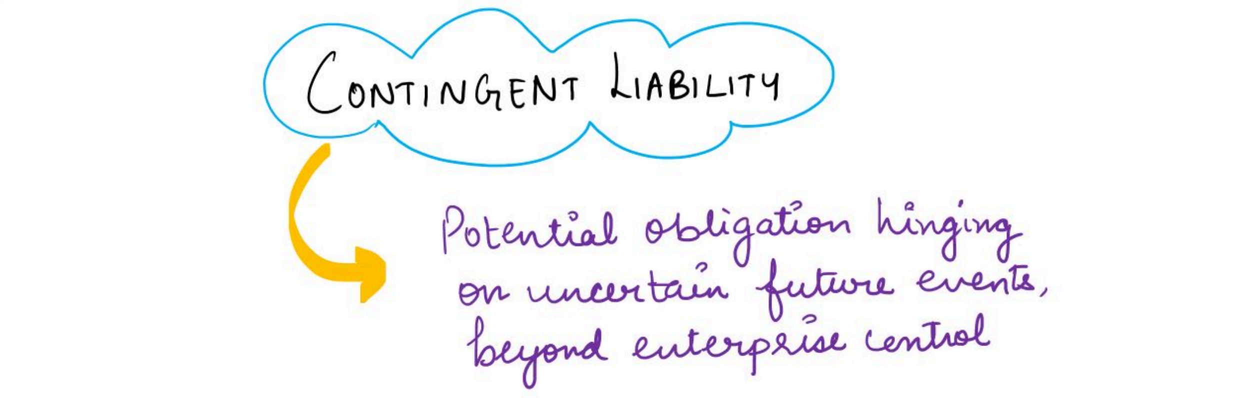
For example, a claim that an enterprise is pursuing through legal process, where the outcome is uncertain, is a contingent asset. Insurance claim for damage of property is another example of contingent asset.

According to prudence concept, an enterprise should not recognise a contingent asset as there exists uncertainty in realisation of claim. It is possible that recognition of contingent assets may result in recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset no longer remains as contingent asset.

A contingent asset need not be disclosed in the financial statements. It is usually disclosed in the report of the approving authority, if an inflow of economic benefit is probable.

10. Contingent Assets and Contingent Liabilities

A contingent liability is kind of like a "maybe" debt for a company. It's an obligation or potential debt that might arise in the future, but it's not certain yet. For instance, if a company provides a guarantee for someone else's loan, they might have to pay that loan if the other person can't. That potential payment is a contingent liability. But because it's not a definite debt yet, we don't list it as a liability in the company's books until we're more sure it will actually need to be paid.



Contingent Liability is defined as a possible obligation arising from past events and may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events. It can also be a present obligation that arises from past events.

For example, claims against the enterprise not acknowledged as debts, guarantees given in respect of third parties, liability in respect of bills discounted and statutory liabilities under dispute, uncalled liability on partly paid up shares, arrears of fixed cumulative dividend etc.

A business should not recognise a contingent liability. But a contingent liability is required to be disclosed where there is a probable possibility of outflow of a resource to settle such contingent liability in the future. These liabilities are assessed regularly to determine whether an outflow of resources embodying economic benefits has become probable. If an outflow becomes probable and it will be required for an item previously dealt with as a contingent liability, a provision should be made in financial statements of the period in which the change in probability occurs.

10. Contingent Assets and Contingent Liabilities

It is important to understand the difference among Liability, Provision and Contingent Liability.

First, let us look at the difference between liability and Contingent liability.

A liability represents a definite and certain obligation that exists at the present time, requiring the company to make future payments or provide goods or services. On the other hand, a contingent liability is a potential obligation arising from past events, whose existence will be confirmed by uncertain future events.

For example, ABC Company enters into a lease agreement with a clause stipulating a penalty for early termination equivalent to three months' rent. If ABC Company decides to terminate the lease early, the obligation to pay the penalty becomes a certain liability and must be recognized on the balance sheet. However, if the decision to terminate the lease has not been made, the potential penalty remains a contingent liability, disclosed in the footnotes until the decision is finalized.

The difference between liability and contingent liability is given below.

Liability	**Contingent Liability**
A liability is defined as the present financial obligation of an enterprise, which arises from past events.	A possible obligation arising from past events and may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events.
The settlement of a liability results in an outflow of resources embodying economic benefits from the enterprises. A liability is certain and must be met by the firm as it is their obligation.	In case of contingent liability, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with appropriate reliability.
A liability is treated as a present obligation and is recognized as liabilities in the Balance Sheet.	A contingent liability is to be disclosed by an enterprise in the Balance Sheet by way of footnotes.

10. Contingent Assets and Contingent Liabilities

Now let us look at the differences between Provision and Contingent Liability.

A provision is a known liability where the amount or timing is uncertain but is probable and can be estimated reasonably. On the other hand, a contingent liability is a potential obligation that depends on uncertain future events, and its occurrence or amount is not probable or cannot be reasonably estimated.

For example, the GST officer imposes a penalty on Beta Ltd. for violation of a provision in the GST Act. The company goes for an appeal. If the management of the company estimates that it is probable that the company will have to pay the penalty, it recognises a provision for the liability. On the other hand, if the management anticipates that the judgement of the appellate authority will be in its favour and it is less likely that the company will have to pay the penalty, it will disclose the obligation as a contingent liability instead of recognising a provision for the same.

The difference between Provision and Contingent Liability is given below.

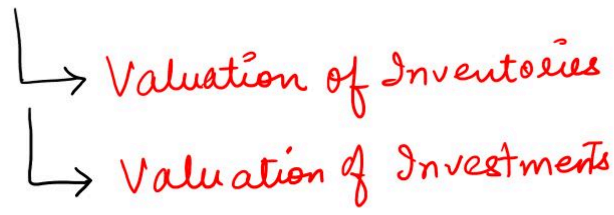
Provision	**Contingent Liability**
Provision is a present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation.	Contingent liability is a possible obligation that may or may not exist depending on the occurrence or non-occurrence of one or more uncertain future events.
Provisions must be recognized in the financial statements.	Contingent liabilities should not be recognized in Books of Accounts.
If the management estimates that it is probable that the settlement of an obligation will result in an outflow of economic benefits, it recognizes a provision in the balance sheet.	If the management estimates, that it is less likely that any economic benefit will outflow the firm to settle the obligation, it discloses the obligation as a contingent liability by way of notes.
Provision is recognized when an enterprise has a present obligation arising from past events; an outflow of resources embodying economic benefits is probable, and a reliable estimate can be made of the amount of the obligation.	Contingent liability includes present obligations that do not meet the recognition criteria because either it is not probable that settlement of those obligations will require outflow of economic benefits, or the amount cannot be reliably estimated.

11. Accounting Policies

Accounting Policies include specific accounting principles and methods of applying these principles adopted by the enterprise in preparation and presentation of financial statements. Policies are based on various accounting concepts, principles, and conventions which we have already discussed in previous chapters. However, there is no single list of accounting policies, which are applicable to all enterprises in all circumstances, exists.

Enterprises operate in diverse and complex environmental situations and so they must adopt various policies. Selection of an accounting policy depends on the circumstances in which an enterprise is operating.

The areas wherein different accounting policies are often discovered are as follows:



However, this is not to be viewed as an exhaustive list but only illustrative, and no list of accounting policies can be formulated which will have universal applicability.

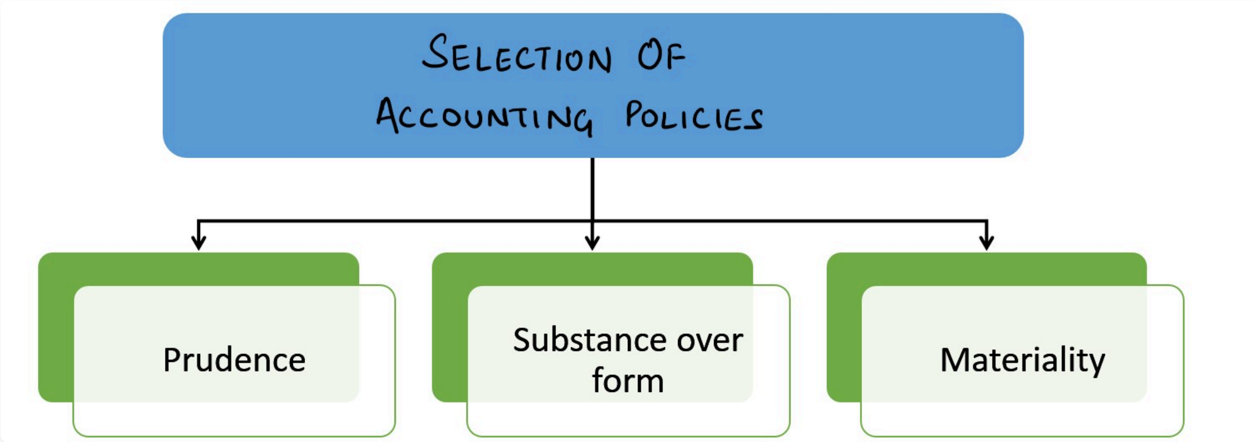
For example, an enterprise can choose among various alternative methods available for valuing an inventory. For example, an enterprise holds an investment in the form of inventory at the end of an accounting period. For valuation of this inventory, the enterprise may adopt simple average method, FIFO method etc. The method selected by that enterprise for valuation is called an accounting policy.

Similarly, there are different methods of providing depreciation on fixed assets, such as straight line, written down, etc. are available to the business enterprises which lead to different depreciation amounts.

11. Accounting Policies

Selection of accounting policy is a crucial policy decision which affects the performance measurement and financial position of a business entity. If an inappropriate accounting policy is selected, it may lead to understatement or overstatement of performance and financial position.

Thus, accounting policy should be selected with due diligence, estimating its effect on the financial performance of the business enterprise from the point of view of various users of accounting information.



The essential characteristics which should be considered while selecting and applying accounting policies are as follows:

1. Prudence
Prudence in accounting implies a cautious approach to financial reporting, where uncertainties and risks are recognized. It suggests that when making judgments or estimates, accountants should err on the side of caution, avoiding overestimation of assets or income and underestimation of liabilities or expenses.

For example, if there is uncertainty about the collectibility of a receivable, prudence dictates that it should be recognized as a bad debt expense, even if the loss has not yet been realized.

2. Substance over Form
Substance over form principle emphasizes the importance of economic reality over legal form in accounting. It requires that transactions and events be recorded and presented in financial statements based on their economic substance rather than just their legal form.

This principle ensures that financial statements accurately reflect the underlying economic reality of transactions, even if their legal structure might suggest otherwise. For instance, a lease arrangement that transfers substantially all risks and rewards of ownership should be accounted for as a finance lease, even if it's classified as an operating lease based on legal terms.

3. Materiality
Materiality refers to the relative significance or importance of an item or event to the financial statements. It suggests that only items or events that could influence the economic decisions of users need to be disclosed or accounted for in financial statements.

Determining materiality involves considering both the size and nature of an item or event. For instance, while a small error in recording office supplies expense may not be material, a large error in recognizing revenue from a major contract would likely be material and require correction.

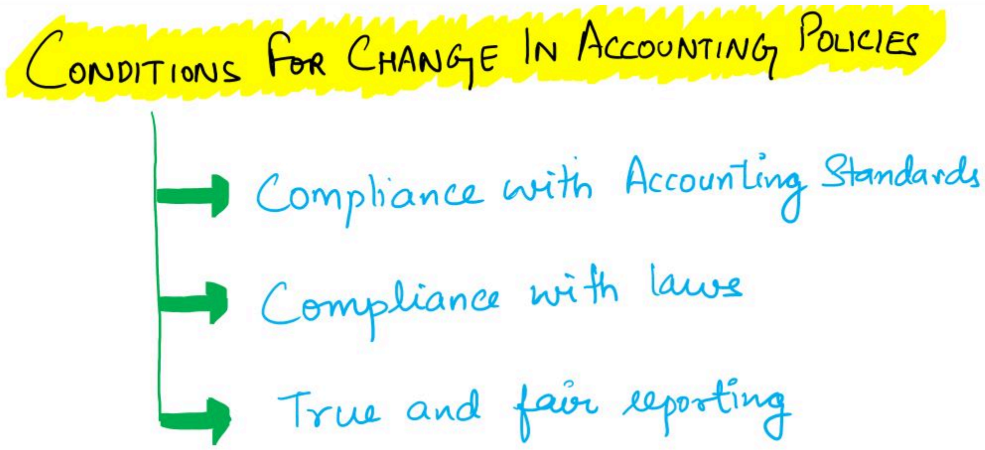
The financial statements prepared based on such accounting policies, should exhibit true and fair view of state of Balance Sheet and the Profit & Loss Account.

Let us take few examples where selection from a set of accounting policies is made.

1. Inventories are valued at cost except for finished goods and by-products. Finished goods are valued at lower of cost or market value and by-products are valued at net realizable value.
2. Long term investments are valued at their acquisition cost and provision for permanent reduction in value must be made, wherever necessary.

11. Accounting Policies

Changes in accounting policies are significant decisions for any organization and should only be made under certain conditions to ensure transparency and accuracy in financial reporting.



The conditions under which changes in accounting policies should be made:

To comply with Accounting Standards
Changes in accounting policies may be necessary to bring the books of account in line with issued accounting standards. Accounting standards provide guidelines and rules for preparing financial statements, and adherence to these standards ensures consistency and comparability in financial reporting across different entities.

To comply with legal provisions
Changes in accounting policies may also be required to comply with legal provisions or regulatory requirements. Laws and regulations may change over time, necessitating adjustments to accounting policies to ensure compliance and avoid legal consequences.

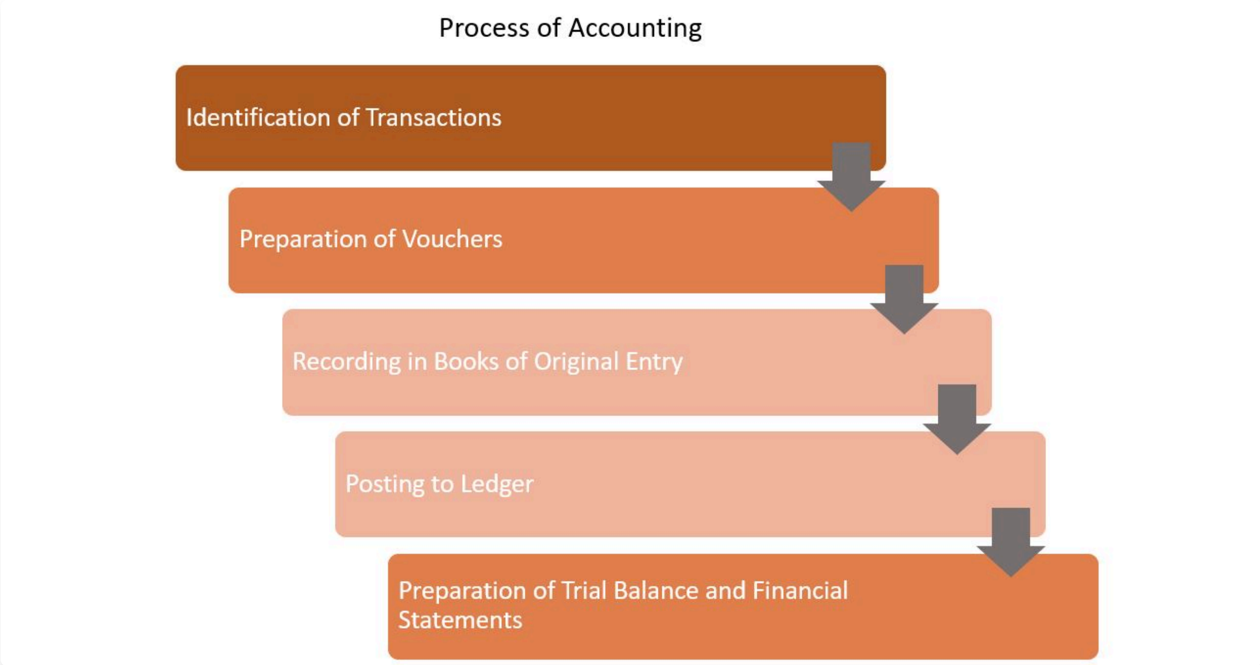
To reflect true and fair picture
The primary objective of financial reporting is to provide users with a true and fair view of the financial position and performance of the enterprise. Changes in accounting policies may be necessary to accurately reflect the economic reality of the organization's affairs and ensure that financial statements present a faithful representation of its financial condition.

A change in accounting policy may have a significant material effect on the items of financial statements. For example, if depreciation method is changed from the straight-line method to the written-down value method, or if cost formula used for inventory valuation is changed from weighted average to FIFO, or if interest is capitalized which was earlier not in practice, or if proportionate amount of interest is charged to inventory which was earlier not in practice, all these may increase or decrease the net profit.

Unless the effect of such change in accounting policy is measured, the financial statements may not help serve the purpose of users of financial information. Therefore, it is necessary to correctly estimate the effect of change on financial statement items like assets, liabilities, and profit/loss.

1. Accounting Process

Now, we will discuss what is an accounting process. The accounting process involves a systematic series of steps: identifying and analyzing business transactions, recording them, classifying and summarizing their effects, and finally communicating this information to the interested users of accounting data. This process ensures that financial information is accurate, organized, and useful for decision-making by stakeholders.



The step-by-step breakdown of accounting process is as follows.

1. Identification of Transactions
The first step is recognizing transactions that have a financial impact on the business. These can include sales, purchases, payments, receipts, etc.

These transactions are supported by source documents like invoices, receipts, bills, contracts, etc.

2. Analysing Transactions
The next step is to analyze each transaction. The accounting equation is essential in this process as it ensures that every financial transaction is recorded in a manner that keeps the balance between assets, liabilities, and equity (the components of the balance sheet). By using the equation, one can assess how each transaction impacts the company's financial position and maintain overall balance in the records.

3. Recording Transactions (Journalizing)
After identifying transactions, they are recorded in the accounting system through journal entries. This involves entering the details of each transaction in the general journal, where debits and credits are noted. Transactions are recorded in the order they occur, ensuring that all activities are tracked systematically.

4. Posting to the Ledger (Ledger Posting)
The information from the journal entries is then posted to the general ledger, which is a collection of all accounts (e.g., cash, accounts receivable, expenses).

This process involves categorizing the transactions into different accounts using T-accounts, where debits and credits are recorded.

5. Preparing a Trial Balance
Once all transactions are posted, a trial balance is prepared to ensure that total debits equal total credits. This step helps in identifying any errors in the recording process.

These initial steps set the foundation for further stages in the accounting cycle, such as adjusting entries, preparing financial statements, and closing the books.

6. Adjusting Entries

Adjustments are made for accrued and deferred items, such as unpaid expenses, unearned revenues, and depreciation. These are necessary to match revenues and expenses to the correct accounting period.

7. Preparing Financial Statements

After adjustments, the financial statements are prepared. These include the income statement, balance sheet, and cash flow statement, which summarize the financial performance and position of the business.

This cycle repeats each accounting period, ensuring that financial information is recorded, summarized, and reported accurately. Thus, the accounting cycle is a series of steps starting with recording business transactions and leading up to the preparation of financial statements. One of the main duties of a bookkeeper is to keep track of the full accounting cycle from start to finish.

The details of each of the steps of accounting process are discussed next one by one.

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2. Business Transactions

To grasp the accounting process, we should first understand the concepts of Transactions and Business Transactions.

During an accounting period, businesses encounter numerous transactions that undergo analysis in financial terms before being individually recorded.

Transactions are financial activities that involve exchanging goods, services, or money.

For example, selling a laptop for cash is a business transaction that includes a reciprocal exchange: (i) receiving cash and (ii) giving the laptop. Here, the "give" aspect is the delivery of the laptop, while the "take" aspect is the receipt of cash. This transaction affects two accounts: the cash account increases (because cash is received), and the stock account decreases (because the laptop is given away).

Thus, **business transactions** involve giving something and receiving something in return, impacting at least two accounts in the financial records.

Now, these business transactions are supported by various documents such as cash memos, invoices, sales bills, pay-in slips, cheques, and salary slips. These documents, which provide proof of the transactions, are known as **Source Documents** or **Vouchers**.

In the above example of business transaction of selling a laptop for cash, the source document or voucher would typically be a sales receipt or cash memo. This document provides evidence of the sale, showing details like the date of the transaction, the amount received, and a description of the laptop sold.
