UNIT-V
INTRODUCTION TO FINANCIAL ACCOUNTING

Meaning of Accounting

Accounting is a process of recording, classifying and summarizing business transactions which are of financial character and analyzing and interpreting and communicate the results to interested parties.

Definitions of Accounting:

According to Smith and Ashburne, "Accounting is the science of recording and classifying business transactions and events, primarily of financial character and art of making significant summaries, analysis and interpretations of those transactions and events and communicating the results to persons who must make decisions or form judgments".

According to committee on terminology of American Institute of Certified Public Accountants (AICPA), "Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money transactions and events which are in part, at least of financial character and interpreting the results thereof."

Another definition given by the same professional body, namely, AICPA stated that: "Accounting is the collection, measurement, recording, classification and communication of economic data relating to an enterprise for the purpose of reporting, decision making and control.

In 1966, the American Accounting Association defined accounting as follows: "Accounting is the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of the information."

Functions / Nature of Financial Accounting:

1. Systematic record of business transactions / Recording: Recording is the basic function of accounting. Accounting records business transactions in terms of money. It is essentially concerned with ensuring that all business transactions of financial nature are properly recorded. Recording is done in **Journal** in chronological order. To keep systematic record of transactions, post them into ledger and ultimately to prepare the final accounts is the first function of accounting.

2. Classifying: Accounting also facilitates classification of all business transactions recorded in the journal. Items of similar nature are classified under appropriated heads. It deals with classification of recorded transactions so as to group similar transactions at one place. The work of classification is done in a book called the Ledger, where similar transactions are recorded at one place under individual account heads. Eg. In sales account all sale of goods are recorded. In purchases account all purchase of goods are recorded.

3. Summarizing: It involves presenting classified transactions in a manner useful to both its internal and external users. It involves preparation of financial statements i.e profit& lossaccount and Balance sheet etc., Accounting summarizes the classified information. This process leads to the preparation of Trial balance, Income statement and balance sheet.

4. Analyzing: The recorded data in financial statement is analyzed to make useful interpretation. The figures given in financial statements need to be put in a simplified manner. Eg. All items relating to fixed assets are placed at one place while long term liabilities areplaced at one place.

5. Interpretation: It deals with explaining the meaning and significance of the data simplified. The accountants should interpret the statements in a manner useful to the users. Interpretation of data helps management, outsiders and shareholders in decision making. It aims at drawing meaningful conclusions from the information. Different parties can make meaningful judgments about the financial condition and profitability of business operations.

6. Communicating Results to Interested Parties: Accounting also serves as an information system. It is the language of the business. It supplies the meaningful information about the financial activities of the business to varies parties i.e., owners, creditors, investors, employees, government, public, research scholars and managers at the right time. It is a service function. It is not an end itself but ameans to an end. It involves preparation and distribution of reports to the users to make decisions.

Significance of Accounting:

Maintaining proper/systematic record of Business Transactions: Accounting replaces the limitations of human memory. The main purpose of accounting is to identify business transactions of financial nature and enter them into appropriate books of accounts. Accounting helps to keep record of all financial transactions and events systematically in proper books of accounts.

To ascertain the financial results of the enterprise: One of the main important of accounting is to ascertain or calculate the profit or loss of the businessenterprise. Income statements are prepared with the help of trial balance (prepared with the balances of ledger accounts). At the end of the accounting period, we prepare trading account and ascertain gross profit or gross loss. Afterwards profit and loss account is prepared to ascertain net profit or net loss.

To ascertain financial position or financial health of the business: At the end of the accounting period, we prepare position statement. Balance sheet is a statement of assets and liabilities of the business on a particular date and serves as a parameter to measure the financial health of the business.

To help in decision making: Accounting serves as an information system for helping to arrive at rational decisions. American Accounting Association also stresses upon this point while defining the term Accounting as “the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of the information. Accounting keeps systematic record of all transactions and events which are used to assist the management in its function of decision making and control.

Providing Effective Control over the Business: Accounting reveals the actual performance of the business in terms of production, sales, profit, loss, cost ofproduction and the book value of the sundry assets. The actual performance can be compared with the planned and or desired performance of the business. It can also becompared with the previous performance. Comparison reveals deviation in terms ofweaknesses and plus points.

Making Information to various groups: Accounting makes information available to all these interested parties. Proprietors have interest in profit or dividend, debenture holders, lenders and investors are concerned with the safety of money advanced by them to the business and interest thereon. The object of the accounting is to provide meaningful information to all these interested parties.

Advantages of Accounting:

Replacement of memory: In a large business it is very difficult for a business-man to remember all the transactions. Accounting provides records which will furnishinformation as and when desired and thus it replaces human memory. All financial transactions are recorded in a systematic manner in books of accounts so that there is no needto relay on memory.

Evidence in court: Properly maintained accounts are often treated as goodevidence in the court to settle a dispute.

Settlement of taxation liability: If accounts are properly maintained, it will be of great assistance to the businessman in settling the income tax and sale tax liabilityotherwise tax authorities may impose any amount of tax which the businessman will have to pay.

Comparative study: Accounting provides the facility of comparative study of the various aspects of the business such as profits, sales, expenses etc. with that of previous year and helps the business man to locate significant factor leading to the change, if any. Systematic maintenance of business records enables the accountant to compare the profit of one year with those of earlier year‟s profits and to know the significant facts about the changes. This helps the business to plan its future affairs accordingly.

Sale of the business: If accounts are properly maintained, it helps to ascertainthe proper purchase price in case the businessman is interested to sell his business.

Assistance to the insolvent person: If a person is maintaining proper accounts and unfortunately he becomes insolvent (i.e., when he is unable to pay to hiscreditors), he can explain many things about the past with the help of accounts and can start afresh life.

Assistance to various interested parties: It provides information to various interested parties, i.e., owners, creditors, investors, government, managers, research scholars, public and employees and financial position of a business enterprise from their own view point. Various interested parties or groups are interested in accountinginformation related to various aspects viz., sales, production, profit etc. Accounting provides suitable information to such interested parties.

Preparation of Financial Statements: Systematic records enable the accountant to prepare financial statements. Trading and Profit and Loss account isprepared for calculating profit or loss during a particular period and Balance sheet is prepared to state the financial position of the business on a particular date.

Decision Making: The accountant helps the management by providing the relevantinformation for solving the day to day problems of the business.

Planning and Control of Operations: Planning operations like sales, production, cash requirements for the next account period are achieved with the help ofaccounting information and estimates can be prepared based on that information.

Value of Business: Accounting records kept in a proper way enables a businessunit to determine the purchase or sale value of the business in a simple manner.

Limitations or disadvantages of Accounting:

Records only monetary transactions: Accounting records only those transactions which can be measured in monetary terms. Those transactions which cannot be measured in monetary terms as conflict between production manager and marketing manager, office management etc., may be very important for concern but not recordedin the business books.

Effect of price level changes not considered: Accounting transactions are recorded at cost in the books. The effect of price level changes is not brought into the books with the result that comparison of various years becomes difficult. For example, the sales to total assets in 2007 would be much higher than in 2003 due to rising prices, fixed assets beingshown at cost and not at market price.

No realistic information: Accounting information may not be realistic as accounting statements are properly prepared by following basic concepts and conventions. Forexample, going concern concept gives us an idea that the business will continue and assets are to be recorded at cost but the book value which the asset is showing may notbe actually realizable. Similarly, by following the principles of conservation the financial statements will not reflect the true position of the business.

No real test of managerial performance: Profit earned during an accounting period is the test of managerial performance. Profit may be shown in excess by manipulation of accounts by suppressing such costs as depreciation, advertisement and research and development or taking excess value of closing stock.

Historical in nature: Usually accounting supplies information in the form of Profit and Loss Account and Balance Sheet at the end of the year. So, the information provided is of historical interest and only gives post-mortem analysis of the past accounting information. For control and planning purposes management is interested in quick and timely information which is not provided by financial accounting.

Personal bias / judgment of Accountant affects the accounting Statements: Accounting statements are influenced by the personal judgment of the accountant. He may select any method of depreciation, valuation of stock, amortization of fixed assets and treatment of deferred revenue expenditure. Such judgment based on integrity and competency of the accountant will definitely affect the preparation of accounting statements.

Permits alternative treatments: Accounting permits alternative treatments within generally accepted accounting concepts and conventions. For example, method of charging depreciation may be straight line method or diminishing balance method or some other method. Similarly, closing stock may be valued by FIFO(First-in-First Out) or LIFO(Last in First Out) or Average Price Method. Application of different methods may give different results and results may not be comparable.

Process of Accounting:

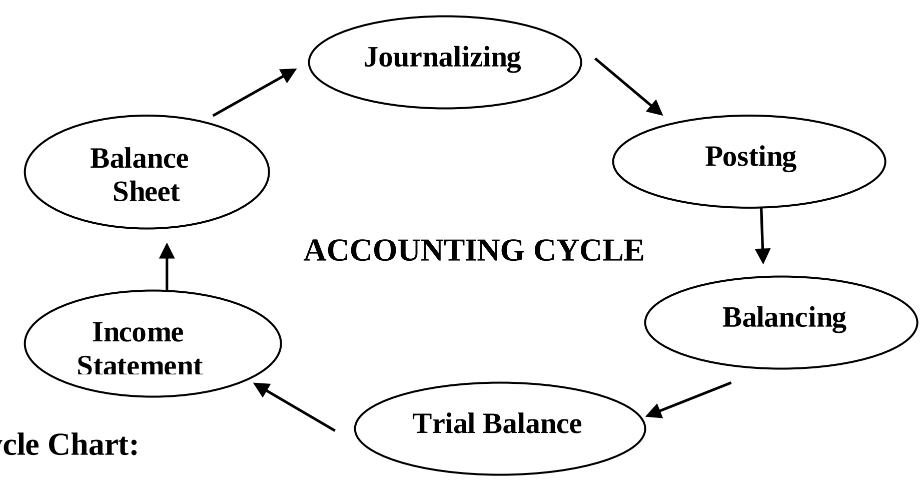
Accounting Process consists of the following stages:

1. Recording of entries for all business transactions in Journal.
2. Posting of entries into Ledger.
3. Balancing of accounts.
4. Preparing of Trial Balance with the help of different accounts to know the arithmetical accuracy.
5. Preparing final accounts with the help of Trial Balance.
   - Trading and Profit and Loss Account is prepared to know the Profit or Loss.
   - Balance Sheet is prepared to know the financial position of the Business concern.

   Accounting Process is also known as accounting cycle.

Accounting Cycle:

An Accounting cycle is a complete sequence beginning with the recording of the transactions and ending with the preparation of the final accounts. The sequential steps involved in an accounting cycle are as follows:



Accounting Cycle Chart:

Step 1: Journalizing: Record the transactions and events in the Journal.

Step 2: Posting: Transfer the transactions in the respective accounts opened in the ledger.

Step 3: Balancing: Ascertain the difference between the total of debit amount columnand the total of credit amount column of a ledger account.

Step 4: Trial Balance: Prepare a list showing the balance of each and every account to verify whether the sum of the debit balances is equal to the sum of the credit balances.

Step 5: Income Statement: Prepare Trading and Profit and Loss account to ascertain the profit or loss for accounting period.

Step 6: Balance Sheet: Prepare the Balance Sheet toascertain the financial position as at the end of accounting period.

Book-keeping

Bookkeeping is a part of the accounting process that deals with recording of the transactions. It is the systematic recording and classification of accounting transactions. Bookkeeping can be described as an accounting function that is helpful in the accounting process.

Bookkeeping is associated with proper classification of all the financial transactions that take place in the business. It ensures that the recorded transactions are correct and properly updated.

Bookkeeping is the source of information from which financial accounts are prepared. Accurate bookkeeping is essential for the external users, which includes investors, government and other financial institutions.

Bookkeeping provides these users with reliable information that influences decisions related to lending and investment.

Types of Bookkeeping

Bookkeeping can be of different types, the most common ones are single entry and double entry bookkeeping systems.

1. **Single Entry bookkeeping:** Single entry bookkeeping is the recording of transactions using a single entry. The transactions are either recorded as incoming or outgoing.
2. **Double Entry bookkeeping:** Double entry bookkeeping is that system of bookkeeping where two entries are given for a transaction; one will be debit while the other will be a credit entry.

Double Entry Book-keeping

Double entry system is a scientific way of presenting accounts. As such all the business concerns feel it convenient to prepare the accounts under double entry system. The taxation authorities also compel the businessmen to prepare the accounts under Double Entry System. Under dual aspect the Account deals with the two aspects of business transaction i.e., (1) Receiving Aspect and (2) Giving Aspect. Receiving Aspect is known as Debit aspect and Giving Aspect is known as Credit aspect. Under which system these two aspects of transactions are recorded in chronological manner in the books of the business concern is known as Double Entry System. In Double Entry System these two aspects are recorded facilitating the preparation of Trial Balance and the Final Accountsthere from.

Principle of Double Entry System

Every business transaction has got two accounts, where one account is debited and the other account is credited. If one account receives a benefit, there should be another account to impart/give the benefit. The principle of Double Entry is based on the factthat there can be no giving without receiving nor can there be receiving without something giving. The receiving account is debited (i.e., entered on the debit side of the account) and the giving account is credited (i.e., entered on the credit side of the account).

The principle under which both debit and credit aspects are recorded is known asthe principle of double entry. According to this principle every debit must necessarily have a corresponding credit and vice versa.

Advantages of Double Entry System:

1. **Scientific system**: Double entry system records, classifies and summarizes business transactions in a systematic manner and, thus, produces useful information for decision makers. It is more scientific as compared to single entry of book-keeping.

2. **Full Information:** Full and authentic information can be had about all transactions as thetrader maintains the ledger with all types of accounts**.**

3. **Assessment of Profit and Loss:** The businessman/trader will be able to know correctly whether he had earned profit or sustained loss. It facilitates the trader to take such steps so asto increase the efficiency of the firm.

4. **Knowledge of Debtors:** The trader will be able to know exactly what amounts are owed by different customers to the firm. If any amount is pending for a long time from any customer, he may stop credit facility to that customer.

5. **Knowledge of Creditors:** The trader is also knows the exact amounts owed by the firmto others and he will be able to arrange prompt payment to obtain cash discount.

Limitations / Disadvantages of Double Entry System:

The Double Entry System however may not provide any solution to the following errors.

1. Not Practical to All Concerns: This system requires the maintenance of a number of booksof accounts which is not practical in small concerns.

2. Costly system: This system is costly because of a number of records are to be maintained.

3. No guarantee of Absolute Accuracy of the Books of Account: There is no guarantee of absolute accuracy of the books of account inspite of agreement of the trial balance because of there are some errors like errors of principles, errors of omission, compensating errors etc., which remain understand inspite of agreement of trial balance.

4. Errors of Omission: In case the entire transaction is not recorded in the books of accounts, the mistake cannot be detected by accounting. The Trial Balance will tally inspite of the mistakes.

5. Errors of Principle: Double entry is based upon the fact that every debit has its corresponding credit and vice versa. It will not be able to detect the mistake such as debiting Ram‟s account instead of Rao‟s account or Building account in place of Repairs account.

Difference between Single Entry System & Double Entry System

Basis of Comparison	Single Entry System	Double Entry System
Meaning	The system of accounting in which only one sided entry is required to record financial transactions is Single Entry System.	The accounting system, in which every transaction affects two accounts simultaneously, is known as the Double Entry System.
Based on	Based on the cash book	Based on the principles of debit and credit
Nature	Simple and easy to maintain	More complex and requires proper knowledge
Recording	Records only cash and personal accounts	Records all types of accounts and transactions
Information	Provides limited financial information	Provides comprehensive financial information
Suitable for	Suitable for small businesses	Suitable for large businesses and organizations
Preparation of	No trial balance or balance sheet is prepared	Trial balance and balance sheet are prepared
Errors	Difficult to detect errors and frauds	Errors and frauds can be detected more easily
Suitable for tax purposes	No	Yes
Financial position	Cannot be ascertained easily.	Can be ascertained easily.

Accounting Principles:

Account is a system evolves to achieve a set of objectives. In order to achieve the goals,we need a set of rules or guide lines. These guide lines are termed as "Accounting Principles"

Accounting Principles are of 2 types:-

1. Accounting Concepts
2. Accounting Conventions.

Accounting Principles

Accounting Concepts

1. Business Entity Concept
2. Going Concern Concept
3. Money Measurement Concept
4. Cost Concept
5. Accounting Period Concept
6. Dual Aspect Concept
7. Matching Concept
8. Realization Concept

Accounting Conventions

1. Convention of full Disclosure
2. Convention of Consistency
3. Convention of Conservation
4. Convention of Materiality

Different types of Accounting Concepts:

The term concept means an idea or thought. Basic accounting concepts are the fundamental ideas or basic assumptions underlying theory and practice of financial accounting. These are broad working rules of accounting activity. They are evolved over a period in response to changing business environment. They are developed and accepted by accounting profession. The concepts guide the identification of events and transactions to be accounted for.

The concepts help in bringing about uniformity in the practice in accounting. In accountancy following concepts are quite popular.

1. **Business Entity Concept:** Business is treated separate from the proprietor. All the transactions are recorded in the books of the proprietor. The proprietor is also treated as a creditor for the business. When he contributes capital, he is treated as a person who has invested his amount in the business. Therefore, capital appears in the liabilities of balance sheet of the proprietor.

2. **Going Concern Concept:** This concept relates with the long life of the business. The assumption is that business will continue to exist unlimited period unless it is dissolved due to some reason or the other. When final accounts are prepared, record is made for outstanding expenses and prepaid expenses because of the assumption that business will continue. Going concern concept helps other business undertaking to make contracts withspecific business unit for business dealing in future.

3. **Money Measurement Concept:** Only those transactions are recorded in accounting which can be expressed in terms of money. The transactions which cannot be expressed in money fall beyond the scope of accounting. One serious short coming of this concept is that the money value of that date is recorded on which transaction has taken place. It does not recognize the changes in the purchasing power of monitory unit.

4. **Cost Concept:** According to this concept, an asset is recorded at its cost in the books of account, i.e., the price, which is paid at the time of acquiring it. In balance sheet, these assets appear not at cost price every year, but depreciation is deducted and they appear at the amount, which is cost less depreciation. Under this concept, all such events are ignored which affect the business but have no cost. For example, if

an important and influential director dies, then the earning capacity and position of the business will be affected. But this event has nocost. Hence it will not be recorded in account books.

5. **Account Period Concept:** Every businessman wants to know the result of his investment and efforts after a certain period. Usually one-year period is regarded as an ideal for this purpose. The life of the business is considered to be indefinite, but the measurement of income cannot be postponed for a very long period of time. Therefore, it is necessary to have a period for which the operational results are assessed for external reporting. Hence a period of one year i.e., twelve months is considered as accounting period. It may be a calendar year (January to December or any period of one year.) In India, the accounting period beginson 1st April every year and ends on 31st March every year. This concept implies that at the end of each accounting period, financial statements i.e., profit & loss account and balance sheet are to be prepared. It is mandatory under Income Tax Act to assess profit of the business every year and determine tax liability.

6. **Dual Aspect Concept:** Under this concept, every transaction has got a twofold aspects i.e., (i) receiving aspect/ receiving benefit and (ii) giving aspect/ giving of benefit. For instance, when a firm acquires an asset (receiving of the benefit), it must haveto pay cash (giving of benefit). Therefore, two accounts are to be passed in the books of accounts. One for the receiving benefit and the other for the giving of benefit. Thus, there will be a double entry for every transaction – debit for receiving the benefit and credit for giving the benefit.

7. **Matching Concept:** Every businessman is eager to make maximum profit at minimum cost. Hence, he tries to find out revenue and cost during the accounting period.An accountant records all expenses of a year (whether they are paid in cash or are outstanding) and all revenues of a year (whether they are received in cash or accrued).

   Expenses, which are incurred during a particular accounting period forearning the revenue of the related period, are to be considered. All expenses incurred during the accounting period must not be taken. Only relevant cost should be deducted from the revenue of a period for periodic income statement. The process of relating coststo revenue is called "Matching process". While ascertaining profit, other appropriatecost which are not directly related to cost of goods sold are to be taken into consideration. Example, rent paid, interest paid, depreciation etc., Thus appropriate costshave to be matched against the appropriate revenues for the accounting period.

8. **Realization Concept:** This concept is also known as "revenue recognition concept". Revenue results out of sale of goods and services. According to this concept revenue is realized when a sale is made. Sale is considered to be made at the point when the property in goods passes to the buyer and he becomes legally liable to pay. No profit or income will arise without the realization of sales. Likely sales and anticipated revenues are not to be recorded in account books. The realization concept is important in ascertaining the exact profit earned during a period in a business concern. Accordingto this concept, the revenue should be considered only when it is realized. Any business transaction should be recorded only after it actually taken place. Production of goods does not mean that the total production is sold, it should be recorded only when they are sold and cash realized or obligation created.

Different types of Accounting Conventions:

In accounting, convention means a custom or tradition, used as a guide for thepreparation of accounting statement. The following are the accounting conventions:

1. **Convention of Full Disclosure:** Accounting to this convention, accounts should be prepared honestly and they should disclose all materials and significant information. Every company shall keep proper books of

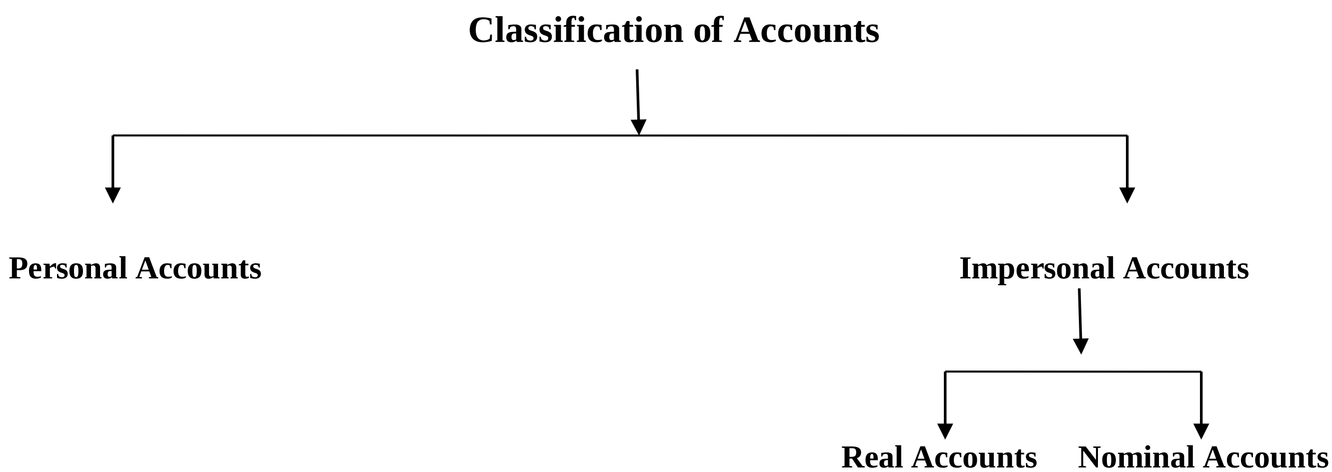
accounts. Auditor records expenses, incomes, profits, losses, assets and liabilities. The essential items to be disclosed in the Profit and Loss Account are given. There is legal form for the balance sheet.

2. **Convention of Consistency:** In every business, the management draws important conclusion from the financial statements, regarding working of the concern, for this purpose in preparing the final accounts. The same principle and practices should be followed from year to year.

3. **Convention of Conservation:** This is very important in preparing final accounts. This term suggests caution. All prospective profits should be ignored. All outstanding expenses should be taken into account. Adequate reserves or provisions should be provided for. This means that there should be no window dressing and secret reserves.

4. **Convention of Materiality:** This is also called the convention of reasonable degree of accuracy. According to this, the information given in the accounts should bereasonable accurate. All the entries should be exact. Fraction of a rupee is avoided.

Classification of Accounts:



Broadly speaking accounts are classified into two types. They are

I. Personal Accounts
II. Impersonal Accounts. Impersonal accounts are again divided into RealAccounts and Nominal Accounts. Thus accounts are of Two types.
   1. Real Accounts
   2. Nominal Accounts

1. **Personal Accounts: Personal Accounts are those which are opened in the names of persons.** These are accounts of persons and institutions with whom the business deals. A separate account is kept for each person. Personal accounts can be also sub classifiedinto three categories:

   They are i) Natural personal accounts ii) Artificial Personal accounts iii) Representative Personal accounts.

   i) **Natural Personal Accounts:** The term Natural Persons means who are creations of Gods. For example Ravi Account, Rani Account, Raghu account Nagarjuna

Account etc., are called as Natural Personal Accounts.

ii) **Artificial Personal Accounts:** These accounts include accounts of corporate bodies or institutions which are recognized as persons in business dealings. The account of a Limited Company, the accounts of co-operative society, the accounts of clubs, the account of Government, the account of insurance company, the account of Colleges, Schools, Universities and Hotels etc., are examples of Artificial Personal Accounts.

iii) **Representative Personal Accounts:** These are accounts which represent a certain person or group of persons. For example, Outstanding expenses A/c, Prepaid expenses A/c, Income Receivable A/c and Income received in advance A/c, Drawings A/c and Capital A/c are termed as Representative Accounts.

<u>Principle/ Rule of Personal Account:</u>

1. **Debit the receiver and**
2. **Credit the giver.**

For example, if cash has been paid to Raja, the account of Raja will have to be debited since Raja is the receiver of cash.

Similarly, if cash received from Krishna, the account of Krishna will have to be credited since Krishna is the giver of cash.

2. Real Account: Real Accounts are those which are relating to Properties and Asset of the business concern. Accounts relating to properties or assets or possessions of the firm are called Real Accounts. Every business firm needs Fixed Assets such as Land and Buildings, Plant and Machinery, Furniture and Fixtures etc for running its business. A separate account is maintained for each asset. There are four types of Assets. They are

I. **Fixed Assets:** Those assets which are acquired for long term use by the business concern are known as Fixed assets. For example Land and Buildings, Plant and Machinery, Furniture and Fixtures etc are called as Fixed Assets.

II. **Current Assets:** Those assets which are possible to convert into cash are known as known as Current assets. For example cash in hand, cash at Bank, Stock in trade, Debtors, Bills Receivable etc., are called as current assets.

III. **Tangible Assets:** Tangible assets are those which relate to such things which can be touched, felt, measured etc., Tangible assets have physical existence. Hence these assets may be transferred from one place to another place. Fixed assets and Current assets are the examples of Tangible assets.

IV. **Intangible Assets:** These accounts represent such things which cannot be touched. Of course, they can be measured in terms of money. Intangible assets haven’t any physical existence. Goodwill, copy rights, patents and trademarks are the examples of Intangible assets.

<u>Principle/Rule of Real Account:</u>

1. **Debit what comes into the business and**
2. **Credit what goes out of the business.**

For example, if machinery has been purchased for cash, machinery account should be debited since Machinery is coming into the business, while cash account should be credited since cashis going out of the business.

If furniture is sold for cash, cash account should be debited since cash is coming into the business, while Furniture account should be credited since furniture is going out of the business.

3. Nominal Accounts: Nominal accounts include accounts of all Expenses, Losses, Incomesand Profits or Gains.

The examples of Expenses and Losses are salaries, wages, rent, taxes, lighting charges, transport charges, travelling charges, coolie charges, warehouse rent, insurance, advertisement paid, Bad debts, commission paid, Discount allowed, interest paid, interest paid on capital,

The examples of Incomes and Profits are rent received, interest received, commission received, discount received, dividend received, interest on investment received, bad debts recovered etc.,

These accounts are opened in the books to simply explain the nature of the transactions. Theydo not really exist. For example, in a business when salary is paid to the manager, commissionis paid to the salesmen, rent is paid to landlord, cash goes out of the business and it is somethingreal, while salary, commission, or rent as such does not exist. The accounts of these items are opened simply to explain how the cash has been spent. In the absence of such information, it may be difficult for the cashier to explain how the cash at his disposal was utilized. Nominal accounts are also called Fictitious Accounts.

<u>Principle or Rule of Nominal Account:</u>

1. **Debit all Expenses and Losses and**
2. **Credit all Incomes and Profits/Gains.**

For example when salaries paid in cash, salaries account should be debited since Salaries is an expenditure to the business, while cash account should be credited since cash is going out of the business.

For example If Rent received in cash, Cash account should be debited since cash is coming into the business, while rent account should be credited since Rent Received is an income to the business.

The principle of Nominal account is quite opposite to the principles of personal account and real account. As per the principle of Nominal account receiving aspects (Incomes and profits) are credited and giving aspects (expenses and losses) are debited. But as per the principles of personal account and real account, receiving aspect is debited and giving aspect is credited. Hence the rule of Nominal account is different from the principles of Real account andNominal account.

JOURNAL:

The word Journal is derived from the French word “Jour” which means a day. Journal, therefore, means a daily record of business transactions. Journal is a book of original entry/prime entry because transaction is first written in the journal from which it is posted to the ledger at any convenient time. The journal is a complete and chronological record of business transactions. It is recorded in a systematic manner. The process of recording a transaction in the journal is called **Journalising**. The entries made in the book are called **Journal Entries**.

Proforma of Journal

Journal Entries in the books of-------------------

Date	Particulars	L.F	Debit (Rs.)	Credit (Rs.)

Advantages of Journal/ Importance of Journal

The main advantages of Journal are given below:

1. Availability of Full information/Complete Record: All business transactions date-wise will be recorded in the Journal As such the total information for every transaction can be obtained very easily without late. So Journal serves as a complete record. It provides a chronological record of all transactions and hence provides permanent record.

2. Posting becomes easy: When once the transactions are entered in the Journal, recording the same in the relevant accounts in the ledger can be made easily. The businessman can have an understanding on debit and credit principles in the beginning itself. It provides information of debit and credit in an entry and an explanation to make it understandable properly.

3. Explanation of the transaction: Every Journal entry will be briefly explained with a narration. Narration helps in proper understanding of the entry.

4. Location of the errors easy: Journal helps to locate the errors easily. Both debit and credit aspects of a transaction are recorded in the journal. Since the amount recorded in debit amount column and credit amount column must be equal. Therefore, the possibility of committing errors is reduced and the detection of errors, if any, committed becomes easy.

5. Chronological order: Transactions are recorded in a chronological order in the Journal. Hence, when any information is required, the information can be traced out quickly and easily.

LIMITATIONS / DISADVANTAGES OF JOURNAL:

The following are the main limitations of the journal.

1. The Journal will be too long and becomes unwieldy if all transactions are recorded in the journal.
2. The Journal is unable to ascertain daily cash balance. That is why cash transactions are directly recorded in a separate cash book so that daily cash balances may be available.
3. It becomes difficult in practice to post each and every transaction from the Journal to the ledger. Hence in order to make the accounting easier and systematic, transactions are recordedin total in different books.

LEDGER:

Ledger means posting transactions entered in the journal into their respective accounts in the ledger. It is the book of final entry. The Ledger is designed to accommodate the various accounts maintained by a trader. It containsthe final and permanent record of all transactions in duly classified form. A ledger is a book which contains various accounts. The process of transferring the entries from the journal intothe ledger is called posting.

- It is vertically divided into two halves/parts.
- It is prepared in the form of Alphabet T.
- The left side of this account is known as Debit side and right side of the account is known as Credit side.
- Debit is the Receiving Aspect / Benefit and Credit is the Giving Aspect / Benefit.
- The word Dr should be written at the top left hand corner side of the account. The word Cr should be written at the top right hand corner side of the account.
- The title or name of the account should be written at the top in the middle of the account.
- The word "To" should be written on the debit side of an account in the particulars column.
- The word "By" should be written on the credit side in the particulars column of an account.
- All the Receiving Aspects are entered on the debit side and all the Giving Aspects are entered on the credit side of the account in the particulars column.
- All accounts are maintained in Ledger. So they are called "Ledger accounts".

Performa of an Account: An account contains the following columns on the following columns on either side. 1) Date column 2) Particulars column 3) Journal Folio column 4) Amount column.

The format or ruling of an account is as follows:

Dr **Name of the account** **Cr**

Date	Particulars	J.F	Amount Rs.	Date	Particulars	J.F	Amount Rs.
	To Particulars of benefits received				By Particulars of benefits given		

Features of a Ledger:

i. Ledger contains all the accounts-personal, real and nominal accounts.
ii. It is a permanent record of business transactions.
iii. It provides a means of easy reference.
iv. It provides final balance of the accounts.

Ledger is the principal book of accounts because it helps us in achieving the objectives of accounting. It gives answers to the following pertinent questions.

- How much amount is due from others to the business?
- How much amount is owed to others?
- What are the total sales to an individual customer and
- What are the totalpurchases from an individual supplier?
- What is the amount of profit or loss made during a particular period?
- What is the financial position of the firm on a particular date?

Advantages/ Utilities/Importance of Ledger

The following are the main utilities of Ledger

1. It provides complete information about all accounts in one book.
2. It is easy to ascertain how much money is due to suppliers (trade creditors from creditors‟ ledger) and how much money is due from customers (trade debtors from debtors‟ ledger).
3. It enables to ascertain, what are the main items of revenues/incomes (Nominal accounts).
4. It enables to ascertain, What are the main items of expenses(Nominal accounts)
5. It enables to know the kind of assets the enterprise holds and their respective values(Real Accounts)
6. It facilitates preparation of trial balance and thereafter preparation of financial statements i.e., profit and loss account and balance sheet.

Differences between Journal and Ledger

Point of difference	Journal	Ledger
Meaning	The book in which all the transactions are recorded, as and when they arise is known as Journal.	The book which enables to transfer all the transactions into separate accounts is known as Ledger.
What is it?	It is a subsidiary book.	It is a principal book.
Also known as	Book of original entry.	Book of second entry.
Record	Chronological record	Analytical record
Process	The process of recording transactions into Journal is known as Journalizing.	The process of transferring entries from the journal to ledger is known as Posting.
How transactions are recorded?	Sequentially	Account-wise
Debit and Credit	Columns	Sides
Narration	Must	Not necessary.
Balancing	Need not to be balanced.	Must be balanced.

TRIAL BALANCE:

Trial balance is a bookkeeping worksheet in which the balances of all ledgers are compiled into debit and credit account column totals that are equal. A company prepares a trial balance periodically, usually at the end of every reporting period.

Definitions of Trial Balance:

According to J.R.Batliboi, "A Trial Balance is a statement of Debit and Credit balances extracted from the various accounts in the ledger with a view to test the arithmetical accuracy of the books."

According to Spicer and Pegler, "A Trial Balance is a list of all the balances standing on the ledger accounts and cash book of a concern at any given date."

Features of a Trial Balance:

1. It is not an account., it is only a statement which is prepared to verify the arithmetical accuracy of ledger accounts.

2. It contains debit and credit balances of ledger account.
3. It is prepared on a particular date generally at the end o f business year.

4. Trial Balance helps in preparing final accounts.
5. As it is prepared by taking up the ledger account balances, both debit and credit side of a Trial Balance are always equal.
6. The preparation of Trial Balance is not compulsory. There is no hard fast rule in this regard.

Importance / Merits /Advantages of Trial Balance:

1. **Proof of Arithmetical accuracy:** It helps in checking the arithmetical accuracy of books of accounts.

2. **Preparation of financial statements:** It helps in the preparation of final accounts i.e., Trading Account, Profit & Loss Account and Balance Sheet.

3. **Detection of Errors:** It will help in detection of errors in the books of accounts and intheir rectification.

4. **Rectification of Errors:** It serves as instrument for carrying out the job of rectificationof errors.

5. **Easy Checking:** It is possible to find out the balances of various accounts at one place.

Limitations of Trial Balance:

1. Trial balance can be prepared only in those concerns where double entry system of accounting is adopted. This system is **very costly** and **time consuming**. It cannot be adopted by the small business concerns.

2. Though Trial Balance gives arithmetical accuracy of the books of accounts but there are certain errors which are not disclosed by Trial Balance. That is why it is said that Trial balance is not a conclusive proof of the accuracy of the books of accounts.

3. If Trial Balance is not prepared correctly then the final accounts prepared will not reflect the true and fair view of the state of the affairs/financial position of the business. Whatever conclusions and decisions are made by the various groups of persons will not be correct and will mislead such persons.

4. Trial Balance tallies even though errors are existing in the books of accounts.

5. Even some transactions are omitted the Trial Balance tallies.

Objectives of Trial Balance:

The following are the **main objectives** of preparing the Trial Balance.

1. To have balances of all the accounts of the ledger in order to avoid the necessity of going through the pages of the ledger to find it out.
2. To have a proof that the double entry of each transaction has been recorded because ofits

agreement.

3. To have arithmetical accuracy of the books of accounts because of the agreement of the Trial Balance.
4. To have material for preparing the profit or loss account and balance sheet of the business.

Specimen of Trial Balance

S.No	DEBIT		S.No	CREDIT	
1	Opening Stock	Asset	1	Sales	Gain
2	Provision for discount on Creditors	Asset	2	Creditors	Liability
3	Debtors	Asset	3	Cash in Hand	Liability
4	Goodwill	Asset	4	General Reserve	Liability
5	Plant & Machinery	Asset	5	Provision for Depreciation	Liability
6	Land & Buildings	Asset	6	Bills Payable	Liability
7	Furniture & Fittings	Asset	7	Bank Overdraft	Liability
8	Investments	Asset	8	Outstanding Salaries	Liability
9	Loan Advances	Asset	9	Capital	Loan
10	Horse & Carts	Asset	10	Loan Taken	Loan
11	Bills Receivables	Asset	11	Discount Received	Revenue
12	Prepaid Insurance	Asset	12	Commission Received	Revenue
13	Patents & Trademarks	Asset	13	Interest Received	Revenue
14	Motor Cycle	Asset	14	Petty Receipts	Revenue
15	Income Tax	Drawings	15	Bad Debts Reserve	Revenue
16	Purchases	Expenses	16	Outstanding Rent	Revenue
17	Wages	Expenses	17	Returns Outwards	Gain
18	Freight	Expenses	18	Provision for discount on Debtors	Liability
19	Transport Expenses	Expenses			
20	Royalties on Production	Expenses			
21	Gas & Fuel	Expenses			
22	Repairs	Expenses			
23	Rent	Expenses			
24	Salaries	Expenses			
25	Interest Paid	Expenses			
26	Insurance	Expenses			
27	Carriage Outwards	Expenses			
28	Advt.	Expenses			
29	Petty Expenses	Expenses			
30	Trade Expenses	Expenses			
31	Office Expenses	Expenses			
32	Customs Duty	Expenses			
33	Sales Tax	Expenses			
34	Excise Duty	Expenses			
35	Returns Inwards	Loss			
36	Discount Allowed	Loss			
37	Bad Debts	Loss			
38	Depreciation	Loss			

TRADING ACCOUNT:

This account is prepared to know the trading results or gross margin on trading ofbusiness, i.e., how much gross profit the business has earned from buying and selling during a particular period. The difference between the sales and cost of goods sold is gross profit. This is a nominal account in its nature hence all the trading expenses should be debited where as all the trading incomes should be credited to Trading Account. The balance of trading account will be considered as Gross Profit (credit balance) or Gross Loss (debit balance) and will be transferred to profit and loss A/c. While preparing the trading A/c the following equations also can be used.

Sales less returns – Cost of goods sold = Gross Profit or

Gross LossSales = Total cash sales + credit sales.

Cost of goods sold = Opening stock + purchases less purchase returns + Direct expenses–Closing stock

Advantages / Importance of Trading A/c:

Trading Account has the following advantages.

- **Information of Gross profit or Gross Loss:**

  Trading Account provides information regarding gross profit and sets the upper limit within which indirect expenses are to be incurred. Indirect expenses should be much less than the gross profit so that a good amount of profit may be earned. If trading account discloses gross loss , it is better to close the business rather than running at a gross loss because gross losswill further increase when indirect expenses are added to it.

- **Gross Profit Ratio:** This ratio is calculated as follows:
  Gross profit Ratio = Gross Profit / Sales X 100

  Higher the ratio, it is better condition. Gross profit ratio can be calculated with the help the Trading account year after year and comparison of performance of year after year can be made. A low ratio indicates unfavorable trend in the form of reduction in selling prices not accompanied by the proportionate decrease in cost of goods purchased or increase in cost of production.

- **Comparison of Closing Stock with Opening Stock:**
  Comparison of stock figures of one period with another period will be helpful in avoiding overstocking. Investment in stock should be reasonable so that production and sales go on smoothly.

- **Fixation of selling price:** In case of a new product, the selling price can be easily fixed by adding in the cost of purchases or cost of goods manufactured the desired percentage of gross profit.

- It enables the comparison of sales, purchases and direct expenses of one period with another period. The comparative study helps the management to control theaffairs of the business and take sound decisions.
- It helps to check the direct expenses.
- It gives us the information about the proportion of gross profit or gross loss to the direct expenses. This study helps the management in arresting the unnecessary expenditure on any time.

Dr Trading A/C of MR……………………………for the year ended………………… Cr

Particulars		Amount	Particulars		Amount
To Opening stock		xxx	By Sales	xxx	
To Purchases	xxx		Less: Returns	xxx	xxx
Less: Returns	xxx	xxx	By Closing Stock		xxx
To Carriage Inwards		xxx			
To Wages		xxx	By Gross Loss c/d		xxx
To Freight		xxx			
To Customs Duty		xxx			
To Gas, Fuel, Coal & Water		xxx			
To Factory Expenses		xxx			
To Productive Expenses		xxx			
		xxx			
		xxx			
To Gross Profit c/d		xxx			
		xxx			xxx

PROFIT AND LOSS ACCOUNT:

This account is prepared to calculate the net profit or net loss of the business concern. There are certain items of incomes and expenses of the business which must be taken into consideration for calculating net profit or net loss of the business concern. These are of indirect nature i.e., the whole business and relating to various activities which are done by the business for the purpose of making the goods available to the customers. Indirect expenses may be administrative expenses or management expenses, selling and distribution expenses, financial expenses and extra-ordinary losses and expenses to maintain the assets into working order. This account is prepared from nominal accounts and its balance is transferred to capital account asthe whole the profit or loss will be that of the owner and it will increase or decrease the capital.

Importance of Profit and Loss Account:

Information of Net profit or Net loss: One of the important objectives of maintains the accounts are to see whether the business has earned profit of suffered loss during the accounting period. Profit and Loss

A/c provides information regarding this important objective because it gives information about the profitability or otherwise of the business.

Comparison of current profit with the last year profit: Profit and Loss A/c affords comparison of the current year’s net profit with those of the past years. With this comparison it can be ascertained whether net profit of the business is showing a rising trend or down ward trend.

Comparison of expenses: Comparison of various expenses included in the profit and loss account with expenses of the previous period helps in taking effective steps for control of unnecessary expenses.

Helpful in preparation of Balance Sheet: Net profit or Net loss disclosed by the profit and loss A/c is transferred to capital Account and Capital Account appears on the liabilities side of the Balance Sheet. Without taking net profit or net loss, the balance sheet cannot be completed. Thus, the profit and loss account helpsin the preparation of the balance sheet.

Helpful in future Growth of business: On the basis of their profit figures of the current and previous period, estimates about the profits in the years to come canbe made and projections about the expansion of the business can be made.

Dr Profit & Loss A/C of MR…………………………for the year ended………………… Cr

Particulars	Amount	Particulars	Amount
To Gross Loss b/d	xxx	By Gross Profit b/d	xxx
To Office Salaries	xxx	By Interest Received	xxx
To Rent, Rates & Taxes	xxx	By Discount Received	xxx
To Printing & Stationary	xxx	By commission Received	xxx
To Legal Charges, Audit fee	xxx	By Income from Investments	xxx
To Insurance	xxx	By Dividend on Shares	xxx
To General Expenses	xxx	By Rent Received	xxx
To Advt.	xxx	By Miscellaneous Investments	xxx
To Bad Debts	xxx	By Net Loss…	xxx
To Carriage Outwards	xxx	(Transfer to Capital A/C)	xxx
To Repairs	xxx		
To Depreciation	xxx		
To Interest Paid	xxx		
To Interest On Capital	xxx		
To Interest on Loans	xxx		
To Discount Allowed	xxx		
To Commission	xxx		
To Net Profit….	xxx		
(Transferred to Capital A/C)	xxx		
	xxx		
	xxx		
	xxx		xxx

BALANCE SHEET:

A Balance Sheet a statement prepared with a view to measure the financial position of a business on a certain fixed date. The financial position of a concern is indicated by its assets on a given date and its liabilities on that date. Excess of assets over liabilities represent the capitaland is indicative of the financial soundness of a company.

A Balance sheet is also described as a "statement showing the sources and application of the capital". It is a statement and not an account and prepared from real and personal accounts. Sources or liabilities are shown on the left hand side of the Balance Sheet. Application of funds (Assets) is shown on the right hand side of the Balance Sheet.

Characteristics of Balance Sheet:

1. It is prepared on a particular date and not for a particular period.
2. It is prepared after preparation of the Trading and Profit & Loss A/c.
3. As assets must be equal to the total liabilities. The two sides of the Balance must havethe same total.
4. It shows the financial position of a business as a going concern.
5. It is a statement of assets and liabilities and not an account.

Information that Balance Sheet convey to Outsiders (Importance):

1. The nature and the value of assets.
2. It shows the nature and extent of liabilities.
3. It shows the owner's equity (i.e., assets-liabilities = capital)
4. It tells about the creditworthiness and solvency of the firm.
5. It reflects the liquidity of a firm.
6. It reveals other information required to changes in economic reserves and obligations.

Balance Sheet of MR………………………as on…………………

Liabilities		Amount	Assets	Amount
Creditors		xxx	Cash in Hand	xxx
Bills Payable		xxx	Cash at Bank	xxx
Outstanding Income		xxx	Bills Receivables	xxx
Loans		xxx	Debtors	xxx
Mortgage		xxx	Closing stock	xxx
Reserve Funds		xxx	Investments	xxx
Capital	xxx	xxx	Furniture & fittings	xxx
Add: Net Profit	<u>xxx</u>		Plant & Machinery	xxx
	xxx		Land & Buildings	xxx
Less: Drawings	xxx	xxx	Patents, Goodwill, Copyrights	xxx
			Prepaid Expenses	xxx
				xxx
		xxx		xxx

RATIO ANALYSIS:

Definition of Ratio

A ratio is defined as "the indicated quotient of two mathematical expressions and as the relationship between two or more things." Here ratio means financial ratio or accounting ratio which is a mathematical expression of the relationship between accounting figures.

Ratio Analysis

The term financial ratio can be explained by defining how it is calculated and what the objective of this calculation is

a. Calculation Basis (Basis of Calculation)

- A relationship expressed in mathematical terms;
- Between two individual figures or group of figures;
- Connected with each other in some logical manner; and
- Selected from financial statements of the concern

b. Objective for financial ratios is that all stakeholders (owners, investors, lenders, employees etc.) can draw conclusions about the

- Performance (past, present and future)
- Strengths & weaknesses of a firm; and
- Can take decisions in relation to the firm

Ratio analysis is based on the fact that a single accounting figure by itself may not communicate any meaningful information but when expressed relative to some other figure, it may definitely provide some significant information. Ratio analysis is not just comparing different numbers from the balance sheet, income statement, and cash flow statement. It is comparing the number against previous years, other companies, the industry, or even the economy in general for the purpose of financial analysis.

Sources of Financial Data for Analysis

The sources of information for financial statement analysis are:

1. Annual Reports
2. Interim financial statements
3. Notes to Accounts
4. Statement of cash flows
5. Business periodicals.
6. Credit and investment advisory services

ADVANTAGES OF RATIO ANALYSIS

1. **Helps in Decision making:** Though Financial Statements provide necessary data for decision making. It isnot possible to take appropriate decisions merely on the basis of each data. RatioAnalysis provides a meaningful analysis and interpretation to the data containedin Financial Statements. This ratio analysis facilitates the managers to take correct decisions.
2. **Helps in Financial Forecasting and Planning:** Ratios calculated for a number of years reveal the trends in the phenomenon. As such, it is possible to make predictions for a future period. Thus, ratio analysis helps in financial forecasting and planning

3. **Helps in assessing the operational efficiency:** Ratio Analysis helps in analyzing the strengths and weaknesses of a concern.It helps in diagnosing the financial health of a concern in terms of liquidity, solvency, profitability etc
4. **Helps in controlling business:** With the help of ratio analysis, it is possible to identify the weak spots withregard to the performance of the managers. Weakness in financial structure due to incorrect policies in the past and present isrevealed by the ratios. These weaknesses may be communicated to the people concerned and as such ratio analysis helps in better communication, Coordinationand control of unfavorable situations.
5. **Helps in comparison of performance:** Through accounting ratios comparison can be made between one departments ofa firm with another of the same firm in order to evaluate the performance of various departments in the firm. This is needed for the smooth functioning of thedepartments.

Limitations of Ratio Analysis

1. **Limited use of a Single Ratio:** A single ratio does not convey meaningful message. As such, a number of ratioswill have to be calculated for a better understanding of particular situation. Thus, a series of ratios computed may create confusion. Ratios can be useful only when they are computed in a sufficient large number. calculation of more ratios sometimes confuses the analysts than help him.
2. **Lack of Adequate Standards:** Expecting a few situations, in majority cases, universally accepted standards for ratios are not available. It renders interpretation of ratios difficult.
3. **Lack of comparability:** The results of two firms are comparable with the help of accounting ratios onlyif they follow the same accounting methods. Comparison becomes difficult if they follow different methods. Similarly, utilization of facilities, availability of facilities and scale ofoperation affects the Financial Statements of different firms. Comparison of such firms would be misleading.
4. **Inherent Limitations of Accounting:** Accounting records contain historical data. As such, ratios based on data drawn from accounting records also suffer from the inherent weaknesses ofaccounting records. Thus, accounting ratios of the past may not be true indicators of the future.
5. **Price-Level Changes:** Since ratios are computed for historical data, no consideration is made to thechanges in price levels and this makes the interpretation of ratios invalid

CLASSIFICATION OF RATIOS

Ratios may be classified into four categories. They are

1. Liquidity Ratios
2. Capital structure/ gearing Ratios.(Leverage / Solvency Ratios)
3. Turnover Ratios
4. Profitability Ratios

1. LIQUIDITY RATIOS

Liquidity ratios are helpful in determining the ability of the company to meet its debt obligations by using the current assets. At times of financial crisis, the company can utilise the assets and sell them for obtaining cash, which can be used for paying off the debts.
Some of the most commonly used liquidity ratios are quick ratio, current ratio, cash ratio, etc.
The liquidity ratios are used mostly by creditors, suppliers and any kind of financial institutions such as

banks, money lending firms, etc for determining the capacity of the company to pay off its obligations as and when they become due in the current accounting period.

FORMULAE:

1. Current Ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}}$

   The Standard Current Ratio is 2:1
2. Quick Ratio/ Liquid Ratio = $\frac{\text{Liquid Assets}}{\text{Current Liabilities}}$

   The Standard Quick Ratio is 1:1

2. CAPITAL STRUCTURE/ SOLVENCY / LEVERAGE RATIOS

Solvency ratios are used for determining the viability of a company in the long term or in other words, it is used to determine the long term viability of an organization. Solvency ratios calculate the debt levels of a company in relation to its assets, annual earnings and equity. Some of the important solvency ratios that are used in accounting are debt ratio, debt to capital ratio, interest coverage ratio, etc.
Solvency ratios are used by government agencies, institutional investors, banks, etc to determine the solvency of a company.

FORMULAE:

1. Debt- Equity Ratio = $\frac{\text{Long-Term Debts}}{\text{Shareholders' Funds}}$

   = $\frac{\text{External Equity}}{\text{Internal Equity}}$
2. Proprietary Ratio = $\frac{\text{Shareholders' Funds}}{\text{Total Assets}}$
3. Interest Coverage Ratio= $\frac{\text{Earnings before Interest and Taxes (EBIT)}}{\text{Fixed Interest Charges.}}$
4. Debts to Total Funds Ratio = $\frac{\text{Debts}}{\text{Total Funds}}$

3. TURNOVER/ ACTIVITY RATIOS

Activity ratios are used to measure the efficiency of the business activities. It determines how the business is using its available resources to generate maximum possible revenue.

These ratios are also known as efficiency ratios. These ratios hold special significance for business in a way that whenever there is an improvement in these ratios, the company is able to generate revenue and profits much efficiently.
Some of the examples of activity or efficiency ratios are asset turnover ratio, inventory turnover ratio, etc.

FORMULAE:

1. Stock / Inventory Turnover Ratio = $\frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$

   Cost of Goods sold= Sales-Gross Profit

   Average Inventory= $\frac{\text{Opening stock + Closing stock}}{2}$
2. Debtor/Receivable Turnover Ratio = $\frac{\text{Net Credit sales}}{\text{Average Debtors}}$
3. Creditors Turnover Ratio = $\frac{\text{Net Credit purchases}}{\text{Average Creditors}}$
4. Working Capital Turnover Ratio = $\frac{\text{Cost of Sales}}{\text{Net Working Capital}}$

4. PROFITABILITY RATIOS

The purpose of profitability ratios is to determine the ability of a company to earn profits when compared to their expenses. A better profitability ratio shown by a business as compared to its previous accounting period shows that business is performing well.

The profitability ratio can also be used to compare the financial performance of a similar firm, i.e it can be used for analysing competitor performance. Some of the most used profitability ratios are return on capital employed, gross profit ratio, net profit ratio, etc.

FORMULAE:

1. Gross Profit Ratio= (Gross Profit / Net Sales) x 100

   Or

   =(Net Sales- cost of goods sold / net sales)x 100
2. Net Profit Ratio=(Net Profit / Net Sales) x 100
3. Operating Ratio= (Cost of goods sold + operating expenses)/ Net Sales.
4. Operating ProfitRatio= (Operating Net profit / Net Sales) x 100

   OR

   =100% - Operating Ratio

PROBLEMS

Journal:

From the following transactions prepare the Journal in the books of Raghu

1-01-2020 He started business with cash Rs 14,00,000
2-01-2020 He purchased goods from Ramana for Rs 1,25,000
4-01-2020 Cash Deposited with Bank Rs 4,00,000
6-01-2020 Sold goods to Madhan on credit Rs 3,25,000
8-01-2020 Machinery purchased for Rs2,00000
10-01-2020 Stationery purchased for Rs 15,000
12-01-2020 Cash withdrawn from bank for office use Rs1,00,000
18-01-2020 Cash withdrawn from bank for his son's birthday Rs 25,000
22-01-2020 Goods sold on cash Rs 4,00,000
26-01-2020 Goods purchased from kishan on cash Rs1,40,000
28-01-2020 Furniture purchased for Rs 40,000
30-01-2020 Rent paid 22,000
31-01-2020 Salaries paid Rs 35,000

Sol:

Journal Entries in the books of Raghu

Date	Particulars	L.F	Debit(Rs.)	Credit(Rs.)
1/01/2020	Cash A/c Dr To Capital A/c (Being Business Started with Cash)		14,00,000	14,00,000
2/01/2020	Purchase A/c Dr To Ramana A/c (Being Goods Purchased on Credit)		1,25,000	1,25,000
4/01/2020	Bank A/c Dr To Cash A/c (Being Cash deposited in Bank)		4,00,000	4,00,000
6/01/2020	Madhan A/c Dr To Sales A/c (Being Goods sold on Credit)		3,25,000	3,25,000
8/01/2020	Machinery A/c Dr To Cash A/c (Being Machinery Purchased)		2,00,000	2,00,000
10/01/2020	Stationery A/c Dr To Cash A/c (Being Stationery Paid)		15,000	15,000
12/01/2020	Cash A/c Dr To Bank A/c (Being Cash withdrawn from Bank)		1,00,000	1,00,000
18/01/2020	Drawings A/c Dr To Bank A/c (Being Cash withdrawn from bank for Personal use)		25,000	25,000
22/01/2020	Cash A/c Dr To Sales A/c (Being Goods Sold)		4,00,000	4,00,000

26/01/2020	Purchase A/c Dr To Cash A/c (Being Goods Purchased)		1,40,000	1,40,000
28/01/2020	Furniture A/c Dr To Cash A/c (Being Furniture purchased for Cash)		40,000	40,000
30/01/2020	Rent A/c Dr To Cash A/c (Being Rent Paid)		22,000	22,000
31/01/2020	Salaries A/c Dr To Cash A/c (Being Salaries Paid)		35,000	35,000
			32,27,000	**32,27,000**

From the following information prepare Journal in the books of kumar

1-1-20 He started business with cash, Rs 14,00,000
2-1-20 Cash deposited with bank Rs.2,00,000
4-1-20 purchased goods from Rajesh Rs 22,500
6-1-20 Goods return to Rajesh worth of 2,000
8-1-20 Sold to Mahesh Rs 36,500
10-1-20 Goods return by Mahesh worth of 3,000/-
12-1-20 Stationery purchased Rs.2,000
16-1-20 Cash sales Rs. 50,000
22-1-20 Cash Purchases for Rs.40,000
24-1-20 Machinery purchased and paid by cheque Rs.80,000
26-1-20 Cash paid to Rajesh for full settlement of his account 20,000 and received discount for Rs 500
28-1-20 Cash received from Mahesh for the full of his account 33,000 and allowed discount Rs 500
29-1-20 Cash withdrawn from office for personal use Rs.5000
30-1-20 Cash withdrawn from bank for office use Rs 12,000
31-1-20 Salaries paid Rs. 5,000

Sol:

Journal Entries in the books of Kumar

Date	**Particulars**	**L.F**	**Debit(Rs.)**	**Credit(Rs.)**
1/01/2020	Cash A/c Dr To Capital A/c (Being Business Started with Cash)		14,00,000	14,00,000
2/01/2020	Bank A/c Dr To Cash A/c (Being Cash deposited in Bank)		2,00,000	2,00,000
4/01/2020	Purchase A/c Dr To Rajesh A/c (Being Goods Purchased on Credit)		22,500	22,500
6/01/2020	Rajesh A/c Dr To Purchase Return A/c (Being Goods return to Rajesh)		2,000	2,000

8/01/2020	Mahesh A/c Dr To Sales A/c (Being Goods sold on Credit)		36,500	36,500
10/01/2020	Sales Return A/c Dr To Mahesh A/c (Being Machinery Purchased)		3,000	3,000
12/01/2020	Stationery A/c Dr To Cash A/c (Being Stationery Paid)		2,000	2,000
16/01/2020	Cash A/c Dr To Sales A/c (Being Cash Sales)		50,000	50,000
22/01/2020	Purchase A/c Dr To Cash A/c (Being Goods Purchased)		40,000	40,000
24/01/2020	Machinery A/c Dr To Bank A/c (Being Machinery purchased paid by cheque)		80,000	80,000
26/01/2020	Rajesh A/c Dr To Cash A/c To Discount Received A/c (Being cash paid to Rajesh and discount received)		20,500	20,000 500
28/01/2020	Cash A/c Dr Discount Allowed A/c Dr To Mahesh A/c (Being cash received and discount allowed)		33,000 500	33,500
29/01/2020	Drawings A/c Dr To Cash A/c (Being Cash withdrawn from office for Personal use)		5,000	5,000
30/01/2020	Cash A/c Dr To Bank A/c (Being Cash withdrawn from Bank)		12,000	12,000
31/01/2020	Salaries A/c Dr To Cash A/c (Being Salaries Paid)		8,000	8,000
			32,27,000	**32,27,000**

<u>QUESTION BANK PROBLEM</u>

Journalize the following transactions in the books of Gopal.

2022 June 03 Received cash from Ram- Rs.5,000
04 Purchased Goods for cash- Rs.500
11 Sold Goods to Hari- Rs.200
13 Paid Ramakrishna- Rs.400
17 Received from Hari- Rs.200
20 Bought Furniture from Raju- Rs.200
27 Paid Room Rent- Rs.80
30 Paid Stationery- Rs.100

Sol:

Journal Entries in the books of Gopal

Date	Particulars	L.F	Debit(Rs.)	Credit(Rs.)
03/06/2022	Cash A/c Dr To Ram A/c (Being Cash received from Ram)		5,000	5,000
04/06/2022	Purchase A/c Dr To Cash A/c (Being Goods Purchased)		500	500
11/06/2022	Hari A/c Dr To Sales A/c (Being Goods Sold on Credit)		200	200
13/06/2022	Ramakrishna A/c Dr To Cash A/c (Being Cash paid to Ramakrishna)		400	400
17/06/2022	Cash A/c Dr To Hari A/c (Being Cash received from Hari)		200	200
20/06/2022	Furniture A/c Dr To Raju A/c (Being Furniture purchased from Raju)		200	200
27/06/2022	Rent A/c Dr To Cash A/c (Being Rent Paid)		80	80
30/06/2022	Stationery A/c Dr To Cash A/c (Being Stationery Paid)		100	100
			6,680	**6,680**

Journalize and Ledger the following transactions in the books of Hari.

2020 March 01 Started business with cash- Rs.6,000
02 Sold Goods- Rs.3,500
04 Bought Goods- Rs.1,500
07 Sold Goods to Rajesh on credit- Rs.3,800
08 Bought Furniture for cash from Krishna Murthy- Rs.1440
10 Bought Plant& Machinery- Rs.15,000

Sol:

Journal Entries in the books of Hari

Date	Particulars	L.F	Debit(Rs.)	Credit(Rs.)
01/03/2020	Cash A/c Dr To Capital A/c (Being Business Started with Cash)		6,000	6,000
02/03/2020	Cash A/c Dr To Sales A/c (Being Goods Sold)		3,500	3,500

04/03/2020	Purchase A/c Dr To Cash A/c (Being Goods Purchased)		1,500	1,500
07/03/2020	Rajesh A/c Dr To Sales A/c (Being Goods Sold on Credit)		3,800	3,800
08/03/2020	Furniture A/c Dr To Cash A/c (Being Furniture purchased for Cash)		1,440	1,440
10/03/2020	Plant & Machinery A/c Dr To Cash A/c (Being Furniture purchased for Cash)		15,000	15,000
			31,240	**31,240**

Ledger:

Dr **Cash A/c** **Cr**

Date	**Particulars**	**J.F**	**Amount(Rs.)**	**Date**	**Particulars**	**J.F**	**Amount(Rs.)**
01/03/20	To Capital A/c		6,000	04/03/20	By Purchase A/c		1,500
02/03/20	To Sales A/c		3,500	08/03/20	By Furniture A/c		1,440
				10/03/20	By Plant & Machinery A/c		15,000
31/03/20	To Balance c/d		8,440				
			17,940				**17,940**
				01/04/20	By Balance b/d		8,440

Dr **Capital A/c** **Cr**

Date	**Particulars**	**J.F**	**Amount(Rs.)**	**Date**	**Particulars**	**J.F**	**Amount(Rs.)**
				01/03/20	By Cash A/c		6,000
31/03/20	To Balance c/d		6,000				
			6,000				**6,000**
				01/04/20	By Balance b/d		6,000

Dr **Purchase A/c** **Cr**

Date	**Particulars**	**J.F**	**Amount(Rs.)**	**Date**	**Particulars**	**J.F**	**Amount(Rs.)**
04/03/20	To Cash A/c		1,500				
				31/03/20	By Balance c/d		1,500
			1,500				**1,500**
01/04/20	To Balance b/d		1,500				

Dr **Sales A/c** **Cr**

Date	Particulars	J.F	Amount(Rs.)	Date	Particulars	J.F	Amount(Rs.)
				02/03/20	By Cash A/c		3,500
				07/03/20	By Rajesh A/c		3,800
31/03/20	To Balance c/d		7,300				
			7,300				**7,300**
				01/04/20	By Balance b/d		7,300

Dr **Rajesh A/c** **Cr**

Date	Particulars	J.F	Amount(Rs.)	Date	Particulars	J.F	Amount(Rs.)
07/03/20	To Sales A/c		3,500	31/03/20	By Balance c/d		3,500
			3,500				**3,500**
01/04/20	To Balance b/d		3,500				

Dr **Furniture A/c** **Cr**

Date	Particulars	J.F	Amount(Rs.)	Date	Particulars	J.F	Amount(Rs.)
08/03/20	To Cash A/c		1,440	31/03/20	By Balance c/d		1,440
			1,440				**1,440**
01/04/20	To Balance b/d		1,440				

Dr **Plant & Machinery A/c** **Cr**

Date	Particulars	J.F	Amount(Rs.)	Date	Particulars	J.F	Amount(Rs.)
10/03/20	To Cash A/c		15,000	31/03/20	By Balance c/d		15,000
			15,000				**15,000**
01/04/20	To Balance b/d		15,000				

<u>TRIAL BALANCE:</u>

From the following balances prepare the trial balance in the books of Ramchandran Rao

Furniture 3,000/-
Machinery 8000/-
Stock at 01-01-2002 4,000/-
Bank overdraft 1,000/-
Purchases 8,000/-
Wages 2,000/-
Interest paid 40/-
Discount allowed 60/-.
Capital 10,000/-
Purchase returns 400/-
Carriage outwards 200/-
Creditors 3,000/-
Debtors 4,000/-
Sales returns 300/-
Rent taxes 500/-
Drawings 500/-
Salaries 1000/-
Bad debts 300/-
Sales 19,000/-
Carriage 900/-
Commission 600/-

Trial Balance of Ramachandra Rao as on ………………..

S.No	Particulars	L.F	Debit(Rs.)	Credit(Rs.)
1	Furniture		3.000	
2	Machinery		8.000	
3	Stock at 01-01-2002		4.000	
4	Bank overdraft			1.000
5	Purchases		8,000	
6	Wages		2,000	
7	Interest paid		40	
8	Discount allowed		60	
9	Capital			10,000
10	Purchase returns			400
11	Carriage outwards		200	
12	Creditors			3.000
13	Debtors		4.000	
14	Sales returns		300	
15	Rent taxes		500	
16	Drawings		500	
17	Salaries		1,000	
18	Bad debts		300	
19	Sales			19,000
20	Carriage		900	
21	Commission		600	
			33,400	**33,400**

From the following balances prepare trial balance in the books of Jagadish as on 31-03-2002

Capital 25,000/-
Discount received 200/-
Bills receivable 2000/-
Salaries 6,000/-
Commission 600/-
Bills payable 6,800/-
Purchases 26,000/-
Bad debts 1,200/-
Opening stock (01-04-01) 7000/-
Sales 47,000/-

Debtors 30,000/-
Cash in hand 500/-
Trading exp 1,000/-
Creditors 21,000/-
Cash at bank 3,600/-
Wages 7,800/-
Furniture 3,000/-
Fright 400/-
Machinery 10,000/-
Office expenses 500/-
Insurance 400

/

Trial Balance of Jagadish as on 31-03-2002

S.No	Particulars	L.F	Debit(Rs.)	Credit(Rs.)
1	Capital			25,000
2	Discount received			200
3	Bills receivable		2,000	
4	Salaries		6,000	
5	Commission		600	
6	Bills payable			6,800
7	Purchases		26,000	
8	Bad debts		1,200	
9	Opening stock		7,000	
10	Sales			47,000
11	Debtors		30,000	
12	Cash in hand		500	
13	Trading exp		1,000	
14	Creditors			21,000
15	Cash at bank		3,600	
16	Wages		7,800	
17	Furniture		3,000	
18	Fright		400	
19	Machinery		10,000	
20	office expenses		500	
21	Insurance		400	
			1,00,000	**1,00,000**

From the following balances prepare trial balance in the books of Lokeswara Rao as on 31-12-2005

Capital 3,90,000/-
Drawings 21,000/-
6% Loan 40,000/-
Cash in Hand 6,060/-
Bills Receivable 19,000/-
Furniture and Fittings 17,940/-
Plant and Machinery 57,600/-
Purchases 5,13,180/-
Wages 81,940
Salaries 22,000/-
Taxes and Trade Expenses 11,240/-
Repair 6,740/-

Buildings 1,50,000/-
Trade Creditors 1,50,000/-
Cash at Bank 39,940/-
Debtors 1,24,000/-
Provision for Doubtful Debts 5,000/-
Commission Received 11,280/-
Stock(1/01/05) 1,79,360/-
Sales 7,12,860/-
Sales Returns 5,560/-
Travelling Expenses 3,760/-
Bad Debts 7,240/-
Interest & Discount 11,649/-
Insurance 800/-

Trial Balance of Lokeswara Rao as on 31-12-2005

S.No	**Particulars**	**L.F**	**Debit(Rs.)**	**Credit(Rs.)**
1	Capital			3,90,000
2	Drawings		21,000	
3	6% Loan			40,000
4	Cash in Hand		6,060	
5	Bills Receivables		19,000	
6	Furniture and Fittings		17,940	
7	Plant and Machinery		57,600	
8	Purchases		5,13,180	
9	Wages		81,940	
10	Salaries		22,000	
11	Taxes and Trade Expenses		11,240	
12	Repair		6,740	
13	Buildings		1,50,000	
14	Trade Creditors			1,50,000
15	Debtors		1,24,000	
16	Cash at Bank		39,940	
17	Provision for Doubtful Debts			5,000
18	Commission Received			11,280
19	Stock(1/01/05)		1,79,360	
20	Sales			7,12,860
21	Sales Returns		5,560	
22	Travelling Expenses		3,760	
23	Bad Debts		7,240	
24	Interest & Discount		11,649	
25	Insurance		800	
26	Suspense Account		30,031	
			13,09,140	**13,09,140**

QUESTION BANK PROBLEM

A. Smrita Ltd. has current ratio of 3/1. If its stock is Rs.40,000 and Total current liabilities are Rs.75,000. Find its Liquid Ratio.

B. A company has current ratio of 3/1 and liquid ratio of 1/2 If the working capital is Rs.1, 80,000. Find current liabilities and stock.

Sol:

A: Calculating the Liquid Ratio

Given:

- Current Ratio = 3:1
- Stock = Rs. 40,000
- Total Current Liabilities = Rs. 75,000

Step 1: Determine Current Assets

Current Ratio is the ratio of Current Assets to Current Liabilities.

Current Ratio=Current Assets/Current Liabilities

Given the current ratio is 3:1 and Current Liabilities are Rs. 75,000:

Current Assets/75,000=3

Current Assets=3×75,000=2,25,000

Step 2: Calculate Liquid Assets

Liquid Assets are Current Assets minus Stock (since stock is not included in liquid assets).

Liquid Assets=Current Assets−Stock

Liquid Assets=225,000−40,000=185,000

Step 3: Calculate Liquid Ratio

Liquid Ratio is the ratio of Liquid Assets to Current Liabilities.

Liquid Ratio=Liquid Assets/Current Liabilities

Liquid Ratio=185,000/75,000

Liquid Ratio=2.47

So, the Liquid Ratio is 2.47:1.

B: Calculating Current Liabilities and Stock

Given:

- Current Ratio = 3:1
- Liquid Ratio = 2:1
- Working Capital = Rs. 180,000

Step 1: Determine Current Liabilities

Working Capital is the difference between Current Assets and Current Liabilities.

Working Capital=Current Assets−Current Liabilities

Given Working Capital is Rs. 180,000:

180,000=Current Assets−Current Liabilities

Step 2: Use Current Ratio to Express Current Assets

From the Current Ratio:

Current Assets/Current Liabilities=3

Current Assets=3×Current Liabilities

Step 3: Substitute Current Assets in the Working Capital Equation

180,000=3×Current Liabilities−Current Liabilities

180,000=2×Current Liabilities

Current Liabilities=180,000/2

Current Liabilities=90,000

Step 4: Determine Current Assets

Current Assets=3×Current Liabilities

Current Assets=3×90,000

Current Assets=270,000

Step 5: Calculate Stock

Liquid Ratio is the ratio of Liquid Assets to Current Liabilities.

Liquid Assets/Current Liabilities=1/2

2×Liquid Assets=Current Liabilities

2×Liquid Assets=90,000

Liquid Assets=45,000

Liquid Assets = Current Assets - Stock

45,000=270,000−Stock

Stock=270,000−180,000

Stock=2,25,000

So, the Current Liabilities are Rs. 90,000 and the Stock is Rs. 2,25,000

FINAL ACCOUNTS:

From the following Trail Balance and adjustments of Raj, prepare trading and profit and loss account for the year December 31,2012 and a Balance Sheet as on that date.

Gangappa (Dr) 4,000/-
Guptaji (Dr) 2,050/-
John (Dr) 2,000/-
Stock (1.1.2012) 6,920/-
Cash in Hand 2,200/-
Motor Car 12,000/-
Buildings 35,000/-
Furniture 1,280/-
Sundry Creditors 16,100/-
Purchase 10,950/-
Purchase Return 250/-
Drawings 150/-
Sales 25,900/-
Capital 45,000/-
Naidu (Cr) 9,800/-
Syamalal (Cr) 6,300/-
Cash at Bank 4,200/-
Salaries 3,000/-
Advertisement Expenses 900/-
Commission 750/-
Repairs to Motor Car 220/-
General Expenses 1,580/-
Insurance 700/-
Repairs to Buildings 1,000/-

Adjustments:

1) The stock as on December 31st, 2012 was 8,000
2) Depreciate Furniture @ 10% per annum.
3) Outstanding Salaries 200/-
4) Prepaid Insurance 200/-
5) Interest on Capital 4%
6) Drawings 150/-

Working Notes:

Debtors= Gangappa+Guptaji+John
= 4,000+2,080+2,000
= 8,050

Creditors= Naidu+ Syamlal
= 9,800+6,300
= 16,100

Depreciation of Furniture= Furniture × 10%
= 1,280 × 10%
= 280

Interest on Capital = Capital × 4%
= 45,000 × 4%
= 1800

Dr Trading & Profit and Loss Account of Raj for the year ending 31/12/2012 Cr

Particulars		Amount(Rs.)	Particulars	Amount(Rs.)
To Opening Stock		6,920	By Sales	25,900
To Purchases	10,950		By Closing Stock	8,000
(-) Returns	250			
	10,700			
(-) Drawings	150	10,550		
To Gross Profit c/d		16,430		
		33,900		**33,900**
To Salaries	3000		By Gross Profit b/d	16,430
(+) O/S	200	3,200	By Commission	750
To Advertisement Expenses		900		
To Repairs to Motor Car		220		
To General Expenses		1,580		
To Insurance	700			
(-) Prepaid	200	500		
To Repairs to Buildings		1,000		
To Depreciation of Furniture		280		
To Interest on Capital		1,800		
To Net Profit (Transfer to Capital A/c)		7,700		
		17,180		**17,180**

Balance Sheet of Raj for the year ending 31/12/2012

Liabilities		**Amount(Rs.)**	**Assets**		**Amount(Rs.)**
Creditors		16,100	Cash in Hand		2,200
Outstanding Salaries		200	Cash at Bank		4,200
Capital	45,000	1,56,260	Debtors		8,050
(+) Net Profit	7,700		Prepaid Expenses		200
(+) IOC	1,800		Closing Stock		8,000
	54,500		Furniture	1,280	
(-)Drawings	150	54,350	(-) Dep	280	1,000
			Motor Car		12,000
			Buildings		35,000
		70,650			**70,650**

QUESTION BANK PROBLEM

From the following Trail Balance and adjustments of Raju Emporium, prepare trading and profit and loss account for the year December 31,2022 and a Balance Sheet as on that date.

Particulars	**Debit (Rs)**	**Credit (Rs)**
Sundry debtors	64,000	---
Stock (1.1.2022)	44,000	---
Cash in hand	7,810	---
Plant and machinery	35,000	---
Sundry creditors	---	21,300
Trade expenses	2,150	---
Sales	---	2,69,000
Salaries	4,450	---
Carriage outwards	800	---
Rent	1,800	---
Bills payable	---	15,000
Purchases	2,30,000	---
Discounts	2,200	---
Business premises	69,000	---
Capital (1.1.2022)	---	1,59,000
Cash at bank	3,090	---
	4,64,300	**4,64,300**

Adjustments:

1) The stock as on December 31^{st}, 2022 was 24,900
2) Depreciate plant and machinery @ 10% per annum.

Working Notes:

Depreciation of Plant and Machinery = Plant and Machinery × 10%
= 35,000 × 10%
= 3,500

Dr Trading & Profit and Loss Account of Raju Emporium for the year ending 31/12/2022 Cr

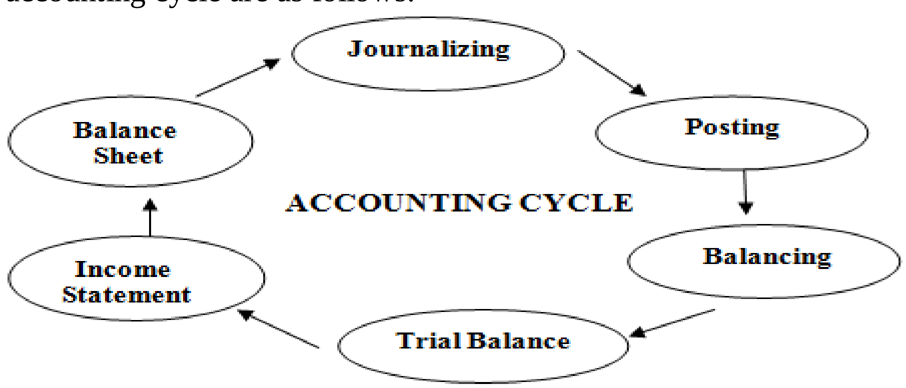
Particulars	**Amount(Rs.)**	**Particulars**	**Amount(Rs.)**
To Opening Stock	44,000	By Sales	2,69,000
To Purchase	2,30,000	By Closing Stock	24,900
To Gross Profit c/d	19,900		
	2,93,900		**2,93,900**
To Discount	2,200	By Gross Profit b/d	19,900
To Carriage Outwards	800		
To Rent	1,800		
To Salaries	4,450		
To Trade Expenses	2,150		
To Depreciation of P&M	3,500		
To Net Profit (Transfer to Capital A/c)	5,000		
	19,900		**19,900**

Balance Sheet of Raju Emporium for the year ending 31/12/2022

Liabilities		**Amount(Rs.)**	**Assets**		**Amount(Rs.)**
Sundry Creditors		21,300	Sundry Debtors		64,000
Bills Payable		15,000	Cash In Hand		7,810
Capital	1,59,000		P&M	35,000	
(+) Net Profit	5,000	1,64,000	(-)Dep 10%	3500	31,500
			Cash At Bank		3090
			Closing Stock		24,900
			Business Premises		69,000
		2,00,300			**2,00,300**

2 MARKS QUESTIONS

1. **Define Accounting?**
   Accounting is a process of recording, classifying and summarizing business transactions which are of financial character and analyzing and interpreting and communicate the results to interested parties.
   According to committee on terminology of American Institute of Certified Public Accountants (AICPA), "Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money transactions and events which are in part, at least of financial character and interpreting the results thereof."
2. **What are the branches of accounting?**
   Accounting has several branches, each specializing in different aspects of financial information and reporting. The main branches of accounting include:
   1. **Financial Accounting** – Focuses on recording, summarizing, and reporting financial transactions through financial statements (e.g., income statement, balance sheet, cash flow statement) for external stakeholders like investors and creditors.
   2. **Managerial Accounting** – Provides internal management with financial data to aid in decision-making, budgeting, and performance evaluation. It includes cost analysis, financial forecasting, and variance analysis.
   3. **Cost Accounting** – A subset of managerial accounting that focuses on calculating and analyzing the costs of production or services to help businesses control expenses and improve profitability.
   4. **Auditing** – Involves examining financial records and statements to ensure accuracy, compliance with regulations, and adherence to accounting principles. Auditing can be internal (done by company employees) or external (done by independent auditors).
   5. **Tax Accounting** – Deals with preparing tax returns, tax planning, and ensuring compliance with tax laws and regulations.
3. **Define accounting cycle?**
   An Accounting cycle is a complete sequence beginning with the recording of the transactions and ending with the preparation of the final accounts. The sequential steps involved in an accounting cycle are as follows:



4. **What is Journal?**
   The word Journal is derived from the French word "Jour" which means a day. Journal, therefore, means a daily record of business transactions. Journal is a book of original entry/prime entry because transaction is first written in the journal from which it is posted to the ledger at any convenient time. 0The journal is a complete and chronological record of business transactions. It is recorded in a systematic manner. The process of recording a transaction in the journal is called **Journalising**. The entries made in the book are called **Journal Entries**.

Proforma of Journal

Journal Entries in the books of-------------------

Date	Particulars	L.F	Debit (Rs.)	Credit (Rs.)

5. **What is Ledger?**
Ledger means posting transactions entered in the journal into their respective accounts in the ledger. It is the book of final entry. The Ledger is designed to accommodate the various accounts maintained by a trader. It contains the final and permanent record of all transactions in duly classified form. A ledger is a book which contains various accounts. The process of transferring the entries from the journal intothe ledger is called posting.
Performa of an Account: An account contains the following columns on the following columns on either side. 1) Date column 2) Particulars column 3) Journal Folio column 4) Amount column.

The format or ruling of an account is as follows:

Date	Particulars	J.F	Amt Rs.	Date	Particulars	J.F	Amt Rs.
	To Particulars of benefits received		Xxxxxx		By Particulars of benefits given		xxxxxx

6. **What is meant by Trial balance?**
Trial balance is a bookkeeping worksheet in which the balances of all ledgers are compiled into debit and credit account column totals that are equal. A company prepares a trial balance periodically, usually at the end of every reporting period.
7. **What is Capital expenditure?**
Capital expenditure refers to the funds a business spends on acquiring, upgrading, or maintaining long-term assets such as property, equipment, or infrastructure. These investments are intended to improve a company's efficiency, expand operations, or extend the lifespan of assets.
8. **What is deferred revenue expenditure?**
Deferred Revenue Expenditure refers to expenses that are incurred in the current accounting period but whose benefits extend over multiple periods. These expenditures are initially recorded as assets and then gradually expensed over time.
9. **What is EPS?**
EPS refers earnings for share is relationship between net profits and the number of shares outstanding at the end of the given period.

$$EPS = \frac{\text{Net profit After Taxes}}{\text{No of Shares Outstanding}}$$

10. **What is the formula for current ratio?**
Current ratio is relationship between the current assets and current liabilities it is standard ratio is 2:1. The following formula is used for computing current ratio.

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities.}}$$

11. **Define ratio analysis?**

    Ratio analysis is based on the fact that a single accounting figure by itself may not communicate any meaningful information but when expressed relative to some other figure, it may definitely provide some significant information. Ratio analysis is not just comparing different numbers from the balance sheet, income statement, and cash flow statement. It is comparing the number against previous years, other companies, the industry, or even the economy in general for the purpose of financial analysis.

12. **Define profitability ratios.**

    The profitability ratio can also be used to compare the financial performance of a similar firm, i.e it can be used for analyzing competitor performance. These ratios are calculated to understand the profit positions of the business. These ratios measure the profit earning capacity of an enterprise.

13. **Write formula of inventory turnover ratio?**

    $$\text{Stock / Inventory Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

    $$\text{Average Inventory} = \frac{\text{Opening Inventory + Closing Inventory}}{2}$$

14. **Define liquidity ratio?**

    Liquidity ratios are helpful in determining the ability of the company to meet its debt obligations by using the current assets. At times of financial crisis, the company can utilise the assets and sell them for obtaining cash, which can be used for paying off the debts.

15. **Define solvency or leverage ratios?**

    Solvency ratios are used for determining the viability of a company in the long term or in other words, it is used to determine the long term viability of an organization. Solvency ratios calculate the debt levels of a company in relation to its assets, annual earnings and equity. Solvency ratios are used by government agencies, institutional investors, banks, etc to determine the solvency of a company.

16. **Formula of debt equity ratio?**

    $$\text{Debt- Equity Ratio} = \frac{\text{Long-Term Debts}}{\text{Shareholders' Funds}} = \frac{\text{External Equity}}{\text{Internal Equity}}$$

17. **Write formula of current ratio.**

    Current ratio is relationship between the current assets and current liabilities it is standard ratio is 2:1. The following formula is used for computing current ratio.

    $$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$