Contents

UNIT1. BASIC PRINCIPLES OF BOOKKEEPING AND ACCOUNTING

Learner's Objectives:

At the end of this chapter the student should be able to:

- ***Understand the meaning and appreciate the importance of accounting especially in the context of non-profit organizations***
- ***Understand the basic principles, concepts and conventions of accounting.***
- ***Understand the meaning of book keeping and the distinction between accounting and bookkeeping.***
- ***Understand the advantages and limitations of accounting***

1. 1 INTRODUCTION

All organizations, whether business or non-business, for profit or not-for-profit require money and other economic resources for carrying on their activities. Wherever the use of such resources is involved, accounting is required to record their movement and to keep track of them. Accounting is therefore, often called the language of business.

For centuries, accounting had been generally confined to the financial record keeping functions of the accountant. However, in recent times, the role of an accountant has gradually evolved from that of a mere recorder of transactions to that of a member providing relevant information to the decision-making team. Accounting is now regarded as an information system that forms an integral part of management information system. As an information system, it collects data and communicates

economic information about an enterprise to a wide variety of persons whose decisions and actions are related to the entity.
The evolving role of the accounting function is the result of the contributions made by various factors such as the Industrial revolution which demanded formation of new forms of business organizations; separation of ownership and management; increasing investment in new ventures; escalated complications in the business sector; and the consequent need for transparency in accounting.

In short, accounting is a tool for decision makers or managers. It helps with resource allocation and deployment, allows control of resources and is an aid to monitoring performance.

1.2 MEANING OF ACCOUNTING:
In 1941, the American Institute of Certified Public Accountants (AICPA) defined accounting as:
'the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part, at least, of a financial character, and interpreting the results thereof'.

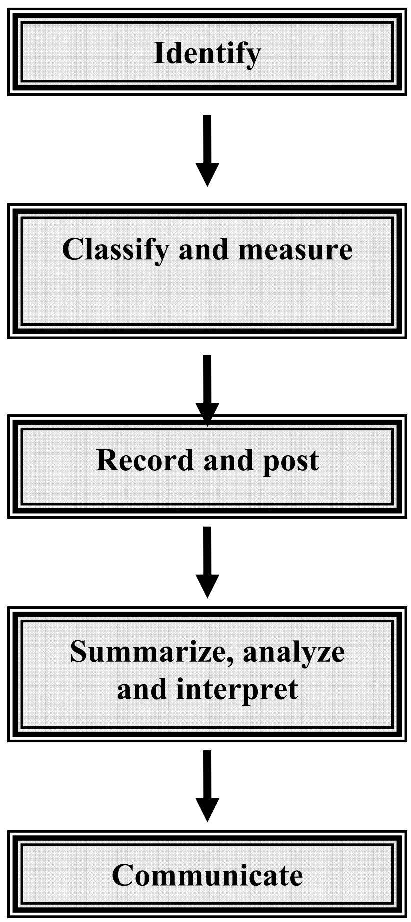
With greater economic development, the meaning of the term accounting gradually became broader. In 1970, the Accounting Principles Board of American Institute Certified Public Accountants (AICPA) re-stated the functions of accounting as *'to provide quantitative information, primarily financial in nature, about economic entities, that is intended to be useful in making economic decisions'*.

In summary, accounting can be defined as: The process of identifying, measuring, recording the financial transactions and communicating the events in terms of economic and business transactions of the organization to interested users of the information.

Thus the definition of accounting covers the following activities:
- Identifying the transaction and events;

- Classifying and measuring the transactions and events;
- Recording the identified and classified transaction;
- Posting them into respective ledgers;
- Summarizing the classified transaction and events in the form of various statements;
- Analyzing the summarized results;
- Interpreting the analyzed results;
- Communicating the interpreted information to the interested parties.

The following diagram enumerates the various functions of accounting:



Identifying the transaction and events:

Accounting identifies transactions and events of a specific entry. A transaction is an exchange in which each participant receives or sacrifices value. An event is a happening of a consequence to an entity (an economic unit which performs economic activities).

Classifying and Measuring:

Accounting measures the transactions and events in terms of a common measurement unit, i.e. the currency of a country. This step involves quantifying the transaction in monetary terms, identifying the accounts that are affected and whether those accounts are to be debited or credited.

Recording and posting:

The next step is to record these identified and classified transactions by making entries in the appropriate journal and post them into respective ledgers.

Summarizing, analyzing and interpreting:

The next step is summarization of the transactions recorded in a manner useful to the users. This function involves the preparation of financial statements such as Income Statement, Balance sheet, Statement of changes in financial position, Statement of cash flow, Statement of value added etc.

Analyzing is concerned with the establishment of relationship between the various items or groups of items taken from Income statement or Balance sheet or both. The purpose of analyzing is to identify the financial strengths and weaknesses of the enterprise.

Interpreting is concerned with explaining the meaning and significance of the relationship so established by the analysis. The accountants should interpret the statements in a manner useful to the users, so as to enable the users to make reasoned decisions out of the alternative courses of action.

Communicating:

The process of accounting is fruitful when the summarized, analyzed and interpreted information is transmitted to the users to enable them to take a reasoned decision. The users can be internal such as Board of Directors, Partners, Managers and Officers and external such as creditors, lenders, funding agencies, other investors, bankers and government agencies.

1.3 PRIMARY OBJECTIVES OF ACCOUNTING

Based on the above discussions, the objectives of accounting can be summarized as follows:

a) **Maintain the accounting records:**
   Written records are always better than oral records, since written records can be used by different persons for different decision-making purposes and serve as evidence of transactions. Nowadays, the volume of transactions is so large that a human memory cannot absorb each and every transaction. Accounting is done to keep a systematic record of (i) financial transactions, (ii) assets and (iii) liabilities.

b) **Ascertain the results of operations:**
   To measure the financial performance of an enterprise, the results of operations are ascertained by preparing an Income Statement (also called Profit and Loss Account) which shows the matching of current costs with current revenues during a particular accounting period. A systematic record of incomes and expenses facilitates the preparation of the Income Statement.

c) **Ascertain the financial position:**
   To evaluate the financial strength and weakness of an enterprise, the financial position is ascertained by preparing a Position Statement (also called Balance Sheet)"which shows resources (assets) owned by an enterprise and the sources of financing those resources. A businessman wants to know what the business owes to others and what it owns, and what happened to his capital whether the capital has increased, decreased or remained constant. A systematic record of various assets and liabilities facilitates the preparation of a Position Statement (also known as Balance Sheet) which answers all these questions.

d) **Communicate the information to the users:**
   Accounting communicates information to internal users and external users. The

internal users include all the organizational participants at all levels of management (i.e., top, middle and lower). Top level management requires information for planning, middle level management requires information for controlling the operations. For internal use, the information is usually provided in the form of reports; for instance cash budget reports, variance reports, project-wise spending, activity-wise spending, trend analysis and the like.

Since the external users (banks, creditors etc.) do not have direct access to all the records of an enterprise, they have to rely on the general purpose financial statements as the source of information. In case of NPOs, the external users are interested in the overall financial position of the organization including the various sources of funding and the amount accumulated by way of creating reserves.

1.4 IMPORTANCE OF ACCOUNTING IN NOT-FOR-PROFIT ORGANIZATIONS (NPOS):

1.4.1 Overview of NPOs

"The 21st century will be the century of the social sector organization. The more the economy, money, and information become global, the more community will matter. And only the social sector non profit organization performs in the community, exploits its opportunities, mobilizes its local resources, and solves its problems. The leadership, competence, and management of the social sector non profit organization will thus largely determine the values, the vision, the cohesion, and the performance of the 21st century society."

Peter F. Drucker

The inspiring words of Peter Drucker very effectively highlight the importance of social sector organizations. Voluntary effort has always been an integral part of Indian culture and social tradition. In a societal context, voluntary organizations constitute the "third sector", the first sector being the "government" and the second sector being the "market" or private business. The "third sector" is also known as the "independent sector", emphasizing the important role voluntary organizations play as an independent force outside the realm of government and private business though, in financial terms, this sector depends heavily on both the government and private business.

Some voluntary organizations call themselves Non-Government Organizations (NGOs). This is, once again, to emphasize that the organization is not controlled by the government or any other outside agency. Other synonyms used to describe these organizations include Private Voluntary Organizations (PVOs), Non-Profit Organizations (NPOs) and Civil Service Organization (CSOs). The terminology used for the purpose of this course material is Non-Profit Organizations (NPOs).

The World Bank defines NPOs as "private organizations that pursue activities to relieve suffering, promote the interests of the poor, protect the environment, provide basic social services, or undertake community development".

The World Bank further classifies operational NPOs into three main groups:

- ***Community Based Organizations (CBOs)*** *– which serve a specific population in a narrow geographical area in individual developing countries*
- ***National Organizations (NPOs)*** *– which operate in individual developing countries*
- ***International Organizations (INPOs)*** *- which are typically headquartered in developed countries and carry out operations in more than one developing country*

Thus NPOs differ in their scope of work, their size as also in their geographical focus.

What is the significance of accounting for NPOs and who are the stakeholders interested in their financial statements?

As we have seen above, the accounting process in an organisation culminates in the preparation of its financial statements. The financial statements are intended to reflect the operating results during a given period and the state of affairs at a particular date in a clear and comprehensive manner. The basic financial statements relevant to NPOs are Income and Expenditure Account and Balance

Sheet and notes, other statements and explanatory material that are an integral part of the financial statements. They may also include supplementary schedules and information based on or derived from, and expected to be read with such statements. In addition, NPOs should also prepare a Cash Flow Statement or a Receipts and Payment account, in accordance with Accounting Standard 3, 'Cash Flow Statements', issued by the Institute of Chartered Accountants of India. Financial statements do not, however, include reports by the governing body, for example, the trustees, statement by the chairman, discussion and analysis by management and similar reports that may be included in a financial or annual report.

Many sets of people are interested in the information provided by financial reporting by NPOs. Among present and potential users are donors, lenders, suppliers, creditors, employees, managers, directors and trustees, service beneficiaries, financial analysts, economists, taxing authorities, regulatory authorities, legislators, the financial press and reporting agencies. The following groups are especially interested in information provided by the financial reporting of a NPO:

- ***Donors***. One of the key sources of funding to NGOs is by grant making agencies like trusts, foundations and institutional donors, for programmes that fit their chosen areas of interventions. This makes grant making agencies one of the key stakeholders, who are interested in financial statements generated by NPOs.

- ***Other Resource providers***. *These are persons who* are directly compensated for providing resources - lenders, suppliers, and employees and those who are not directly and proportionately compensated - contributors and donors.

- ***Constituents***. Constituents are those who use and benefit from the services rendered by the organization.

- ***Governing bodies***. Governing bodies are those responsible for setting policies and for overseeing and appraising managers of NPOs. Governing bodies include boards of trustees and other bodies with similar responsibilities. These bodies are also responsible for reviewing the organization's conformance with various laws, restrictions, guidelines, or other items of a similar nature. In some NPOs, governing bodies are elected representatives of a constituency that is largely comprised of resource providers. In other NPOs, governing bodies may be self-perpetuating through election of their successors.

- ***Managers***. Managers of an organization are responsible for carrying out the policy mandates of governing bodies and managing the day-to-day operations of an organization. Managers could include certain elected officials, managing executives appointed by elected governing bodies executive directors, and staff, such as fund-raising and program directors.

- **Regulators**. Since most NPOs are registered as Trusts, Societies or Companies registered under section 25 of the Companies Act, the regulators of the said Acts are also interested in their financial statements. Other key interested regulators include the Foreign Contribution (Regulation) Act, the Income Tax Act and state wise regularity authorities.

Some of the above users have specialized information needs, but also have power to obtain the information they need. For example, donors and grantors who restrict the use of resources they provide, often stipulate that they be apprised periodically of the organization's compliance with the terms and conditions of the gift or grant. Creditors also may be able to stipulate that certain specialized types of information be provided. Similarly, the statute under which the NPO is registered or other legislations which govern and regulate it, like the Income Tax Act and the Foreign Contribution (Regulation) Act, may prescribe the reports that need to be periodically filed under the provisions of the respective Acts.

With particular reference to the donors, NPOs receive funds from the founders at the time of commencing operations and also frequently receive grants/donations and other forms of revenue the use of which is subject to the restrictions imposed by the contributors; i.e., such funds can only be used for specific purposes and, therefore, are not available for organisation's general purposes. Similarly, there might also be legal/other binding restrictions on NPOs for usage of certain funds. For the purpose of appropriate accounting for these funds and their reflection in the financial statements, it is necessary to understand their nature and characteristics. These have been dealt with in the module pertaining to fund accounting.

In view of the above we can well appreciate the importance of accounting in NPOs, in generating the financial information required by the various stakeholders. The objective of generating these financial statements is to provide timely and regular information about the financial position and performance of an enterprise that is useful to the wide range of users in making economic decisions.

1.5 STREAMS OF ACCOUNTING:

As we have discussed earlier, economic development and technological improvements have resulted in an increase in the scale and complexity of business operations. This, coupled with increasing social awareness, has made management functions more complex and has given rise to specialized branches of accounting.

Accounting has got split into following four main streams:

- Financial Accounting
- Cost Accounting
- Management Accounting
- Social responsibility Accounting

We will understand these streams in a little more detail in the following paragraphs.

1.5.1 Financial Accounting:

Financial Accounting is the process of systematic recording of the monetary transactions in the various books of account maintained by the organization with the ultimate intention of preparing the financial statements there from. These financial statements are basically in two forms.

- Financial Performance Statement which indicates the result of operations carried out by the organization during a given period of time and
- Balance sheet which indicates the state of affairs of the organization at any given point of time in terms of the assets and liabilities.

The nature of financial accounting indicates the following characteristics features of financial accounting:

a. **Expression in terms of money:**
   Financial Accounting considers those transactions which can be expressed in terms of money. All those transactions which cannot be expressed in terms of money, however important they may be from the activity point of view, find no place in accounting and hence in financial statements.

b. **Historic form of Accounting**
   Financial Accounting is referred to as a historical form of accounting. It is concerned with recording of events that have already taken place.

c. **Performance for the whole activities and not for individual department**
   Financial Accounting discloses the financial performance and financial status of the business as a whole. It does not indicate the details about the individual department or job or process inside the organization

d. **Legal requirement**
   Financial Accounting is more or less a legal requirement. In certain cases it also obligatory to get the accounts audited. Even in case of NPOs, the funding agencies require an audited utilization certificate of the funds.

Due to the increasing size and complexities of the business operations and specifically due to the segregation of ownership and management, only financial accounting was realized to be insufficient. This was specifically due to certain limitations of financial accounting, which we will discuss later.

1.5.2 Cost Accounting:

Cost accounting is the process of classifying and recording of the expenditure in a systematic manner with the intention of ascertaining the cost of a unit or a centre or an activity with the intention of controlling costs and to communicate information for decision making.

The Institute of Cost and Management Accountants, London has defined Cost Accounting as '*the application of costing and cost accounting principles, methods and techniques to the science, art and practice of cost control and the ascertainment of profitability as well as the presentation of_information for the purpose of managerial decision making*'.

1.5.3. Management Accounting:

Management Accounting is the process of analysis and interpretation of financial data collected with the help of financial accounting and cost accounting with the ultimate intention to draw certain conclusions there-from in order to assist the management in the process of decision-making. Management Accounting is not only confined to the areas of cost accounting but also covers other areas (such as pricing, capital expenditure decisions, capital structure decisions and buy or lease decisions) as well.

Definition of Management Accounting

The Institute of Chartered Accountants of England and Wales has defined management accounting as '*any form of accounting which enables a business to be conducted more efficiently*'.

Management Accounting Team of Anglo-American Council on Productivity has described the term Management Accounting as *'the presentation of accounting information in such a way so as to assist management in the creation of policy and the day to' day operation of an undertaking'*

1.5.4. Social responsibility accounting:

It is the process of identifying, measuring and communicating the social effects of activity decisions to permit informed judgment and decisions by the users of information. It is accounting for social responsibility aspects of a business. Management is responsible for what it contributes to the social well being and progress. Accounting for environment and ecology is part of social responsibility accounting.

Having got an overview of accounting we will now understand the basic accounting principles, concepts and conventions. But before that, let us understand book-keeping, which is an integral part of accounting.

1.6. MEANING OF BOOK- KEEPING:

Book-Keeping is a part of accounting and is concerned with record keeping and maintenance of books of accounts.

It covers the following three activities which we have covered in detail:

- Identifying the transaction and events
- Measuring and classifying the identified transaction and events in a common measuring unit
- Record these transaction and events in a proper Book of Accounts

Thus we can say that, "book-keeping is the system of recording, classifying and summarizing all monetary transactions so that the financial position of an organization can be ascertained on a particular date and in the long run."

Book- Keeping is such an integral part of accounting that, until recently, the words were held to be interchangeable. However, accounting is much broader than book keeping. In fact, bookkeeping provides the basic information as is required for accounting. In other words, accounting starts where bookkeeping ends.

It differs from accounting in the following respects:

S.No.	Basis of Distinction	Book- Keeping	Accounting
1.	Definition	Book- Keeping involves identifying the transaction, measuring and classifying the transactions and Recording these transactions.	Accounting, in addition to Book- keeping involve- summarizing the classified transactions, analyzing the summarized results, interpreting the analyzed results and communicating the interpreted information to the interested parties.
2.	**Stage**	Book-keeping is the primary stage.	Accounting is the secondary stage. It starts where book-keeping ends.
3.	**Basic Objective**	To maintain systematic records of financial transaction.	To ascertain the net results of operations and financial position and to communicate information to the interested parties.
4.	**Nature of job**	Routine and clerical in nature	Analytical in nature
5.	**Knowledge level**	The book-keeping requires basic level of knowledge.	Accounting requires higher level of knowledge.
6.	**Analytical skill**	The book-keeper may or may not possess analytical skill.	An accountant is required to possess analytical skill.
7.	**Supervision**	The book-keeper does not	An accountant supervises

	and checking	supervise and check the work of the accountant	and checks the work of the book-keeper.

We are now ready to learn about accounting principles, concepts and conventions.

1.7. ACCOUNTING PRINCIPLES:

In drawing up accounting statements, whether they are external "financial accounts" or internally focused "management accounts", one clear objective has to be that the accounts fairly reflect the true "substance" of the business and the results of its operation.

The theory of accounting has, therefore, developed the concept of a "***true and fair view"***. The true and fair view is applied in ensuring and assessing whether accounts do indeed portray accurately the financial activities.

To support the application of the *"true and fair"*, accounting has adopted certain concepts and conventions which help to ensure that accounting information is presented accurately and consistently.

1.7.1. Accounting Concepts:

Accounting concepts indicate the basic assumptions upon which the basic process of accounting is based. Following are the important accounting concepts:

a) **Business entity concept:**

   This accounting concept proposes that the business is assumed to be a distinct entity than the person who owns the business. The accounting process is carried out for the business and not for the person who owns the business. This concept helps in keeping business affairs free from influence of the personal affairs of the owners. It applies to all the organizations corporate or non-corporate, for-profit or not-profit.

For example, the investment made by the owner of the business treated as capital and reported as liability in the book of business. On the other hand, equipments purchased out of the investment / capital are treated as assets and reported as such in the books of business.

b) Money measurement concept:

This concept proposes that only those transactions and facts find place in accounting which can be expressed in terms of money. As such, all those transactions and facts which can not be expressed in terms of money do not find any place in accounting and in financial statements, though they may be having direct or indirect bearing on the business. This concept imposes severe restrictions on the kind of information available from the financial statements. In fact, this is considered to be one of the major limitations of financial accounting and financial statements. For example morale and motivation of the workers, credibility of the business organization in the market, though considered to be having a great impact on the business yet are not recorded in the books of account.

Generally, the currency of the country where the business operates is considered as the unit of measurement. The NPOs receiving funds from different countries have to prepare separate statements for such funding agencies in their respective currencies converted at appropriate exchange rate. However, these statements would be useful only for the sole purpose of donor reporting.

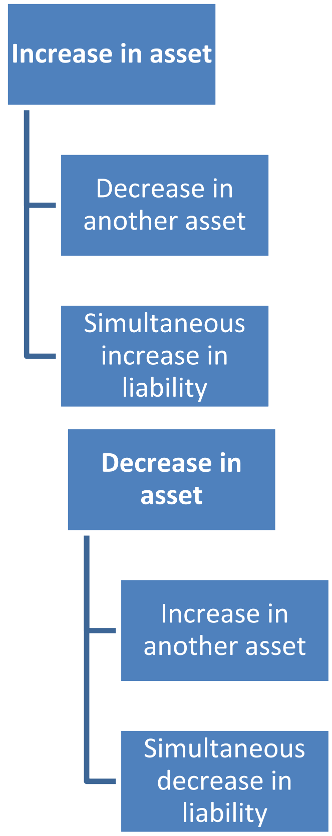
c) Dual aspect concept:

This concept proposes that every business transaction has two aspects. However, basic relationship between assets and liabilities that is the assets are equal to liabilities remains the same.

Capital = Assets – Liabilities

Assets = Liabilities + Capital

This can be better understood through the following diagram



d) Going concern concept:

This concept proposes that the business organization is going to be in existence for an indefinitely longer period of time and is not likely to close down the business in shorter period of time. The valuation of assets and liabilities is based on this assumption of going concern.

Because of this assumption, as the assets are not required to be sold off in near future, they are disclosed in the Balance Sheet at historic cost (original cost) less depreciation and not at the current market price (price at which assets can be replaced). This implies that the probable increase or decrease in the value of the assets is ignored in short-run.

e) Accounting period concept:

Even as the Going Concern Concept proposes that the business is going to be in existence for an indefinitely longer period of time, it becomes impossible and undesirable to prepare the financial statements at the end of its life. Therefore, in order to facilitate the preparation of financial statements, the indefinitely longer life span on the business is divided into shorter manageable time segments, being referred to as accounting period.

The accounting period is generally of twelve months. In India the accounting period starts from 1st April of each year and ends on 31st March of immediately following year.

Profitability is computed for this accounting period (by preparing the profitability statement) and the financial position is assessed at the end of this accounting period (by preparing the balance sheet). It should be noted that the selection of accounting period may depend upon the various factors like characteristics of the organization such as tax considerations, statutory requirements etc.

It is worthwhile to know at this point in time that in case of NPOs, as the funding may also be received from other countries, the financial statements for different accounting period (as required by the funding agency for them to corroborate it with their accounting period) may have to be prepared for the purpose of reporting to the funding agencies.

f) Cost Concept:

This concept proposes that the assets acquired by the organization are recorded at their cost of acquisition and this cost is considered for all the subsequent accounting purposes say charging of depreciation. This concept does not take into consideration current market prices of various assets. Also certain assets which do not have cost of acquisition are also ignored (this is also in accordance to the money measurement concept).

However, to this extent this concept leads to distortion of true position of the accounts.

g) Matching Concept:

This concept proposes that for calculating profit for the accounting period in a correct manner, the expenses and the cost incurred; whether paid or not during such period, should be matched with the revenue generated during the period. For example, if the accounting period ends on 31st March, the salaries for the month of March should also be considered as cost for the year ending on 31st March, even if they are actually paid in the month of April. Otherwise, calculation of the profits for the year ending 31st March will be untrue and unfair as the income will be for 12 months while the expenses will be only for 11 months. This concept is based on the concept of accrual; therefore let us now understand the concept of accrual.

h) Accrual concept:

Under this concept, all the transactions and events pertaining to an accounting period are accounted for / recorded in the same accounting period irrespective of inflow and outflow of money. This concept is also referred to as mercantile system.

Cash Concept:

Another system of accounting is cash basis. Under the cash basis concept only those transactions and events find a place in the financial statements where there is actual inflow or outflow of money.

1.7.2 Accounting Conventions:

Accounting Conventions indicate the customs and traditions the accountants follow while preparing the financial statements. Following are some of the important accounting conventions:

a) Conservatism:

This convention requires that all the future losses and expenses should be anticipated and provided for. At the same time, the future incomes and profits should not be anticipated and considered in the financial statement unless they actually realize.

b) **Materiality:**

This convention proposes that only those transactions and events should be considered in the financial statements which have material impact on the profitability of the organization. This implies that all the other transactions which are insignificant should be ignored.

The term materiality is a subjective term because it completely depends upon the nature of the transaction and the size of the business organization. Further, what may be material for one business entity; may not necessarily be material for another business entity. The core concept of this convention is that the omission of any transaction should not impact on the truth and fairness of the financial statements.

c) **Consistency:**

This convention proposes that the accounting polices and procedures should be followed consistently on period-to-period basis so as to facilitate the comparison of financial statements on periodic basis. If there is any change in any of accounting policies and procedures, such fact coupled with its effect on profitability should be disclosed explicitly while preparing the financial statements.

This convention is applicable when there are more than one acceptable methods of accounting for example, valuation of stock and computation of depreciation.

In the preceding section, we have obtained an overview of accounting, its various streams, also the basic accounting principles, concepts and conventions. We will conclude this unit by reviewing the advantages and limitations of accounting. This would complete our understanding of accounting, before we study the maintenance of basic books of account, with specific reference to NPOs.

1.8. ADVANTAGES OF ACCOUNTING:

The following are the advantages of accounting:

a) **Ascertain net results of operations and financial position**

Accounting facilitates ascertainment of net results of operations by preparing Income Statement and financial position by preparing balance sheet.

b) **Decision making**

Accounting facilitates the users (Short-term Creditors, Long-term Creditors, Funding Agencies, Present Investors, Potential Investors, Employee groups, Management, General Public, and Tax Authorities) to take decisions by communicating accounting information to them.

c) **Comparative study**

Accounting facilitates a comparative study in the following four ways:

(i) Comparison of actual figures with standard or budgeted figures for the same period and the same firm;

(ii) Comparison of actual figures of one period with those of another period for the same firm (i.e., Intra-firm);

(iii) Comparison of actual figures of one firm with those of another standard firm belonging to the same industry (i.e., Inter-firm Comparison); and

(iv) Comparison of actual figures of one firm with those of the industry to which the firm belong (i.e., Pattern Comparison).

d) **Assist the management**

Accounting assists the management in planning and controlling business activities and in taking decisions. For example, Projected Cash Flow Statement facilitates the management to know future receipts and payments and to take decision regarding anticipated surplus or shortage of funds.

e) **Facilitates the ascertainment of value of business**
Accounting facilitates the ascertainment of value of business in case of transfer of business to another entity.

f) **Control over assets**
Accounting facilitates control over assets by providing information regarding Cash Balance, Bank Balance, Debtors, Fixed Assets, and Stock etc.

g) **Facilitates raising loans**
Accounting facilitates raising loans from lenders by providing them historical and projected financial statements.

h) **Compliance with legal requirements**
Accounting facilitates complying with legal requirements, which require an enterprise to maintain books of accounts.

i) **Settlement of tax liability**
Accounting facilitates the settlement of tax liability with the authorities by maintaining proper books of accounts in systematic manner.

j) **Acts as legal evidence**
Proper books of accounts maintained in systematic manner act as legal evidence in case of disputes.

1.9. LIMITATIONS OF ACCOUNTING:

The following are the limitations of accounting:

a) **Ignores the qualitative elements**
Since the accounting is confined to the monetary matters only, the qualitative

elements like quality of management, quality of labour force, public relations are ignored.

b) **Not free from bias**

In many situations, the accountant has to make a choice out of the various alternatives available, e.g., choice in the method of depreciation (e.g., Straight Line or Written down), choice in the method of inventory valuation (e.g., FIFO, LIFO etc.). Since the subjectivity is inherent in personal judgment, the financial statements are therefore not free from bias. As a result, the analysis of financial statements also cannot be said to be free from bias.

c) **Estimated position and not real position**

Since the financial statements are prepared on a going concern basis as against liquidation basis, they report only the estimated periodic results and not the true results since the true results can be ascertained only on the liquidation of an enterprise.

d) **Ignores the price-level changes:**

In case of financial statements prepared on historical costs, the Fixed Assets are shown in the Balance Sheet at historical costs less depreciation and not at the replacement value which is often far higher than the value stated in the Balance Sheet. The analysis of such financial statements will not yield strictly comparable results unless the price-level changes are taken into account.

e) **Danger of window dressing**

Different accounting policies for the treatment of same item leads to manipulation by the management who may decide to enter wrong figures to artificially inflate or deflate the figure of profit, assets and liabilities. As a result of this the Income Statement fails to provide true and fair view of the result of operations and Balance Sheet fails to provide true and fair view of the financial position of the enterprise.

1.10. SUMMARY:

We shall now summarize the learning of this unit.

1. Following are the group of NPOs as classified by World Bank:
   - Community Based Organizations (CBOs)
   - National Organizations (NPOs)
   - International Organizations (INPOs)

2. Following parties are interested in the information provided by Financial reports of a NPO:
   - Resource providers
   - Constituents
   - Governing bodies
   - Managers

3. Definition of Accounting: "The process of identifying, measuring, recording the financial transactions and communicating the events in terms of economic and business transactions of the organization to interested users of the information".

4. Following are the primary objectives of accounting:
   - Maintain the accounting records
   - Ascertain the results of operations
   - Ascertain the financial position
   - Communicate the information to users

5. Bookkeeping is a part of accounting and is concerned with record keeping and maintenance of books of accounts which is often routing and clerical in nature.

6. Accounting is much broader than bookkeeping.

7. To support the application of the *"true and fair"*, accounting has adopted certain concepts and conventions which help to ensure that accounting information is presented accurately and consistently.

8. Following are the accounting concepts that we have understood in detail:

- Business entity concept
- Money measurement concept
- Dual aspect concept
- Going concern concept
- Accounting period
- Cost concept
- Matching concept
- Accrual concept
- Cash basis concept

9. Following are the accounting conventions which we have understood in detail:

- Conservatism
- Materiality
- Consistency

10. The advantages of accounting are enlisted below:

- Ascertain net results of operation and financial position
- Decision making
- Comparative study
- Assist the management
- Facilitates the ascertainment of value of business
- Control over assets
- Facilitates raising loans
- Compliance with the legal requirement
- Settlement of tax liability

- Acts as legal evidence.
- Transparency

11. Following are the limitations of accounting:
    - Ignores the qualitative elements
    - Not free from bias
    - Estimated position and not real position
    - Ignores price level changes
    - Danger of window dressing.

1.11. SELF ASSESSMENT EXCERCISE

1) Which of the following not a function of accounting?

a) Recording and posting the transactions
b) Identification of transaction
c) Classify the transaction
d) Classifying the areas of implementation

2) Which of the following is the historic form of accounting?

a) Financial accounting	**b)** Management accounting
c) Cost accounting	**d)** Social responsibility accounting

3) Bookkeeping is the system of recording, classifying, summarizing all monetary transactions so that the ………………….. position of an Organization can be ascertained.

a) Geographical	**b)** Social
c) Financial	**d)** None

4) Profitability is computed and financial statements are analyzed at the end of………

a) March Month	**b)** Every transaction
c) accounting period	**d)** business

5) Proper books of account maintained in a systematic manner acts as …………

a) Proposal for raising funds	**b)** Statement for future profitability
c) Legal evidence in case of disputes	**d)** Financial statements

6) Accounting is confined to

a) Qualitative matters	b) Monetary matters
c) Both	b) None

7) Different accounting policies for the treatment of same item leads to ……….. by the management

a) Standardization	b) Manipulation
c) Both	d) None

8) Matching concept of accounting is based on the concept of ………………….

a) Business entity concept	b) Cost concept
c) Accrual concept	d) Going concern concept

9) The convention of conservatism requires that future ……………………..……. should be anticipated and provided for

a) Profits / incomes	b) Losses / expenses
c) Both	d) None

10) **State whether the following statements are true or false. In case of the false statements, write the correct statement:**

a) Bookkeeping requires higher level of knowledge.

b) The objective of financial accounting is to ascertain net results of operations.

c) Accountant is required to possess analytical skills

d) Bookkeeper supervises the work of Accountant.

e) The concept of going concern proposes that the business is going to be in existence for a limited period of time.

f) Cost concept of accounting proposes to consider the market price of the assets

- **g)** The convention of consistency proposes that all the accounting policies and procedures should be followed consistently on period-to-period basis so as to facilitate the comparison of financial statements
- **h)** Accounting assists management in planning and controlling business activities but not the decision making.
- **i)** Grant making agencies are key stakeholders who are interested in financial statements generated by NPOs.
- **j)** All the transactions which cannot be expressed in terms of money, find no place in accounting.
- **k)** Financial accounting indicated the performance of individual departments of the organization.
- **l)** NPOs receiving funds from the other countries are required to maintain their books of account in the currency in which the funds are received.
- **m)** The matching concept proposes that only the payments actually made should be matched with the revenues generated during the period.
- **n)** The core concept of materiality is that the omission of any transaction should not impact on the truth or fairness of the financial statements.
- **o)** The process of accounting is fruitful when the summarized, analyzed and interpreted information is confined within the Organization.

11)Match the following:

(1) Transaction	**(a)** Internal users of financial information
(2) Event	**(b)** Proposes that business is assumed to be a distinct entity than the person
(3) Accounting concepts and conventions	**(c)** Provides timely and regular information about the financial position of an Organization
(4) Business entity	**(d)** External users of the financial information
(5) Financial statements	**(e)** is an exchange in which each participant receives or sacrifices value
(6) Board of Directors	**(f)** Helps to ensure that accounting information is presented accurately and consistently
(7) Funding agencies	**(g)** is a happening of a consequence to the

	entity

UNIT 2
BOOKS OF ACCOUNTS

At the end of this unit, the student would be able to:

- ***Understand the diversity in NPOs and consequent impact on accounting.***
- ***Understand basis of accounting and system of record keeping.***
- ***Understand the double entry system of recording transactions.***
- ***Understand accounting at various stages / levels.***
- ***Classify various accounts.***
- ***Acquaint with the complete process of recording a transaction***
- ***Acquaint with rectifying the transaction already recorded.***
- ***Acquaint with the computerized system of accounting.***

In Unit 1, we have obtained an overview of accounting and its basic principles. We will now look at the process of actual accounting of financial transactions. But since our present focus is on NPOs, let us first have a look at the following important areas in NPO accounting:

- Existing Accounting Practices in NPOs
- Diversity in NPO funding and its impact on accounting:

2.1 EXISTING ACCOUNTING PRACTICES IN NPOS

The existing accounting practices in the NPO sector are characterized and influenced by the following important factors:

- **Existence of a large number of unregistered NPOs**

  A majority of the NPOs in India are small community based self-help groups that are not registered under any statute of law. There is no authentic information about the accounting practices being followed by these unregistered NPOs.

- **Lack of awareness on accounting principles, applicability of Accounting Standards and guidelines**
  Because of the existence of a very large number of small, rural-based NPOs, there is not adequate awareness, felt need or resources available to adopt recommended accounting practices.

- **Diversity in the size and activities of NPOs**
  NPOs in India are of various sizes, from the big multilateral international NPOs operating in India to the tiny self-help groups in remote villages and districts. These NPOs have varying financial outlays and carry out a wide range of activities.

- **Bases of accounting**
  Although profit-oriented organizations have long rejected the cash basis of financial reporting in favour of the accrual basis, current practice reveals that this issue has not been resolved for financial reporting by NPOs.

  As a result of the above factors, the existing accounting practices in the NPO sector are evidenced by the following characteristics:

- There is no standard accounting practice being followed amongst NPOs. Cash, hybrid, accrual, modified cash / accrual basis of accounting are being employed;
- The Accounting Standards issued by the Institute of Chartered Accountants of India, are not being uniformly applied;
- There is lack of uniformity in presentation of financial statements;
- There are different disclosure practices used by individual NPOs;
- There is diversity in terminology and accounting policies adopted;

2.2 DIVERSITY IN NPO FUNDING AND ITS IMPACT ON ACCOUNTING:

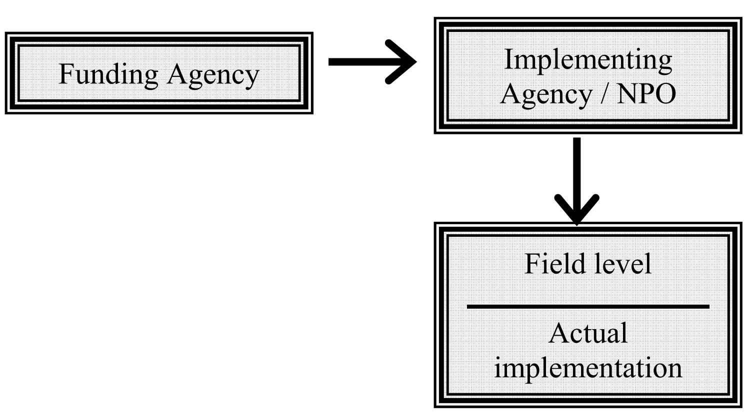
In this section we will try to understand some of the salient aspects of the NPO sector especially in terms of funding, and the consequent impact on the maintenance of books of account.

- **Sources of funds – local or foreign contributions:**
  The funding for the NPOs could either be from the home country where the NPO is located or from another country or it could even be a mix of both. In case the funding is from a foreign source, in a country like India, this would have an implication on maintenance of accounts, because a separate set of accounts would need to be maintained for such foreign funding, apart from a host of other requirements, which would be reviewed in detail in a separate course.

- **Currency: local or foreign currency**
  As mentioned above, funding to NPOs could be from other countries. In such cases, the funds could be received in currencies other than the home currency. Further, the reporting to the funding agency may have to be done in foreign currency (currency of funding). For example, if funds are received in Euros then the reports to the funding agency may have to be prepared in Euros. This would lead to keeping track of currency conversion rates for the purpose of donor reporting. In case the funding is from a number of donors from different countries, there would be a number of such tracking to be done.

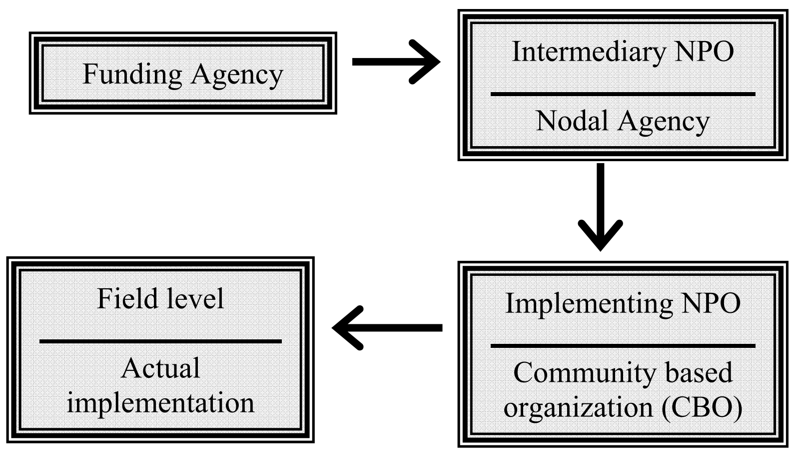
- **Levels of implementation – direct or through a nodal agency :**
  The routing of funds to an NPO could change depending on the level of implementation which could be:

  - Direct implementation, which means that the funds would be directly received by the NPOS and used at the field level for implementing the projects for which the funds are granted. The following would be the flow of funds in such a case.



- Funding through an intermediary NPO. In this scenario, funds are not directly granted to the NPO for implementation. Instead, they are granted to an intermediary NPO for sub-granting to a number of implementing NPOs. The intermediary agency is referred to as *'nodal agency'*. In such kind of funds, generally the implementing NPO are relatively small community based organizations (CBOs).

The following would be the flow of funds in such cases:



The accounting in both the above kinds of funding would be substantially different. While in case of a directly implementing NPO the accounting would be relatively elaborate, entailing project level accounting, in case of a nodal agency (also an NPO) the expenditure would largely comprise of grants given to the implementing NPO.

- **Budget line items: implication on accounting structure**
  Another area of diversity in NPO funding is in terms of budget-line items. Since the funding could come from different donors and for different programmes, the budget-line items would vary from project to project. Donor reporting for such funding would need to be in accordance with the approved budget-line items. This would have an implication on accounting since the accounting systems would need be transparent and in synergy with the donor budgets in order to meet donor reporting requirements. There is a need to convert the approved budget line items into sub groups of natural head of accounts.

- **Allocation of common cost:**
  This is a complex aspect in accounting for NPOs. There may be instances where certain overheads or salaries that are jointly funded by more than one funding

agencies. In such a scenario NPOs require a standard and transparent policy for allocating the common costs to different projects / funding agencies[1].

- **Statutory requirements:**

  NPOs are required to comply with various statutes. Further, when the funds are received from other countries then there are additional statutory requirements to be complied with under Foreign Contribution (Regulation) Act, 2010.[2]

  Thus, the diverse NPO funding and statutory requirements have implications on accounting. The accounting structure in NPOs should be designed in a manner that facilitates meeting all the above mentioned requirements. Therefore structuring of the accounting system assumes a vital importance in NPOs.

2.3 BASIS OF ACCOUNTING:

Having obtained an overview on the current status and issues with regard to NPO accounting, let us now understand the different basis of accounting, and how they impact the financial results of an organization.

As we know, accounting is the discipline which provides financial and other information essential to the efficient conduct and evaluation of the activities of any organization. We have seen that accounting is a critical tool for proper financial management, which is in turn essential in all organizations - profit or non-profit - where funds are involved.

Basis of Accounting

The term ‘basis of accounting’ refers to the method of recognition of revenues, expenses, assets and liabilities in accounts. The commonly prevailing bases of accounting are:

a) Cash basis of accounting;

b) Accrual basis of accounting; and

c) Mixed basis of accounting

2.3.1 Cash Basis Of Accounting:

Under cash basis of accounting, transactions whether of capital or revenue nature, are recorded when the related cash receipts or cash payments takes place.

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[1] Fund accounting covered in detail in a separate module.

[2] Details regarding various statutory requirements covered under a separate module.

Similarly, expenditure on acquisition and maintenance of assets used in rendering of services as well as on employee remuneration and other items is recorded when the related payments take place.

The end-product of cash basis of accounting is a statement of Receipts and Payments that classifies cash receipts and cash payments under different heads.

2.3.2 Accrual Basis Of Accounting:

Accrual Basis of accounting is the method of recording transactions by where revenues, costs, assets and liabilities are reflected in the accounts in the period in which they accrue. Accrual basis of accounting includes considerations relating to deferral, allocations, depreciation and amortization. This is also referred to as 'Mercantile Basis of Accounting'.

Accrual basis of accounting attempts to record the financial effects of the transactions and other events of an enterprise in the period in which they occur rather than recording them in the period(s) in which cash is received or paid by the enterprise.

Accrual basis recognizes those economic events that affect an organization's performance which often do not coincide with the cash receipts and payments.

The goal of accrual basis of accounting is to relate the accomplishments (measured in the form of revenues) and the efforts (measured in terms of costs) so that the reported net income measures an organization's performance during a period rather than merely listing its cash receipts and payments.

Apart from income measurement, accrual basis of accounting recognizes assets, liabilities or components of revenues and expenses for amount received or paid in cash in past and amounts expected to be received or paid in cash in future.

2.3.3 Mixed Basis Of Accounting:

Mixed basis is also called "modified accrual basis". It combines a mix of both; cash as well as accrual basis. In many NPOs expenditure is recognized on accrual basis but income is recognized on cash basis or partly on cash and partly on accrual basis. For example, Grant and Donations may be recognized on cash basis whereas rent and interest income on Fixed Deposits may be accounted on accrual basis.

The extent and nature of mixing (cash and accrual) may vary from organization to organization which are normally clarified by way of "Notes to Account" and followed uniformly.

2.3.4 Distinction Between Cash Basis And Accrual Basis:

Accrual basis of accounting differs from the cash basis of accounting in the following respects:

Sl.No	Basis of Distinction	Accrual Basis of Accounting	Cash basis of Accounting
1.	Prepaid/Outstanding Expenses/accrued/un-accrued income in the balance sheet	There may be prepaid/outstanding expenses and accrued/un-accrued incomes in the balance sheet.	There is no prepaid/outstanding expense or accrued /un-accrued incomes.
2.	Higher / lower income in case of prepaid expense and accrued income.	Income Statement will show a relatively higher income.	Income Statement will show a relatively lower income.
3.	Higher / lower income in case of prepaid expense and un-accrued income.	Income Statement will show a relatively lower income.	Income Statement will show a relatively higher income.
4.	Recognition under the Companies Act, 1956.	Is recognized under the Companies Act, 1956.	Is not recognized under the Companies Act, 1956.
5.	Availability of options to an accountant to manipulate the accounts by way of choosing the most suitable method out of several alternative methods of accounting e.g., FIFO/LIFO/SLM/WDV.	Under this, an accountant has options.	Under this, an accountant has no options to make a choice as such.

2.3.5 Accrual Basis And Accounting Standards:

Accounting is often said to be a social science. It operates in an open and ever-changing economic environment. The nature of transaction entered into by various organizations and the circumstances surrounding such transactions differ widely.

This characteristic of accounting measurements historically led to the adoption of different accounting practices by different organizations for dealing with similar transactions or situations.

Comparability is one of the important qualitative characteristics of accounting information. This implies that the information should be measured and presented in such a manner that the users are able to compare the information of an organization through time and with similar information of other organizations.

Adoption of different accounting practices by different organizations for similar transactions or situations tends to reduce the comparability of accounting information.

Recognizing the need for bringing about a greater degree of uniformity in accounting measurements, the trend all over the world now is towards:

a) Following the accrual basis of accounting;

b) Formulation of accounting standards to be adopted in preparation of accounting information and its presentation in financial statements.

Accounting standards lay down the rules for measurement and presentation of accounting information by different organizations. In India, the task of formulating accounting standards has been taken up by the Institute of Chartered Accountants of India (ICAI).

Accounting Standards issued by the Institute are based on the fundamental accounting assumption of accrual basis of accounting. These Standards thus reflect what can be construed as proper application of accrual accounting to different types of transactions and events.

Recommendation of ICAI on Applicability of Accounting Standards:

The Accounting Standards issued by the Institute of Chartered Accountants of India do not apply to an NPO if no part of the activity of such entity is commercial, industrial or business in nature. The Standards would however apply even if a very small proportion of activities is considered to be commercial, industrial or business in nature. For example, where an NPO is engaged in the commercial activity of granting loans/credit to small entrepreneurs at nominal rates of interest or in the industrial activity of manufacturing clothes of the rural poor, Accounting Standards issued by the ICAI would apply to such an NPO. It may be mentioned that since the Accounting Standards contain wholesome principles of accounting, these principles provide the most appropriate guidance even in case of those organizations to which Accounting Standards do not apply. It is, therefore, recommended that all NPOs, irrespective of the fact that no part of the activities is commercial, industrial or business in nature, should follow accounting standards issued by the Institute. This is because following the Accounting Standards laid down by ICAI would help NPOs to maintain uniformity in presentation of financial statements, proper disclosure and transparency. However, while applying the accounting standards certain terms used in the Accounting Standards may need to be modified in the context of the corresponding appropriate terms for NPOs, e.g., where a standard refers to the 'statement of profit and loss', in the context of NPOs, it should be considered that the standard refers to the 'Income and Expenditure Account'.

Treatment of various items of Revenue Receipts/Expenditure under Cash and Accrual Basis of Accounting:

Revenue Receipts in an NPO normally consist of:

- Grants
- Interest on Investments
- Annual Subscriptions
- Donations
- Miscellaneous Receipts

Similarly, revenue expenditure normally consists of:

- Programme Co-ordination
- Administrative Expenditure
  - Depreciation
  - Others

The treatment of the above major items of revenue receipts and expenditure under cash basis and accrual basis of accounting is given in the table below:

Particulars	Cash Basis of Accounting	Accrual Basis of Accounting
A. Revenue Receipts		
Grants	On actual receipt basis	On actual receipt basis / sanction letter
Interest on Investment	On actual receipt basis	On due/accrual basis(whether actually received or not)
Annual Subscription	On actual receipt basis	On due/accrual basis(whether actually received or not)
Donations	On actual receipt basis	On actual receipt basis
Misc. Receipts	On actual receipt basis	On actual receipt basis
B. Revenue Payments / Expenditure		
Program Expenditure	On actual Payment basis	On actual Payment plus year end adjustment on outstanding/due basis
Program Co-ordination Administrative Expenditure (Rent, Salaries, vehicle running expenses etc.)Others	On actual Payment basis	On actual Payment plus year end adjustment on outstanding/due basis
Depreciation	Normally not charged	Charged as per straight line/ Written Down value Method as per Income Tax Rates/on independent assessment basis

2.3.6 Legal Position:

As mentioned earlier, NPOs are required to comply with various statutes. Now let us try to know the recommended basis of accounting under these statutes[3]:

a) The Companies Act, 1956:

NPOs registered under Section 25A of the Companies Act, 1956, are required to maintain their books of account on accrual basis and according to the double entry system of accounting (Refer Section 209(3) (b) of the said Act). If the books are not kept on accrual basis, it shall be deemed as per the provisions of the aforesaid section that proper books of account are not kept.

b) Income Tax Act, 1961:

Section 145 of the Income Tax Act, 1961 specifies that the income chargeable under the head "Profits and Gains of Business or Profession" or "Income from other Source" is to be computed in accordance with either cash or accrual system of accounting ***regularly*** employed by the assesses (which also includes voluntary organizations). Accordingly, from assessment year 1997-98, all voluntary organizations are required to maintain their books of account either in Cash or Accrual system of accounting on regular basis.

c) Foreign Contribution (Regulation) Act, 2010 (FCRA):

As per the provision of FCRA 2010 and rules framed therein, NPOs are required to submit a statement of Income and Expenditure account and a statement of Receipts and Payments Account in respect of receipt and utilization of foreign contributions along with Balance Sheet. This implies that FCRA also recognizes accrual basis of accounting.

d) Bombay Public Trust Act, 1950:

This Act is applicable to NPOs registered in the states of Gujarat and Maharashtra. This Act does not lay down any basis of accounting which should be followed. However, a format of Balance Sheet and Income &

[3] Detailed requirement under all the statues are covered as part of separate module. This part covers only the requirement of basis of accounting under various statues.

Expenditure Account is given in the rules (schedule VIII and IX).The format shows that both accrual and cash basis is acceptable under the law. Further, accrual basis is mainly considered for rent and interest income. If accounts are kept on cash basis, then outstanding accrued/due income is shown by way of "Notes to Accounts".

e) The Indian Trust Act, 1882 and The Societies Registration Act, 1860:
There is no specific provision with regard to the methods of accounting to be followed by NPOs covered under the aforesaid Acts.

Recommendations of the Institute of Chartered Accountants of India:
Accrual is the scientific basis of accounting and has conceptual superiority over the cash basis of accounting. It, therefore, recommended that all NPOs, including non-company NPOs, should maintain their books of account on accrual basis.

Funding Agencies:
Most of the funding agencies primarily require their assisted NPOs to submit a financial statement in a prescribed form or otherwise at periodical intervals to show:

a) The actual receipts;

b) Disbursements;

c) Utilization of grant amounts; and

d) Unutilized balance;

Refer the following table for requirement under different statues and as per ICAI:

Sl. No.	Particulars	Requirement
1	Companies Act	Accrual basis
2	Income Tax Act	Cash or accrual system on regular basis
3	Foreign Contribution Regulation Act	Cash basis (Implied)
4	Bombay Public Trust Act	Cash or accrual system on regular basis
5	Indian Trust Act and Societies Registration Act	No specific provision
6	ICAI	Accrual basis

2.4 SYSTEM OF RECORDING TRANSACTIONS:

Apart from the different basis of accounting that we have reviewed above, there are also 2 distinct systems of financial accounting. These are:

- Single Entry System/ Incomplete Records System
- Double Entry System

2.4.1 Single Entry System:

Single entry system is a one sided accounting system to maintain financial information. Many small, simple businesses maintain only single entry system that records the bare-essentials. Accounts maintained under single entry systems are usually inadequate and are followed where the operations are simple and the volume of activity is low.

Advantages:

The biggest advantage of single entry system is its simplicity. They are usually less expensive to maintain as they do not required the services of a trained personnel.

Disadvantages:

i. Data may not be available to management for effectively planning and controlling the business;
ii. Lack of systematic and precise bookkeeping may lead to inefficient administration and reduced control over the affairs of the business;
iii. Single-entry records do not provide a check against clerical error, as does a double-entry system. This is one of the most serious defects of single-entry systems.

2.4.2 Double Entry System:

The double entry system takes into account both the aspects of a transaction. The golden rule of double-entry is that every debit should have a credit, and every credit should have a debit. For example if an institution receives cash donation, under double entry book-keeping system, not only our cash balance shall be increased (Debit Balance) in our cash book but we should give due credit to the donation account by increasing the credit balance to that extent. As a result, under this system both the debit and credit balance will invariably tally with each other. The double entry system is so named because it records both the aspects of every transaction.

Advantages:

i. Recording both the aspect of every transaction ensures accuracy of the accounting;
ii. As the records maintained under this system are complete, it facilitates the computation of profit or loss of the organization;
iii. It also facilitates comparison of current year's result with the previous year.

2.4.3 Distinction Between Double Entry System And Single Entry System:

Basis of Distinction	Double Entry System	Single Entry System
Assumptions and principles	It is based on certain assumption and principles.	It is not based on any assumption and principles.
Both aspects of all the transaction	Both the aspects of all the transaction are recorded.	This is single sided accounting.
Nature of accounts maintained	All types-Personal, Real and Nominal, are maintained.	Usually Cash and Personal accounts are maintained.
Trial Balance	Arithmetical accuracy of the records can be checked by preparing a trial balance.	Arithmetical accuracy of the records cannot be checked since trial balance cannot be prepared.
Determination of true profit or loss	True surplus or deficit can be determined by preparing Income and Expenditure accounts.	Only estimated surplus or deficit can be determined since Income and Expenditure account cannot be prepared.
Financial Position	True financial position can be known by preparing a balance sheet.	Only estimated financial position can be known on the basis of Statement of Affairs.
Adjustments	All types of adjustment are made while preparing final accounts	No special attention is given to adjustments.
Utility	It is used by all types of traders	It is used only by small traders.
Recognition by Government	Records maintained according to this system are recognized by the government	Records maintained according to this system are not recognized by the government.

2.5 IMPLICATION OF DEBIT AND CREDIT:

We will now move forward and understand the accounting treatment for various financial transactions. In order to do this we first have to understand the basic implications of the term "Debit" and "Credit".

There is an old accounting adage which says that ***even if a parrot is made to understand these two accounting terms properly, he will become a master in accounts***. Under the section of double entry system we have already understood that every debit has a credit. But now let us try to understand what the terms "debit" and "credit" actually imply.

Every transaction / account has a dual aspect. For example, if we buy something, we have to pay something. Therefore each transaction will have a debit part and a credit part. As we know, every organization will have assets, liabilities, revenues and expenses. We will now understand which side of an account (debit or credit) effects these.

Debits increase assets and expenses and decrease liabilities and revenues. Conversely, credits increase liabilities and revenues and decrease assets and expenses. Another way to think about debits and credits is to consider them as the left and right sides of a transaction. Because we use double-entry accounting, each financial transaction consists of a left-side entry and a right-side entry – debits are the left side and credits are the right side. This can be seen by using a diagram called a T-Account:

Debit (Left side)	Credit (Right side)
Increases assets and expenses	Decreases assets and expenses
Decreases liabilities and revenues	Increases liabilities and revenues

Assets and expenses normally have balances on the debit, or left, side and liabilities and revenues normally have balances on the credit, or right, side. If the balance of an Asset or Expense needs to be increased, then a debit would be used. If the balance of a Liability or Revenue needs to be increased, then a credit would be used. The reverse of this also holds true. Refer the following table for the rules of debits and credits:

Debit	**To increase an asset or expenses**
Debit	**To decrease liability or revenue**
Credit	**To decrease an asset or expenses**
Credit	**To increase liability or revenue**

2.6 CLASSIFICATION OF ACCOUNTS:

It is now time to understand the process of actual accounting of transactions. Lets us start this with obtaining an understanding regarding the different types of accounts.

In preparation of accounts, we are subjected to various types of heads attached with each transaction such as fixed assets, persons, grants, expenses, losses, gains and incomes.

For the sake of convenience, the aforesaid types of accounts are mainly divided into three broad categories:

- Real accounts
- Personal accounts
- Nominal accounts

2.6.1 Real Accounts:

They represent transactions which deal with material things, such as fixed assets, cash and stocks.

Real accounts may consist of the following types of accounts-

- Land account
- Building accounts
- Machinery accounts
- Furniture accounts
- Vehicles accounts

In other words, real accounts include all fixed assets and capital items.

2.6.2 Personal Accounts:

These represent the transactions which deal with persons (both individuals and companies/firms/societies/trusts etc.).

A Personal Account relates to two types of transactions:

- It relates to the persons necessitated by "Credit" transactions i.e., where goods are sold and services rendered but payment being made at a subsequent date, or

- It relates to the "Debit" transactions where payment is made at once for the future delivery of goods or rendering of services.

The principle applicable for Personal Accounts is *"Debit the Receiver and Credit the Supplier".*

Personal accounts may consist of the following types of accounts:

- Accounts of the supplier
- Accounts of the customer
- Bank / financial Institutions
- Capital Accounts

2.6.3 Nominal Accounts:

These represent transactions which deal with income and expenses of an organization. There all the items pertaining to profit or loss fall under nominal account. Nominal accounts may consist of the following types of accounts:

- Salary account
- Wages account
- Printing and stationery account
- Insurance account
- Telephone expenses Account
- Interest paid or received account
- Commission paid or received account

2.6.4 Golden Rules Of Accounting:

Real Account	**"Debit what comes in, Credit what goes out"**
Personal Account	**"Debit the receiver and Credit the giver"**
Nominal Account	**"Debit all expenses/losses, Credit all incomes/profits"**

2.7 TYPES OF EXPENDITURE

For the purpose of financial accounting, the expenditures / payments are classified into three categories:

a) Capital Expenditure:

Capital Expenditure denotes the payments made for acquiring the infrastructural properties such as building, machinery and equipment, furniture and fittings etc., required for doing the business. These are technically referred to as Fixed Assets.

Capital expenditure could either be for procurement of a new asset or for upgrading the useful life of an existing asset. Where the expenditure incurred on the existing assets leads maintenance of the asset to its existing capacities, then it is not considered as capital expenditure.

Treatment for the purpose of accounting:

Fixed Assets do not give the returns immediately in the year of procurement / improvement. As such, benefits available from capital expenditure are long-term benefits. Hence, it will be wrong to consider the entire amount of capital expenditure as expenses while calculating the profitability for that year. Therefore all the capital expenditure needs to be capitalized in order to spread the cost of expenditure over the useful life of the asset which is done by way of charging depreciation at a fixed rate over the life of the asset. The fixed assets are capitalized and reported on the asset side of the balance sheet.

b) Revenue Expenditure:

Revenue Expenditure denotes the payments made during the year with an intention to receive the returns during the same year. As such, the benefits available from revenue expenditure are received during the same period during which they are paid for. The revenue expenditure affects the Profitability Statement. Therefore, the entire amount of payment made towards revenue expenditure is considered for computation of profitability for the year.

c) Deferred Revenue Expenditure:

Deferred Revenue Expenditure denotes such payments which neither result in acquisition of fixed assets nor the benefits of such payment are received during the same year.

The examples of Deferred Revenue Expenditure are-

- Initial Advertisement Expenditure
- Research and Development Expenditure
- In case of company form of organization, Preliminary Expenses or Company Formation Expenses.

Treatment for the purpose of accounting:

Principally, Deferred Revenue Expenditure is not charged to the Profitability Statement during the year in which the payment is made. As such, deferred revenue expenditure does not fully affect the profitability of the period during which it is paid for. It is charged to the Profitability Statement (in technical words 'written off to Profitability Statement') over the period over which benefits are received, by passing the adjustment entry. The balance which is not written off to Profitability Statement is shown on the Asset side of Balance Sheet.

Capital expenditure	**Capitalize and report on the asset side of the Balance Sheet**
Revenue expenditure	**Charge to Profitability Statement of the year in which expenditure is incurred**
Deferred revenue expenditure	**Write off every year by passing an adjustment entry. Till then report in the Balance Sheet on Asset side.**

2.8 TYPES OF VOUCHERS

We have understood the various categories of accounts and the types of expenses incurred in an organization. We will now go a step further and discuss about basic accounting records.

Any payment that is made needs to be supported by documents that validate that the said payment has actually been made. These supporting documents are known as the evidence for the purpose of audit. The need and the methodology of preparing such support documents can be explained as below.

Suppose, Mr. X buys some stationery or equipment from a shop and makes the payment. In return he collects the bill or cash memo from the shop on which the details of the various items along with their values are written. This bill or cash memo forms the support document for the payment made by Mr. X.

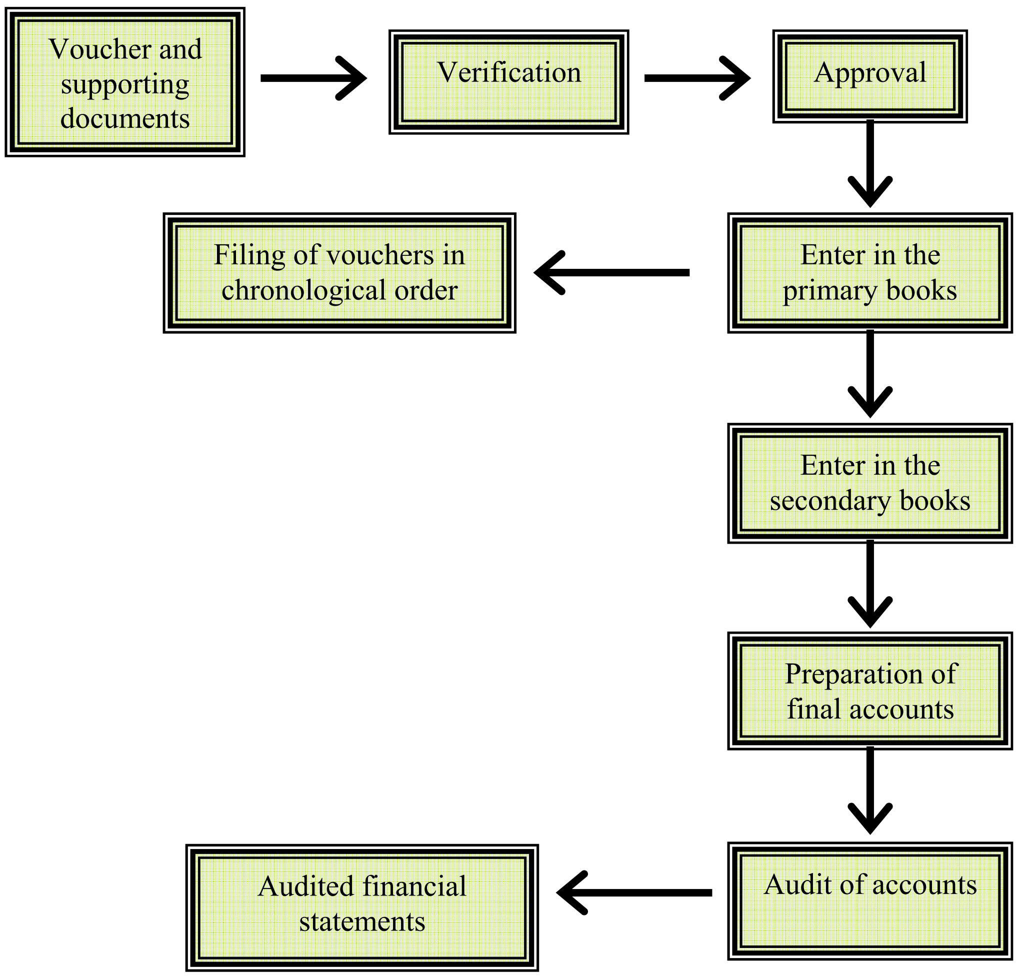
At the office, Mr. X would obtain the approval from the concerned designated authority for making such payment and submit all the supporting documents such as quotations, invoices, delivery Challan to the accounts department. The Accountant would then prepare what is known as a “voucher” which is a covering sheet providing details for the payment made, and attach the supporting documents as ‘Evidence’ or ‘Support’ for the said payment. The following facts are disclosed in a voucher:

1. Details of the goods purchased
2. Amount paid for the purchases made
3. The date of purchase
4. Mode of payment
5. Name of the supplier
6. The persons passing or approving the purchase
7. The person making the payment and
8. brief description of the purpose for which purchases were made

In case of NPOs, the accountant is also required to mention the project name / number and the funding agency to which the expenditure is required to be charged. This is important especially if the organization is dealing with more than one project and funding agencies, as it will provide information as to under which project the expenditure has been incurred.

As mentioned earlier, the implementation of the projects may be in extreme remote areas. In such cases it would be difficult to obtain proper supporting documents. In such cases the accountant would need to rely on the appropriate evidence called as **circumstantial evidence**. This can be better understood by the following example:

Suppose, an organization conducts a campaign to make people aware of some disease say Goitre, caused by the deficiency of iodine. The team members plan to distribute to the villagers packets of iodized salt. To encourage more and more people to attend the programme and receive the packets, they offer meals. Both, buying of packets of iodized salt and offering of meals result in incurring of expenses. Such expenses in many instances are not supported by proper bills or cash memos. In such cases the list of participants, photographs, pamphlets, newspaper clippings, or else even a video recording during the time of the campaign could serve as evidence that the expenses have been incurred. Such evidence is called the circumstantial evidence. Similar example is that of tea/snacks consumed by the persons participating in campaigns or community meetings, where it becomes difficult in many instances to obtain bills for such expenses. In these situations, use of circumstantial evidence like minutes book or photographs may be useful. The above discussion can be illustrated as follows:



At each of these stages there are various checks and balances required. All these checks and balances put together are called as internal control systems. These internal controls are critically important and form an integral part of financial management. While some of these have been incorporated at relevant places in this course material, we will however learn more about these in the context of NPOs in a separate module.

Objectives of a voucher:

Both the voucher and evidence are an integral part of proper bookkeeping. The objectives of preparing vouchers are:

- To have a proper evidence / supporting of financial transactions.
- To establish safe administrative procedure
- To enable proper recording of transactions.

Contents of a voucher:

The following information is provided in the voucher in a summarized manner:

a) The serial number and the date of transaction
b) The nature of the transaction
c) Amount in words and figures
d) The account head which has to be debited / credited
e) Name and signature of the person who has prepared the voucher
f) Name and signature of the authority who has passed it for payment / receipt / adjustment
g) The supporting document e.g. Bills, invoices, cash, memos

Types of vouchers:

- For recording Cash / Bank Transactions
  - Cash / Cheque Receipt Voucher
  - Cash / Cheque Payment Voucher
- For Adjustment Entries
  - Journal Vouchers

Refer Annexure 1, 2, 3 and 4 for the general formats for cash / bank receipt, payment, petty cash vouchers and journal voucher.

Points to remember for preparation of vouchers:

- Vouchers should be prepared for each and every entry made in the books of account.
- Vouchers should be prepared and filed separately on a day to day basis.
- Each voucher should be serially numbered and such numbers should be mentioned in the respective original books of account maintained in order to facilitate cross – reference.
- It is advisable to print various types of vouchers in different colors for the purpose of identification

- Vouchers should be kept in safe custody of a responsible person in the accounts department
- PAID stamp with date should be affixed on the face of each payment voucher and all the supporting documents.
- Revenue stamps should be affixed on all cash payment vouchers in excess of Rs. 5000 (which is the present limit prescribed)

2.9 CATEGORIES OF BOOKS OF ACCOUNT

Having reviewed the accounting records which form the basis for writing the books of accounts we will now move a step forward and understand how the primary books of account are maintained.

Establishing an accounting system is a serious matter. It requires a lot of thought and expertise to determine an appropriate system suited to the needs of an organization. One has to carefully select the system, after analyzing the following:

- Kind of organization
- Level of implementation
- Quantum and frequency of various transactions
- Number of bank accounts in operation
- Foreign contribution receipts
- The number of Funding Partners and their reporting expectation
- Prevailing legal statues
- Level of internal control measurers required
- Level of Centralization or De-centralization in operations

Irrespective of the type of system selected, the books of account of an NPO would comprise of the following:

a) Primary Books of Account
b) Final Books of Account
c) Subsidiary Registers

2.9.1 Primary books of account:

The Primary (Original) Books of Account can be divided into the following categories:

- Cash/Bank Book
- Petty Cash Book
- Journal

Let us try to understand each of these in detail.

i) Cash / Bank book:

The Cash / Bank book is a primary (original) book of entry used for recording all transactions involving cash or bank receipts and payments in chronological order.

The Cash / Bank Book has two sides:

- The Debit side - left side of the Book which is used for recording receipts (also referred to as receipt side)
- The Credit side - right side of the Book which is used for recording payments (also referred to as payment side).

The debit and credit side of the Cash/Bank book normally has two columns; one for recording cash transactions and the other for recording bank transactions. If more than one bank account is held by the organization, either the bank account columns are extended or a separate bank account is opened in the General Ledger. However, if bank accounts are used frequently, then it is better to maintain the bank account in a multi columnar Cash/Bank book to reduce the workload. The Cash/ Bank book pages should be serially machine numbered in continuation with no break. The Chief Functionary / Project in-charge / Head of Accounts should certify the pages contained in the Cash/Bank book at the beginning of the book itself.

The Cash / Bank book should be written daily by the accounts staff from primary accounting records like the duplicate copies of receipt book, payment vouchers, and cheque book counterfoils. Cash / Bank book should be closed daily and the closing balances should tally with the actual balance of cash in safe. Entries in the Cash / Bank book should also be verified by the Project-in-charge / Head of Accounts / Auditors at a periodical interval and a note on such verification should be recorded in the Cash/Bank book.

Each entry recorded on the receipt and payment sides of the Cash / Bank book is posted into the General Ledger, except **"Contra Entries".** Contra Entries impact both the cash and bank columns in the Cash/Bank book, and are made when cash is withdrawn from bank or deposited into the bank. These entries are denoted by 'C' in the Cash / Bank book.

Kinds of cash / bank book:

The main Cash Book may be of three types:

a) Simple Cash Book or Single column cash book:

Simple cash book has one amount column on each side. All cash receipts are recorded on the debit side and all cash payments on the credit side. Such a cash book appears like an ordinary account. Hence there is no need to open this account in the ledger.

Format of a single column Cash book

Debit side							**Credit side**
Date	**Particulars**	**L. F**	**Amount Rs.**	**Date**	**Particulars**	**L. F**	**Amount Rs.**
1-4-07	To Opening Balance		xxxx	3-4-07	By Purchases		xxxx
10-4-07	To Cash Sales		xxxx	6-4-07	By travel expenses		xxxx
15-4-07	To Rent		xxxx	13-4-07	By Furniture		xxxx
16-4-07	To Interest		xxxx	23-4-07	By salaries		xxxx
28-4-07	To Debtors		xxxx	30-4-07	By Balance c/d		xxxx
	TOTAL		**XXXX**		**TOTAL**		**XXXX**
May 1	To balance b/d		**XXXX**				

From the above, it can be noted that

a) In the simple cash book only cash receipts and cash payments are recorded.
b) The debit side is always higher than the credit side since the payment cannot exceed the available cash.
c) The simple cash book is like an ordinary account.

ii) Double column Cash book:

It consists of two columns on debit and credit side; one column for recording cash receipts and payments and the other column for recording bank transactions.
In the cash column on the debit side, cash received is entered. Similarly, cash paid is entered in the cash column on the payment side. Also, the bank column on the debit side records all receipts through bank and the same column on the credit side show payments through bank. An additional column can be added on each side if there are more than one bank accounts being operated by the organization.

Format of double column cash book (dates are old, may put the latest)

Debit side									**Credit side**
Date	**Particulars**	**L. F No**	**Cash Rs.**	**Bank Rs.**	**Date**	**Particulars**	**L. F No**	**Cash Rs.**	**Bank Rs.**
1-4-07	To opening Bal		Xxx	xxxx	2-4-07	By Salaries			xxxx
6-4-07	To Cash Sales			xxxx	15-4-07	By Sales tax			xxxx
20-4-07	To Bank	C	Xxx		20-4-07	By Cash	C		xxxx
21-4-07	To Commission			xxxx	26-4-07	By Stationery		xxx	
23-4-07	To Interest			xxxx	29-4-07	By Telephone			xxxx
30-4-07	To Rent			xxxx	30-4-07	By Balance c/d		xxx	xxxx
	TOTAL		**XXX**	**XXXX**		**TOTAL**		**XXX**	**XXXX**
May 1	**To balance b/d**		**XXX**	**XXXX**					

b) Petty Cash book:

In many organizations, a number of small payments, such as for telegrams, taxi fare, cartage, tea and coffee, local conveyance etc. have to be made. If all these payments are recorded in the cash book, it will be unnecessarily heavy and cumbersome. Also the main cashier will be overburdened with work. Therefore, it is usual for firms to appoint a person as 'Petty Cashier' and to entrust the task of making petty payments.

Features of Petty Cash Book

The main features of the petty cash book are as follows:

i)The amount of the cash received from the main cashier is recorded on the left side column.

ii) The payments of petty cash expenses are recorded on the right hand side in the respective column.
iii) It never shows a credit balance because the cash payments never exceed the cash receipts.
iv) Its balance represents the unspent petty cash in hand
v) Recording is done on the basis of internal as well as external vouchers.
vi) All the columns of expenses are totaled periodically and such periodic totals are individually posted to the debit side of the respective expenses accounts in the ledgers by writing 'To Sundries as per Petty Cash Book' in the particulars column.
vii) Petty Cash Book is both a book of original entry as well as a book of final entry. In other words, it serves the purpose of both journal and ledger. It is a journal in the sense that all petty cash payments are recorded in it for the first time from the source documents. It is a ledger in the sense that it serves the purpose of 'Petty Cash Account' in which cash receipts from main cashier are recorded on the debit side and cash payments are recorded on the credit side. Hence, there is no need to open Petty Cash Account in the ledger.

Similarities between Main Cash Book and Petty Cash Book:

1) Both are books of original entry. In other words, both serve the purpose of journal. Both are journal in the sense that the transactions are recorded in it for the first time from the source documents.
2) Both are books of final entry. In other words, both serve the purpose of ledger. Both, are ledger in the sense that main cash book serves the purpose of 'Main cash account' and 'Bank account' (only in case of three column cash book) and petty cash book serves the purpose of 'Petty cash account'

Differences between Main Cash Book and Petty Cash Book:

1. In the main cash book all cash receipts are recorded whereas in the petty cash book only cash receipts from main cashier are recorded.
2. In the main cash book all cash payments except payments of petty cash expenses, are recorded whereas in the petty cash book only payments of
3. Petty cash expenses are recorded.

Format of petty cash book

Cash Received	LF	Date	Particulars	V.no	Total Payment	Analysis of Expenses					
						Postage (Rs)	Stationery(Rs)	Carriage(Rs)	Travel(Rs)	Personal Exp	Remarks
XXXX		2011 Jan									
		1	To Bank								
		5	By Postage		xxxx	xxxx					
		6	By Stationery		xxxx		xxxx				
		7	By Carriage		xxxx			xxxx			
		8	By Tips		xxxx						
		9	By Taxi hire		xxxx				xxxx		
		10	By Ramu		xxxx					xxxx	
		31	By Balance c/d		xxxx						
XXXX					XXXX	XXXX	XXXX	XXXX	XXXX	XXXX	
Xxxx		Feb	Op. balance								

c) Journal

Like the cash book, the journal is one of the books of original entry and each transaction is recorded therein on the principle of ***"Double Entry System"***. This book is used for recording all non-cash transactions such as transfer between accounts, non-cash contributions, debit notes from funding agencies, exchange rate adjustments, accruals. Hence Journal Book is generally used for:

(a) Opening Entries

(b) Closing Entries

(c) Rectification/Correction Entries

(d) Transfer Entries

(e) Adjustment Entries

(f) Non-cash Contributions

(g) Debit Notes received from funding agencies

(h) Exchange Rate Adjustments

(i) Accrual/pre-paid Expenses; and

(j) Transactions of a Special Nature.

The opening entries are passed to carry over the balances from the previous year accounts to the current year, the closing entries are passed to close the accounts at the end of the year, rectification/correction entries are passed to rectify mistakes committed in the books of account detected at a later stage; transfer entries are passed to transfer amounts from one account head to another; adjustment entries are passed to effect proper classification and adjustment of different heads of account.

It should be remembered that every transaction is in effect a journal entry and can be entered in the journal book. However, in order to economize labour, other books like Cash/Bank book and Petty cash book are almost invariably used in place of the Journal.

The rule of journal entry is that "for every debit there is an equal and corresponding credit", thus each entry shall consist of at least one debit and one credit and the sum of the debit amounts must always be equal to the sum of the credit amounts. The title of the appropriate account (Account head) will be entered against each item. Further, the amount in the debit column must equal that of the credit column.

At the foot of each entry, a note called the ***"narration"*** is appended, showing the nature and necessity of the transaction being recorded and the authority for passing the entry.

The entries from the "Journal book" are posted into General ledger under the relevant "Account heads" and the folio numbers of the ledger where the posting are made are indicated against "Account Heads" in the column "L.F." (ledger folio number) of the Journal book.

Journal book

Date	Voucher Number	Particulars	Account Code Number	Ledger Folio	Debit amount Rs.	Credit Amount Rs.

2.9.2 Final books of account

Final books of account consist of General Ledger and sub-ledgers.

a) General Ledger:

The General ledger is one of the most important books of account and is the destination of all accounting entries made in the primary / original books of account. The General ledger is written / posted from entries made in the primary books of account. Entries are initially made in the books of original entry i.e. Cash/Bank Book, Petty Cash Book and Journal, and subsequently these entries are entered under the respective heads of account in the General Ledger to complete the system of double entry.

The General Ledger is essentially a collection of the three different types of accounts that we have studied earlier, namely:

- ***Real accounts***
- ***Personal accounts***
- ***Nominal accounts***

All the accounts are listed in the "chart of accounts" of the organization, and find a place in the General ledger. The Accounts are indexed alphabetically in the General ledger in order to facilitate easy access for recording entries and for locating a particular account head.

A Performa of General ledger is given below:

Name of Account Head (Account Title): XYZ Folio No: 10

Account Code Number: A001

Date	Particulars	Posting Reference (Folio No.)	Debit Amount Rs.	Credit Amount Rs.	Balance Amount Dr/Cr Rs.
Total					

The General ledger provides three columns for the monetary amounts. The debit entries are placed in the first column of the monetary amount from the left and credit entries in the second column. The third column is reserved for working out the running debit/credit balances. If the debit entries in an account total more than the credit entries, the account is said to have a debit balance, if the credit entries total more than the debit entries, the account is said to have a credit balance.

In the normal course, a debit balance would be the resultant figure in accounts representing assets, receivables, expenditure, prepaid expenses, advance payment etc. Similarly, a credit balance would be the resultant figure in accounts representing capital funds, liabilities, income, outstanding expenses, income received in advance etc. At the end of the accounting period, every account should be balanced and listed under "Debit" and "Credit" columns.

The General Ledger assigns receipt (income) and payment (expenditure) in approved categories as per the chart of accounts and maintains a complete record of all account balances.

b) Sub Ledgers:

While writing the Main cash book as discussed earlier, there was the felt need of maintaining a Petty cash book. Similarly it was realized that under certain accounts the ledger was running into several pages and the General ledger was becoming fatter and fatter and it was very difficult to handle all the accounts in one book, General ledger. Therefore it is wiser to take away certain accounts involving huge number of transactions and create separate books for these accounts where the details would be recorded. However the periodic sum total of these transactions would find place in the General ledger so that the General ledger balances would also tally. At the same time one can record the transactions more systematically without making the General ledger cumbersome. A detailed analysis of the mechanism of sub-ledger is given below.

Sub-ledgers are subsidiary ledgers maintained for specific accounts appearing in the General ledger. These accounts are those which normally have more than one sub-account. Thus sub-ledgers are maintained for reducing the congestion of the General ledger due to excessive sub-accounts under any main account. For example sub-ledgers are maintained for Debtors and Creditors, since there is normally more than one debtor or creditor account. Similarly, sub ledgers may be maintained for programme activity head of account to record separately different expenses on each Programme, also sub-ledgers may be maintained for loans and advances accounts, deposit accounts etc.

The entries in the sub-ledger are made from the primary (original) books of account and subsequently the balances in the separate sub-ledger accounts are entered into the main account head in the General ledger at periodic intervals. The totals of all the sub-ledger accounts, in a sub-ledger, should tally with the amount shown in the main account head in the General ledger.

2.9.3 Subsidiary Records/Registers

The NPO should maintain subsidiary records/registers for control purposes such as pay-roll records, stock records and inventory of assets. An illustrative list of various such records is given below:

(a) Payroll Records

- Attendance Register
- Salary and Wages Register
- Muster Roll Form
- Leave records

(b) Stock Records

- Agriculture Inputs Stock Register
- Agriculture Produce-Stock Register
- General Stores Stock Register
- Stationery Stock Register

(c) Inventory of Assets

- Fixed Assets Register
- Investments Register

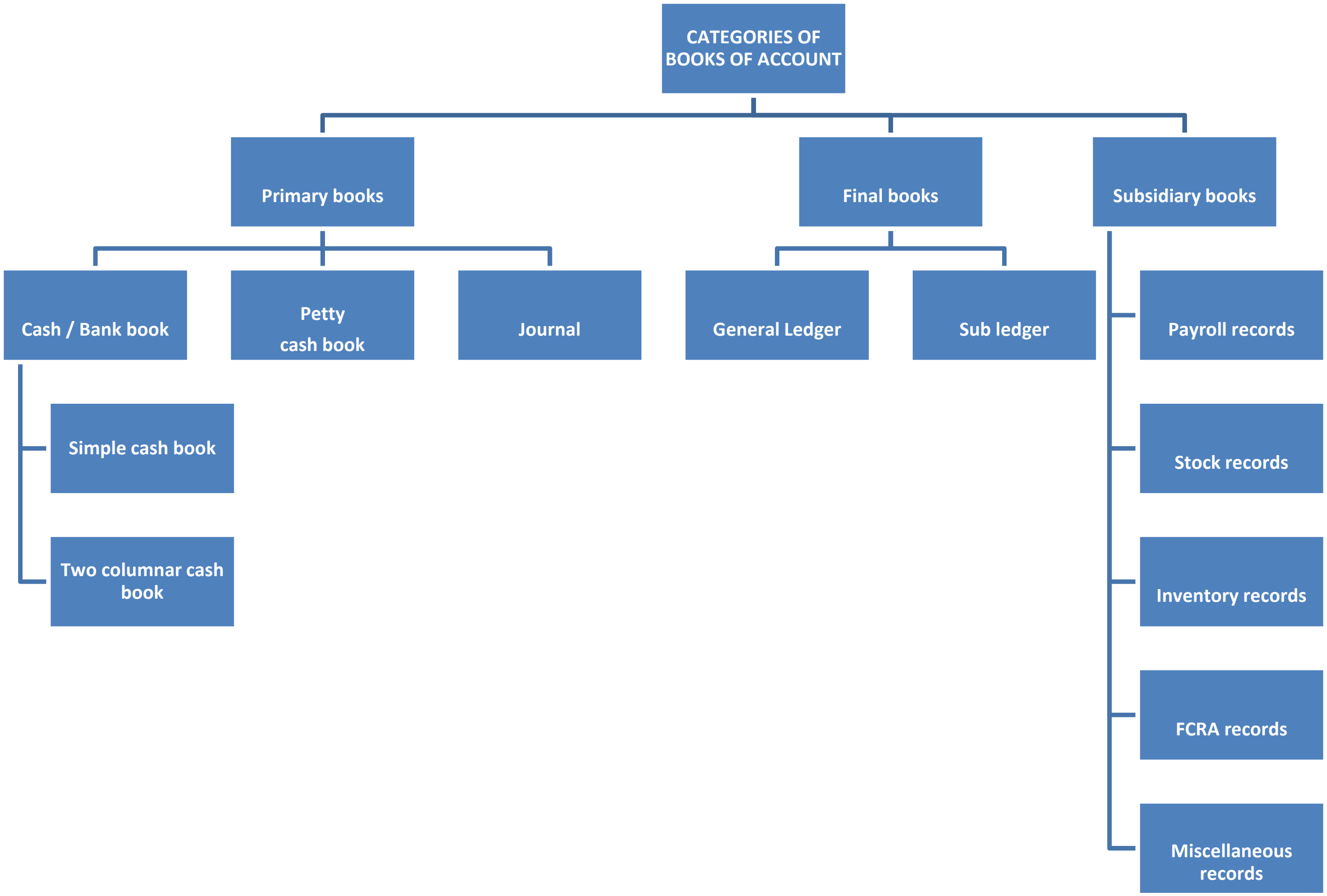
(d) Records as per Foreign Contribution (Regulation) Act, 2010

- Foreign Contribution (Articles) Register
- Foreign Contribution (Securities) Register

(e) Miscellaneous Records/Registers

- Donations in kind
- Dispatch Register
- Inward Mail Register
- Telephone Calls Register
- Vehicle Log Book
- Register of Members

Refer the following diagram for the categories of books of account:



2.10 FIELD LEVEL / PROJECT LEVEL RECORDS

As mentioned earlier, NPOs range from small community groups to large international organizations. But all NPOs irrespective of size should have sound financial management systems across all levels, ranging from the country office to field level operations. The systems and processes at each level could be tailored to the needs of individual organizations

If the organization has a big set up, it could mean that the headquarters is situated at one place, with various regional / projects offices spread over a wide geographical area. In such a case the project offices (also referred to as 'field offices'), require maintaining proper books and records to account for various financial transactions carried on by them.

We have already discussed in detail that various books and records that are to be maintained by an organization. We will now discuss some of the documents required to be prepared and maintained at field offices. The records thus maintained are called as the field level records or project level records. These may differ from organization to organization, depending on the size and nature of accounting systems adopted. For instance, in a centralized accounting set-up, all accounting records including vouchers would need to be sent to the Head-office to facilitate accounting. On the other hand, in a decentralized setup, the accounting would happen at the field level and financial statements would be sent to the head-office for consolidation purposes. In any case some basic accounting records would need to be maintained at field level, some of which are discussed below:

1. Cash Book

As we have studied earlier, a cash book is maintained for recording cash and bank transactions. The field office can also maintain the kind of cash book (single, two or three column cash book) suited to its requirement. The transactions are recorded in this book in chronological order in accordance with the date of occurrence. The cash book reflects the actual movement of funds through cash and bank. The Balance of cash on hand and cash in bank can thus be arrived at, on a daily basis by the field office.

Periodically all the branch / field offices may be required to send their cash book extracts to the headquarters for the purpose of verification / consolidation.

2. Vouchers

We have already discussed in detail the meaning and other relevant information regarding vouchers.

A voucher is a document which is prepared whenever an expense is incurred. An expense can be incurred either in regard to some project undertaken by the organization or some other general purpose. A voucher carries important information such as why an expense was incurred, who made the payment and the account head to which it should be debited. There should be adequate authorization on the vouchers for the transactions made at the field level.

The vouchers maintained at the field offices should also be serially numbered and these numbers should also be mentioned on the cash book for the purpose of cross – reference. All the pre-requisites for a voucher mentioned in the earlier section should also be complied with at the field offices.

3. Funding Agency ledgers

This ledger is required to be maintained by organizations which receive funds from more than one funding agency. This ledger is maintained to record the amount of funds received from each funding agency, amount utilized against various projects/programmes and the balance of funds for each funding agency (for each project).

4. Record of own / other means of contribution.

It is very important for an NPO, that the system with regard to the assessment and documentation of own or other means of contribution is well in place.

Although we shall deal with the concept of own means of contribution in detail in a subsequent course, it is important to have an idea as to what exactly is “own means of contribution”

“Own means” generally refers to the component of resources and funds mobilized or contributed by the implementing or coordinating partner of a development project. In simple words, own means is the commitment or contribution of various stakeholders to the project other than the funding agencies.

A donor/ funding agency normally does not finance 100% of the project and it expects that some of the following stakeholders should contribute the remaining amount of funds or resources:

- Partner organization / Project Implementing Organization
- Community based organization
- Beneficiaries
- Other local organization
- Government Agencies
- Co-funding Organizations

Own means could be in cash as well as in kind, and it can come from various sources as mentioned above. In the case of non-cash contribution it becomes important that proper assessment of the value of the contribution is made and also ensured that the contribution is relevant and as per the project plans.

Particular care should be taken in making out vouchers in support of expenditure representing the project-partner's own non-cash contribution to ensure that they explain adequately and in sufficient detail the nature of such expenditure.

To understand the concept better let us take an example where, in a project, 'Shramdan' (Donation of Labour) is given by a group of farmers / beneficiaries / labourers. It can be assessed as "Own Means" of financing on the basis of the following criteria:

- There should be a provision in the approved "Cost Plan"
- Category of farmers / labourers worked i.e. skilled, semi-skilled and unskilled.
- Actual number of days / hours worked
- Nature of work done
- Rate per day / hour keeping in view of the provisions of Minimum Wages Act prevalent in the States / area of work
- Piece rate / volumes of work done and payments normally made for such services rendered
- Estimated and actual measurement of work done before and after the completion of the assigned job; and
- Certificate from each farmer / labourer regarding "Shramdan" given for a project.

5. Record of the Beneficial Communities

We know that every NPO works for the benefit and upliftment of the communities and society it serves. We also know that it is essential to record each and every transaction; cash or non-cash in proper books. These include some of the programmatic details, and details of beneficiaries which as we saw earlier, can be used a "circumstantial evidence" to support some payments.

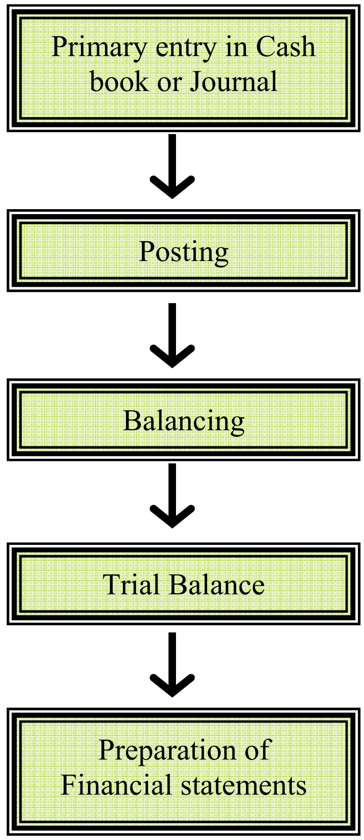
The various documents prepared by the organization may contain the following information:

- Consultation with the communities on programme planning, implementation and evaluation.
- Involvement of communities in the programme planning and implementation
- Contributions made by the communities to the organization / programme
- Minutes of the meeting with the community members
- Registers for various training given to the beneficiaries
- Registers for distributions made to the beneficiaries

For easy understandability, let us take an example where the organization conducts a campaign for the distribution of samples of medicines to the community members. The organization can keep records of the various details like the name of the village, number of infants, old, men, women children etc. They can also keep record of other particulars like the actual number of people who received the samples and the number of persons benefited by the distribution of samples. Such records and details can help the organization to assess how successful the campaign was and also to take into consideration other steps and methods the organization can follow to make the campaign more effective whenever it is conducted next. Apart from all this, such records also help evidence and validate the expenses incurred for conducting the said activities.

2.11 ACCOUNTING PROCESS:

We have already talked about maintenance of some of the basic books of account. Let us now take a step forward and understand the accounting process, which involves sequential steps right from journalizing the transaction to preparation of the financial statements. Following steps are involved in the process of accounting:



While we have already understood some of the steps, under the following section we will try to understand these in the context of the accounting process, up to stage of preparation of Trial Balance. Preparation of financial statements is covered in the following unit.

2.11.1 Journalizing:

Journalizing refers to the process of recording the business transaction in the Journal / cash book that is referred to as the book of original entry or the book of primary entry. We already saw that all the financial transactions are entered in the primary books (cash book / journal) in the chronological order, as and when the transactions take place. Although we use the parlance "journalizing" the terminology in effect includes transactions of both the cash book and the journal, because the cash/bank book entries are nothing but journal entries.

2.11.2. Format of Journal:

The Journal may look as stated below

Journal

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
A	b	c	d	E
	Account (To be Debited) - Dr. To, Account (To be Credited) Narration – (“Being…………………”)			

The Journal consists of five columns which are explained as below:

a) Date Column:

It refers to the date on which a particular transaction has taken place. The transactions should be recorded immediately on the day when it occurs. This means that the date of occurrence of the transaction and the date of recording the transaction should be the same.

b) Particulars Column:

It refers to titles of the account to be debited or credited. The title of the account to be debited starts from the extreme left and the abbreviation "Dr." is written to denote the account debited at the extreme right of the same column on the same line. The title of the account to be credited is entered on the next line preceded by the words "To" leaving some space from the extreme left. In the same column on the next line, brief description of the transaction is written which is referred to as "Narration". The narration conventionally starts with the wording “Being ".

c) L.F. i.e., the ledger folio column:

This column refers to the page number of the ledger to which the entry has been posted.

d) Debit (Rs.)

This denotes the amount debited for the respective account head.

e) Credit (Rs.)

This denotes the amount credited for the respective account head.

It is not necessary that there will be only one account to be debited or only one account to be credited. The table given above is only a sample. Practically there may be more than one debits and credits. In fact, the principles of accounting permits passing of entries with multiple debits and credits normally referred to as compound entry.

2.11.3. Steps in Journalizing:

The various steps to be followed for journalizing the business transactions are as follows:

- Ascertain what accounts are involved in a transaction?
- Ascertain what is the nature of the accounts involved?
- Ascertain which rule of debit and credit is applicable for each of the accounts involved?
- Ascertain which account is to be debited and which is to be debited?
- Record the date of transactions in the 'Date column'
- Write the name of the account to be debited very close to the left hand side (i.e., the line demarcating the 'Date column' and the 'Particulars column') along with the abbreviation 'Dr' on the same line against the name of the account in the 'Particulars column' and the amount to be debited in the 'Debit amount column' against the name of the account.
- Write the name of the account to be credited in the next line preceded by the word 'To' at a few spaces towards right in the 'Particulars column' and the amount to be credited in the 'Credit amount column' against the name of the account.
- Write 'Narration' (i.e., a brief description of the transaction) within brackets in the next line in the 'Particulars column'
- Draw a line across the entire 'Particulars column' to separate one journal entry from the other.

2.11.4. Advantages of Journal:

The main advantages of Journal are as follows:

a) Recording of both the aspects of the transaction:

Both the aspects (i.e. debit and credit of a transaction) are recorded in the Journal. Since the amounts recorded in both debit amount column and credit amount column must be equal, the possibility of committing error is reduced and the detection of errors, if any, committed becomes easy.

b) Explanation of transaction:

Each journal entry in the journal carries narration which gives a brief explanation of the transaction. This plays an important role for future reference of the transactions.

c) Chronological record:

Journal is a chronological record as it records the transaction in the order in which they occur. Again this also helps for future reference of the transactions.

2.11.5.Posting:

While journal records the transactions in the chronological order; ledger is the book where the transactions of the similar nature are pooled together under one ledger account. Ledger or General ledger as it is referred to in practical circumstances, maintains all types of accounts i.e. Personal, Real and Nominal. All the transactions recorded in the Journal in a chronological order are posted in the Ledger, account wise.

Thus, a ledger account can be defined as "***the record of all the transactions pertaining to a person, asset, liability, income or expenditure which have taken place during a specified period and shows the net effect of all these transactions finally***".

The process of recording the transactions from the journal to the respective accounts in ledger is referred to as "ledger posting".

The Ledger Accounts may be maintained in two ways:

Type I: Both debit and credit separately

Dr.							Cr.
Date	Particulars	Folio	Rs.	Date	Particulars	Folio	As.

Type II Both debit and credit side by side and balancing with each entry

Date	Particulars	Folio	Debit (Rs.)	Credit (Rs.)	Balance (Rs.)

Difference between ledger and journal

Now that we know the meaning of journal and ledger, let us understand the distinctions between both of them.

Basis of distinction	Journal	Ledger
Nature of Book	It is the book of Origin or prime entry.	It is a book of final or secondary entry.
Basis for preparation	It is prepared on the basis of source documents of transactions.	It is prepared on the basis of the Journal.
Stage of recording	Recording in the journal is the first stage.	Recording in the ledger is the second stage.
Object	It is prepared to record all transactions in chronological order.	It is prepared to know the net effect of the various transactions affecting a particular account.
Format	In Journal here are five columns: 1.Date 2.Particulars 3. Ledger Folio. 4.Debit amount 5.Credit amount	There are identical four columns on the debit side and credit side. 1. Date 2. Particulars. 3.Folio 4.Amount
Balancing	Journal is not balanced	All ledger accounts (except nominal account) are balanced in the ledger.
Narration	Narration is written for each entry	No narration is given.
Process of recording entries	The process of recording in a journal is called Journalizing.	The process of recording in the ledger is called 'Posting'.
Basis for preparation of final accounts	Journal directly does not serve as a basis for the preparation of final accounts.	Ledger serves as the basis for the preparation of final accounts.

2.11.6. Balancing:

To ascertain the net effect of all the transactions recorded in the ledger account, the account is required to be "balanced". Balancing of ledger account involves the following steps.

a) Take the total of both sides of the ledger account.

b) Calculate the difference between totals of both the sides.

c) If the total of debit side is more than that of the credit side then make an entry on the credit side for balancing the ledger account by writing "By Balance c/f[4]" in the particulars and the differential amount in the credit side amount column. While if the total of credit side is more than that of the debit side then make an entry on the debit side for balancing the ledger account by writing "To Balance c/f". If the balance appears on the credit side, the account will be considered to have debit balance (since the total amount on the debit side is more) and if the balance appears on the debit side, the account will be considered to have credit balance (since the total amount of the credit side is more).

d) After balance is placed on the appropriate side, ensure that totals of both the sides match with each other.

Illustration

Machinery Account

Dr.							**Cr.**
Date	**Particulars**	**Folio**	**Rs.**	**Date**	**Particulars**	**Folio**	**Rs.**
01.04.01	Balance b/f		25,000	31.03.02	Depreciation		10,000
10.04.01	Bank		70,000	31.03.02	Balance c/fd		85,000
					(Balancing figure)		
	TOTAL		**95,000**				**95,000**

(We may also provide one specimen of income & expenditure account)?

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[4] Carried forward for the next period of accounting

2.11.7.Trial Balance

If the journal entries are error-free posted properly to the general ledger, the total of all of the debit balances should be equal to the credit balances. If the debits do not equal credits, then an error has occurred somewhere in the process. The total of the accounts on the debit and credit side is referred to as ***trial balance***.

Therefore, trial balance is the summary of all the balances in all the accounts listed in the general ledger and cash / bank book of an organization at any given date. Tallying of the trial balance is the evidence of the fact that all the transactions have properly been posted in the general ledger. As such, tallying of trial balance generally ensures the arithmetical accuracy of the process of ledger posting.

For the preparation of trial balance, all the accounts in the general ledger need to be balanced to ascertain the closing balance. Similarly, cash book / bank book are also required to be balanced to ascertain the closing balance. Accounts having the debit balance are shown on the debit side of the trail balance whereas the accounts having the credit balance are shown on the credit side. Generally, accounts of the assets will have debit balance and hence will be shown on debit side and accounts of all liabilities will have credit balance and hence will be shown on credit side. Also the accounts of all the expenses will have debit balance and hence will be shown on debit side and accounts of all the incomes will have credit balance and hence will be shown on credit side.

Format of Trial Balance

Trial Balance as at 31st March ……..

PARTICULARS	DEBIT(RS)	CREDIT(RS)
Capital Account		
Fund A/c		**xxxx**
Current Liabilities		
Audit fee payable		**xxxx**
Fixed Assets		
Furniture Fittings	**xxxx**	
Machinery	**xxxx**	
Tape Recorder	**xxxx**	
Current Assets		

PARTICULARS	DEBIT(RS)	CREDIT(RS)
Cash in hand	xxxx	
Cash at bank	xxxx	
Prepaid rent	xxxx	
Staff Loan	xxxx	
Direct incomes		
Grants received		xxxx
Donation received		xxxx
Domestic Donation		xxxx
Indirect Incomes		
Interest Received		xxxx
Direct Expenses		
Programme expenses	xxxx	
Donation/supports	xxxx	
Indirect Expenses		
Cell phone Expenses	xxxx	
Conveyance	xxxx	
Courier charges	xxxx	
Electricity Charges	xxxx	
Internet Scanning Expenses	xxxx	
Petrol Expenses	xxxx	
Printing	xxxx	
Rent	xxxx	
Repairs Maintenance	xxxx	
Salary	xxxx	
Depreciation –Schedule	xxxx	
Staff Welfare	xxxx	
Stationery	xxxx	
Stipend	xxxx	
Telephone charges	xxxx	
Training	xxxx	
Travel Expenses	xxxx	
Audit Fee	xxxx	
TOTAL	XXXX	XXXX

The debit and credit side of the trail balance should be equal. However, this does not guarantee that there are no errors. For example, trial balance would not catch the following types of errors:

- Transactions that were not recorded in the journal
- Transactions recorded in the wrong accounts
- Transactions for which debit and credit were transposed
- Neglecting to post a general entry to the ledger

If the trail balance is not in balance, then an error has been made somewhere in the accounting process. The following are the common errors that would result in an unbalanced trail balance:

- Summation error for the debits and credits of the trial balance
- Errors in transferring the ledger account balances to the trial balance columns
- Error in calculating the ledger account balance
- Error in posting a journal entry into the ledger account
- Error in making a journal entry
- Inter change of figures, say 1931 written as 1391. Such difference will always be devisable by 9.

The more often that the trail balance is calculated during the accounting cycle, the easier it is to isolate any errors; more frequent trail balance calculations narrow the time frame in which an error might have occurred, resulting in fewer transactions through which to search.

2.12. RECTIFICATION OF ERRORS:

The beauty of using double-entry accounting is that the books are designed to be "in-balance". If they are not in balance then there is an error. The trail balance is prepared to check the arithmetical accuracy of accounts. If the trial balance does not tally, it implies that there are arithmetical errors in the accounts which require location, detection and rectification thereof. These errors could be unintentional omission or commission of amount and accounts in the process of recording the transaction.

These errors do not necessarily affect the trial balance. Therefore at times even if the trial balance tallies, this does not necessarily mean that the books of account are free from errors. Hence it can be concluded that there are two types of errors:

- One that affects the trial balance and

- Other which though does not affect trial balance but affects the determination of profit, loss, asset and liabilities of the organization

The errors that affect trial balance are easier to be recognized because on account of these errors, the trial balance will not tally. These errors include:

- Making a debit without corresponding credit
- Making a debit and a credit for differing amounts

2.12.1.Stages of errors:

Errors may happen at any of the following stages of accounting process:

A. At recording stage:
1. Errors of principle
2. errors of omission
3. errors of commission

B. At posting stage:
1. Errors of omission
    a) complete omission
    b) partial omission
2. Errors of commission:
    a) posting to wrong account
    b) posting on the wrong side
    c) posting of wrong amount

C. Balancing stage
1. wrong totaling
2. wrong balancing

D. Preparation of trial balance:
1. Error of omission
2. Error of commission:
    a) Taking wrong amount
    b) Taking wrong account
    c) Taking to the wrong side of ledger

2.12.2.Classification of errors:

Errors can be classified into the following four categories on the basis of the nature of errors and explained hereunder:

a) Errors of commission:

These errors by definition are of clerical nature. These errors may be committed at the time of recording and / or posting. At the time of recording, the wrong amount may be recorded in journal which will be carried throughout. Such errors will not affect the agreement of the trial balance. These errors may also be committed at the time of posting, by way of posting wrong amount, to the wrong side of an account or in the wrong account. The errors resulting in posting to wrong account will not affect agreement of trial balance, whereas, other errors of posting will resulting disagreement of trial balance. For example, an amount of Rs.1,000 received from customer (debtor) is correctly recorded on the debit side of the cash book but while posting, the customer's account is credited with Rs.10,000. This is an error, which is committed at the time of posting, by posting wrong amount to the account. This will result in disagreement of trial balance, since, the credit total of the trial balance will be short by Rs.9,000.

b) Errors of Omission:

The errors of omission may be committed at the time of recording the transaction in the books of original entry or while posting to the ledger. An omission may be complete or partial. Such errors are known as errors of omission. For example, machinery purchased for Rs.50,000 by issuing a cheque is recorded first in the credit side of cash book, in the bank column. Suppose it is not posted to the debit of machinery account, it is an error of partial omission. The trial balance will not tally. Suppose the transaction is not entered in the cash book and hence ignored completely, this is a case of complete omission. It means as if the transaction has not taken place at all. It will not affect the trial balance and hence the trial balance will tally but Bank/cash will remain unreconciled. This is true only in case of complete omission.

c) Error of Principle:

Accounting entries are recorded as per the generally accepted accounting principles. If any of these principles are violated or ignored, errors resulting from such violations are known as errors of principle. As an illustration, periodicity principle required maintaining proper distinction between capital and revenue items. An error of principle may occur due to incorrect classification of expenditure or receipts between capital and revenue. This is very important because it will have an impact on financial statements. It may lead to under / over stating of income or assets or liabilities, etc. for example, amount is debited to maintenance and repairs account, it is treated as a revenue expense. This is an

error of principle. Since instead of asset account, i.e. building, the maintenance and repairs account (expense) is debited, the trial balance will still tally but would not be correct as per generally accepted accounting principles.
Such errors are not disclosed by the trial balance. This will result in understanding of income due to extra charge under maintenance and repairs account and understanding the value of building in the balance sheet.

d) Compensating Errors:

When two or more errors are committed in such a way that the net effect of these errors on the debits and credits of accounts is nil, such errors are called compensating errors. They do not effect the tallying of the trail balance. For example, in a credit sale transaction, the sales account is credited in excess by say, Rs.5,000 and similarly the suppliers account in case of a credit purchase is understated by Rs.5,000, this is a case of two errors compensating for each others effect. It is to be noted that extra credit to the creditor's account, both being credit balance. Since, one plus is set off by the other minus, the net effect of these two errors being of compensating nature and do not affect the agreement of trial balance. These type of errors detected only on reconciliation of supplier account or such reconciliation with stocks etc.

2.12.3.Rectifying the errors:

a) Errors which affect the agreement of trial balance:

These errors are due to the mistake having being committed on the one side of the account. They may happen at any of the stages of the accounting like recording, posting, balancing, etc. such errors can be rectified by giving and explanatory note or by passing a journal entry with the help of a special account called suspense account. Examples of this group of errors are: errors of partial omission; error of casting (totaling); error of carrying forward; errors of balancing; error of posting to the correct account but with wrong amount; error of posting to the correct account but on the wrong side with the wrong amount and omitting to show an account in the trial balance.

An error in the original entry if discovered before posting to the ledger, may be corrected by crossing out the wrong amount and putting an initial at the place.

An error in an amount posted to the correct ledger account may also be corrected in a similar way or by making an additional posting for the difference in amount and giving an explanatory note in the particulars column provided that trial balance is not prepared. But errors should never be corrected by erasing. Crossing / erasures reduce the authenticity of accounting records and give an impression that something is being concealed or manipulated.

b) Errors which do not affect the trial balance:

Errors which do not affect the trial balance are committed in two or more accounts. They can be rectified by passing a journal entry giving the correct accounts. These correcting entries can be recorded in the journal proper. Examples of these errors are omission of the posting of accounts in the ledger. Examples of these errors are:

- Complete omission at the recording stages of the transaction in the books of original entry
- Recording of the transaction with the wrong amount in the books of original entries
- Complete omission of posting of a transaction
- Errors of principle
- Posting of correct amount on the correct side but to a wrong account

2.13. CHART OF ACCOUNTS:

Chart of account is a list of all accounts tracked by a single accounting system, which is designed to capture financial information to make good financial decisions. The organizations have the flexibility to tailor its chart of account to best suit its needs, including adding accounts as needed.

In case of NPOs where there are a number of projects and multiple funding agencies, it becomes necessary that the chart of account should be designed in a manner that can support reporting to the funding agencies directly from books of account.

This means that the chart of account needs to be designed to support accounting for and reporting for multiple projects and to multiple funding agencies.

Once the chart of accounts is set up, it also provides framework for budgeting, recording and reporting of transactions[5]. Further it also facilitates comparison of the accounts from year to year basis.

[5] Details pertaining to budgeting and planning shall be covered in a separate module.

2.14. COMPUTERIZATION OF ACCOUNTS

With the development of technology, computerization of financial accounts has become feasible, as also economical, for all categories of organizations. There are a number of options available to NPOs. For smaller organizations, there are a number of user-friendly made packages available in the market. One can just buy the package, install it, make a chart of account in accordance with the requirements of the organization and start using it. For the larger organizations with relatively complex requirements, there are a number of service providers who develop the accounting packages to meet the specific needs of such organizations.

However, although technology in India has grown extensively and usage of computers had been reachable to large amount of population, computerization of accounts at the field level office may be difficult due to the following reasons:

a) remoteness of the areas of implementation
b) lack of sufficient infrastructural support including continuous supply of electricity in few cases
c) unavailability of the staff of right caliber at such remote places
d) difficulty in sustaining the staff beyond the project period
e) lack of awareness among the staff at the field level
f) high turnover of staff at such places

However, computerization of financial accounting has been embraced by many NPOs in India, though not always for the purpose of accounting at the field level.

2.14.1 Pre-requisites for computerization

For the purpose of computerization of accounts, the following points are required to be considered:

a) Level of computerization – head office accounts / field office accounts
b) Sources of funding
c) Approvals from funding agencies
d) Infrastructure support required for the purpose of computerization

e) Decision on usage of customized / ready made software or development of customized software to suit the needs of the organization
f) Training to be provided to the staff / recruitment of the staff of required caliber.
g) Documentation of the guidelines to be followed for implementation of computerized accounting package.
h) Timeframes for back up of the data – both hard copies and soft copies

2.14.2 Advantages of computerization

The following are some of the advantages of computerization of financial accounts:

a) It increases level of accuracy to a very large extent
b) It saves time because the posting to the ledger is done automatically. Further, preparation of the financial statement can also be automated in the accounting package itself
c) By restricting the usage of the package the risk of misusing the accounting information is reduced
d) It also supports automation of generation of vouchers which again leads to saving of time
e) Also the reliability of the computerized vouchers is more than that of manual vouchers because the error of entering the transaction in the books of account and corresponding posting in the ledgers is eliminated to a large extent
f) Rectification of errors becomes comparatively easier

2.14.3 Checks and balances for computerized accounting:

Although computerized accounts are very beneficial for NPOs, it is important to have checks and balances in place to ensure correctness, accuracy and completeness of accounts. Following are some examples of checks and balances that would need to be put in place while maintaining computerized accounting:

- Security level with the computerized accounting package should be defined. These could be password for accessing the data, entering the data, modifying the data. The security levels could also be in terms of entering the cash / bank transactions, entering the stock data. That is to limited access to the accounting package can be defined in order to the accounting data secured.

- It should be ensured that the person making the payments should not be allowed to enter the transactions in the accounting package.
- Back dated entries should not be allowed
- Modification of the entries should be only by way of passing rectification entry. That is to say the original entry should not be altered at all. For rectifying the entries, proper approval should be obtained.
- Regular back up of the data should be taken. The back ups can be in two forms:
  - ⇒ Soft copy: It means taking back up on any storage device, preferably on the compatible disc (CD). The frequency for taking soft copy of the data would depend from organization to organization based on the quantum of transactions. It could be either every 15 days or monthly or quarterly. It is preferable that the soft copy of data is taken on duplicate. One should be kept in the office while the other should be kept outside the office.
  - ⇒ Hard copy: This refers to taking print out of the data on regular basis. Again the frequency of taking print outs would vary from organization to organization depending upon the quantum of transactions.
- The voucher numbers as generated by the accounting package should be mentioned on the vouchers so that the payment vouchers can be easily located in the accounting package.

2.15 SUMMARY

We shall now summarize the learning of this unit as follows:

1) In this unit we have tried to understand the existing accounting practices in NPOs, the diversity in the NPO funding and its implications on the accounting systems. All these have been listed down as follows for the purpose of quick recalling all the points covered under this section.

Existing accounting practices in NPOs:

a) Existence of a large number of unregistered NPOs;
b) Lack of awareness on accounting principles;
c) Diversity in size and activities of NPOs;
d) Basis of accounting.

Diversity in NPO funding:

a) Sources of funds – local or foreign contribution;
b) Currency – local or foreign currency;
c) Levels of implementation – direct or through nodal agency;
d) Budget line items – implication on the accounting structure;
e) Allocation of common costs;
f) Statutory requirements.

2) We have then tried to understand the different basis of accounting in detail. The following are the different basis of accounting:

- Cash basis of accounting
- Accrual basis of accounting
- Mixed basis of accounting

We have also tried to understand the distinction between the accrual and cash basis of accounting. We have also tried to understand the treatment for various items revenue and expenses under both the system of accounting and the legal position for the method to be adopted as basis of accounting.

3) After understanding the basis of accounting we have tried to understand the system of financial accounting followed by the accounting treatment of various financial transactions.

4) For the purpose of understanding the process of accounting we have tired to understand various categories of account such as:

- Real accounts;
- Personal accounts;
- Nominal accounts

5) For the purpose of financial accounting the expenditures have been classified into:

- Capital expenditure;
- Revenue expenditure;
- Deferred revenue expenditure.

6) All the above types of accounts / transactions are required to be supported by a voucher. Therefore, we have also tried to understand various types, contents, objective and the requisites of the vouchers.

7) Later, we also tried to understand the various categories of books of account required to be maintained from the records which are:

- Primary books of account
- Petty cash book
- Journal

8) We also understood that due to varied nature of NPOs, there are various records required to be maintained at the field level also.

9) Later we understood the complete process of accounting

10) We then tried to understand the various types of possible errors and the ways and means of identifying and rectifying them.

11) We concluded this unit by discussing about the computerizing the complete process of accounting, its advantages and various checks and balances required for the same.

2.16.SELF ASSESSMENT EXCERSICE

1) A nodal agency is normally:

a) Implementing NPO	**b)** Intermediary NPO
c) Both	**d)** None

2) CBOs stands for

a) Common based organizations	**b)** Cash based organizations
c) Community based organizations	**d)** None

3) Which one of the following is not one of the basis of accounting:

a) Cash basis	**b)** Accrual basis
c) Bank basis	**d)** Mixed basis

4) In cash basis of accounting, the transactions are recorded when

a) Cash receipts takes place	**b)** cash payments takes place
c) Both	**d)** None

5) Accrual basis of accounting is also referred to as:

a) Merchandise basis of accounting	**b)** Miracle basis of accounting
c) cash basis of accounting	**d)** Mercantile basis of accounting

6) Under which of the following statues, cash or accrual system can be adopted on regular basis?

a) Income Tax Act	**b)** Bombay Public Trust Act
c) Both	**d)** None

7) Which system of accounting facilitates determination of true profit or loss?

a) Single entry	**b)** Double entry
c) Both	**d)** None

8) One of the following is not applicable for the debit side of the transaction:

a) Increases assets	**b)** Decreases liabilities
c) Increases revenue	**d)** Increases expenses

9) Which of the following is not a real account:

a) Bank account	**b)** Machinery account
c) Land account	**d)** Vehicles account

10) Which of the following is not a personal account:

a) Sanjay's account	**b)** Ram's account
c) Sita's account	**d)** Computer account

11) Which of the following is a nominal account:

a) Shyam stationers account	**b)** Printing and stationery account
c) Furniture account	**d)** Fluorescent printing press account

12) Capital expenditure:

a) Procurement of new asset	**b)** Upgrading useful life of an asset
c) Both	**d)** None

13) The objective of preparing a voucher is to:

a) have a proper evidence / supporting of financial transactions
b) To establish safe administrative procedures
c) To enable proper recording of transactions
d) All

14) Revenue stamps should be affixed on all cash payment vouchers in excess of:

a) Rs.5,000	**b)** Rs.10,000
c) Rs.15,000	**d)** Rs.20,000

15) One of the following is not a primary books of account:

a) Cash / Bank book	**b)** Petty cash book
c) Journal	**d)** Profit and loss account

16) The debit side of the cash book is always …………………… the credit side.

a) Equal	**b)** Lower
c) Higher	**d)** None

17) Cash book should be closed

a) Daily	**b)** Weekly
c) Monthly	**d)** Annually

18) Double column cash book has columns for

a) Cash	**b)** Bank
c) Both	**d)** None

19) General ledger is prepared from entries made in

a) Cash / Bank book	**b)** Petty cash book
c) Journal	**d)** All

20) The process of recording the transactions from the journal to the respective accounts in ledger is referred to as.

a) Journalizing	**b)** Accounting
c) Posting	**d)** Balancing

21) Which of the following error will not effect the tallying of trial balance:

a) Error of commission	**b)** Error of omission
c) Compensating errors	**d)** All

22) State whether following statements are true or false. In case of false statements, write the correct statement:

a) The different budget line items as approved by different funding agencies, does not have any implication on the accounting system.
b) Standard and transparent policies for allocating the common costs to different projects is required by the NPOs who receives grants from different funding agencies and implementing different projects.
c) Accrual basis recognizes those economic events that affect an organization's performance which often do not coincide with the cash receipts and payments.
d) Under mixed basis of accounting, the extent of mixing (cash and accrual) is standard for all the Organizations.
e) Single entry system provides a check against the clerical errors.
f) Double entry system does not facilitate comparison of current year's results with the previous year.
g) Nominal account deals with the material things.

23) State whether following statements are true or false. In case of false statements, write the correct statement:

a) The golden rule for real account is "debit what comes in and credit what goes out".
b) All the capital expenditure needs to be capitalized in order to spread the cost of expenditure over the useful life of the asset.

c) Revenue expenditure does not effect the profitability statement.
d) Deferred revenue expenditure is charged to the Profitability Statement over the period over which benefits are received.
e) Paid stamp with date should be affixed only on the vouchers and not on the supporting documents.

24) State whether following statements are true or false. In case of false statements, write the correct statement:

a) Petty cash book is one of the primary books.
b) Journal is used for accounting both cash and non-cash transactions.
c) The sub-ledgers are maintained for reducing the congestion of the general ledger due to excessive sub-accounts under any main account.
d) The head office is not concerned with the records maintained at the field level.
e) Journal directly serves as a basis for preparation of final accounts.
f) If the debit and credit side of the trail balance is equal, it guarantees that there are no errors.
g) Ledger is prepared to know the net effect of the various transactions affecting a particular account.

25) Match the following:

(1) Basis of accounting	**(a)** Net income measures an Organizations performance rather than merely listing cash receipts and payments
(2) The end product of cash basis of accounting	**(b)** Books of account are required to be maintained on accrual basis of accounting
(3) Under accrual basis of accounting	**(c)** Refers to the method of recognition of revenues, expenses and liabilities in the accounts
(4) Mixed basis of accounting	**(d)** is a statement of receipts and payments
(5) Under Companies Act	**(e)** combines cash and accrual basis of accounting

26) Match the following:

(1) Single entry system	**(a)** Increases assets and expenses
(2) Double entry system	**(b)** Denotes the payment made during the year with an intention to receive the returns during the year
(3) Debit	**(c)**Is a one sided accounting system
(4) Credit	**(d)** Deals with material things
(5) Real accounts	**(e)** Increases liabilities and revenues
(6) Personal accounts	**(f)** Takes into account both the aspects of accounting
(7) Revenue expenditure	**(g)** Debit the receiver, credit the supplier

27) Match the following:

(1) Rule of journal entry	**(a)** May be committed at the time of recording and / or posting
(2) Sub-ledgers	**(b)** For every debit there is an equal and corresponding credit
(3) Trial balance	**(c)** is the list of all the accounts tracked by a single accounting system
(4) Errors of commission	**(d)** are subsidiary ledgers maintained for specific accounts appearing in the general ledger
(5) Errors of omission	**(e)** is the summary of all the balances in all the accounts listed in the general ledger and cash / bank book
(6) Chart of accounts	**(f)** May be committed at the time of recording the transactions in the book of original entry or while posting to the ledgers.

UNIT 3

PREPARATION OF FINANCIAL STATEMENTS

At the end of this unit, the student should be able to:

- ***Understand the meaning of financial statements and the users of these statements***
- ***Understand the characteristics of general purpose financial statements***
- ***Learn to prepare receipts and payments account***
- ***Learn to prepare income and expenditure account***
- ***Learn to prepare balance sheet***
- ***Know various points to be reported under notes to accounts***

3.1 OVERVIEW

The accounting process that we have studied so far culminates in the preparation of an organization's financial reports and financial statements.

A financial statement is a written report which quantitatively describes the financial health of a company. This includes an income and expenditure statement and a balance sheet. In addition to this a cash flow statement is also prepared as part of financial statements[6].

These financial statements are intended to reflect the operating results during the given period and the state of affairs at a particular date in a clear and comprehensive manner. We have already understood in Unit 1, the various stakeholders who are interested in the financial performance on an NPO and the users of its general purpose financial statements.

It should be recognized that while general purpose financial statement are the principal means of information for most users, they may not provide all the information that some of the users may need. While developing a frame work for financial reporting by NPOs, it would, therefore, be necessary to identify what

[6] Preparation of funds flow and cash flow statement shall be covered under the module of Fund accounting

information can best be communicated through financial statements and what information needs to be communicated through other financial reports.

The objective of general purpose financial statements is to provide timely and regular information about the financial position and performance of an enterprise that is useful to the wide range of users in making economic decisions. Financial statements prepared for this purpose meet the common needs of most users. They do not attempt to meet all informational needs of those interested in the NPO or to furnish all the types of information. Similarly, general purpose external financial reporting is not intended to meet specialized needs of regulatory bodies, some donors or grantors, or others having the authority to obtain the information they need. Rather, as mentioned earlier, general purpose external financial reporting focuses on providing information to meet the common interests of external users who generally cannot prescribe the information they want from an organization. Those users must use the information that is communicated to them by the organization. **For the purpose of this Unit we will focus on the general purpose financial statements, which we know are the point of culmination of the accounting process.**

3.2 FUND ACCOUNTING

The reason why we are briefly this topic at this point is that many NPOs receiving funds from a number of agencies, or for a number of projects / programme follow fund accounting. These funds get reflected in their books of account, and therefore in the general purpose financial statements prepared by them

Kinds of Funds[7]

NPOs receive funds from various funding agencies (both national and international) for the purpose of implementation of different projects to achieve their objectives. These funds may be granted either with certain conditions and restrictions or without any restrictions and conditions. When NPOs receive funds from a number of funding agencies, it becomes difficult for the finance staff to keep track of these funds and account for the expenses of the respective funding agencies. Therefore, it is necessary to classify these funds into broad categories as follows:

[7] This module covers only introduction on kinds of funds, detailed accounting treatment and fund accounting is covered in a separate module

Unrestricted income funds: refer to income contributed to an organization with no specific donor restrictions. The NPO's obligation when accepting an unrestricted donation or grant is to use it for the general purposes of the organization. All income (donations, legacies, investment income, fees, etc.) which is not subject to external restrictions is unrestricted income fund.

Designated funds: are unrestricted funds which have been set aside by the trustees for specific purposes or to meet future commitments. Unlike restricted funds, any designations are self-imposed and are not normally legally binding. The NPO can lift the designation whenever it wishes or reallocate the funds to some other designated purpose.

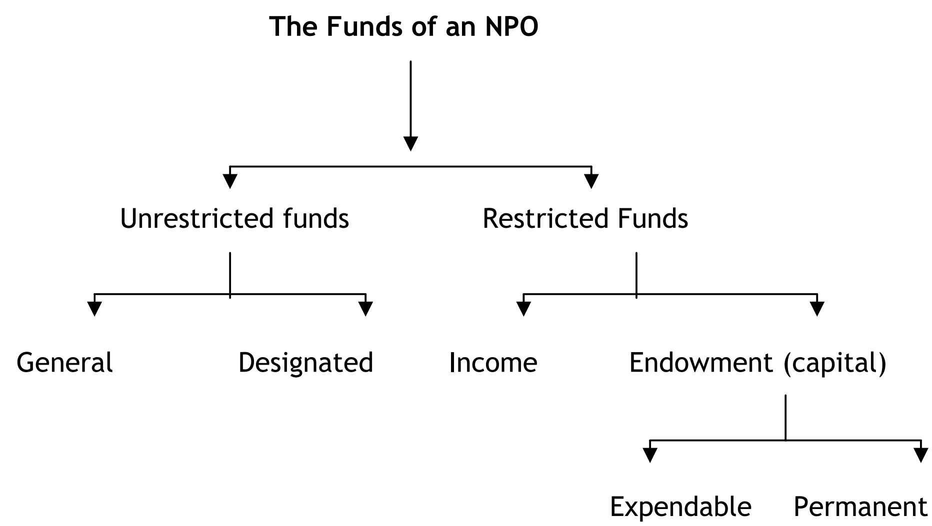
Although an NPO may wish to separate designated funds from other unrestricted funds in its internal accounting records, care must be taken in the published accounts not to give the impression that there is some legal distinction between the two, as in fact the NPO can use both types of funds at its discretion. If the trustees do wish to highlight the fact that they are setting aside resources for a specific project or purpose, they may show the designated funds as a separate category of unrestricted funds.

Restricted income funds: are subject to certain conditions set out by the contributor and agreed to by the organization when accepting the contribution. These funds have to be separately accounted for. The restriction may apply to the use of the capital or income or both. Income generated from assets held in a restricted fund will be subject to the same restriction unless the terms of the original restriction specifically say otherwise.

Endowment Funds: Endowment Funds are another form of restricted funds. Funds which have been given to an NPO subject to the restriction that they are to be held as capital are called endowment funds. Where the NPO must permanently maintain the whole of the fund, it is known as permanent endowment. The initial endowment, and subsequent increases and decreases in the amount of endowment funds should be distinguished as part of those funds. All income derived from assets held in an endowment fund should be included in the financial statements. If the application of the income is restricted to a particular purpose the income and expenditure should be appropriately identified in the restricted fund. Any such income not spent at the year end should be carried forward as a restricted fund.

Endowment assets should be regularly reviewed to ensure that they are properly invested in accordance with the terms of the endowment. This will apply primarily when cash endowments are received to be invested, or when assets are sold and the sales proceeds must be reinvested.

A summary presentation of the Funds of an NPO is as follows:



The different types of funds as outlined above need to be appropriately reflected and disclosed in the general purpose financial statements of an NPO.

3.3 QUALITATIVE CHARACTERISTICS OF GENERAL PURPOSE FINANCIAL STATEMENTS

The following are the qualitative characteristics of general purpose financial statements:

a) Understandability

An essential quality of the information provided in financial statements is that it must be readily understandable by users. However, information about complex matters that should be included in the financial statements because of its relevance to the economic decision-making requirements of the users ***should not be excluded*** merely on the ground that it may be too difficult for certain users to understand.

b) Relevance

To be useful, information must be relevant to the decision-making requirements of users. Information in the financial statements is said to have the quality of relevance when it influences the economic decisions of users. This will be by facilitating them to evaluate past, present or future events or confirming, or correcting, their past evaluations.

c) Materiality

The relevance of information is affected by its materiality. Information is said to be material if its misstatements (i.e., omission or erroneous statement) effects the decisions taken on the basis of the information provided in the financial statements. Materiality depends on the size and nature of the items or error, judged in the particular circumstances of its misstatement.

d) Reliability

To be useful, information must relevant, material at the same time it must also be reliable. Information has the quality of reliability when it is free from material errors and can be depended upon by users to represent faithfully.

e) Neutrality

To be reliable, the information contained financial statements must be neutral, that it must be free from bias. If the Financial statements are not neutral, by the selection or presentation of information, they influence the process of decision making to achieve a predetermined result or outcome.

f) Prudence

The preparers of financial statements have to contend with the uncertainties that inevitably surround many events and circumstances. Uncertainties are recognized by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty.

g) Completeness

To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

h) Comparability

Users must be able to compare the financial statements of an organization from time to time in order to identify the trends in its financial position, performance and cash flows.

3.4 PREPARATION OF FINANCIAL STATEMENT

It is generally believed that the financial statements that reflect a true and fair view of the state of affairs as reflected by the balance sheet and the results of the operations (activities) of the NPOs as reflected by the Income and Expenditure Account, would normally meet the requirement of various users.

It therefore follows that the generic framework of financial statements would be as follows:

- Receipt and Payment Account
- Income & Expenditure Account
- Balance Sheet

Now let us try to understand each of these in details.

3.4.1 Receipts and Payments Account:

It is the summary of the Cash Book (i.e. of cash and bank transactions) over a certain period. This statement is mostly used by societies, associations, trusts or other voluntary agencies for reflecting the movement of funds under various broad heads of account, to know from where the funds are received and how are they utilized. In other words it is a summary of total funds movement made by an organization during a particular year.

All the receipts of each type (whether cash or cheque, capital or revenue) from the cash / bank book are entered on the debit side and all the payments from the cash / bank book (whether cash or cheque, capital or revenue) are entered on the credit side. The opening cash and bank balances are shown as the first item on the debit side whereas the closing cash and bank balances are shown as the last item on the credit side of the Receipt and Payment Account. This closing balance should be actually available with the organization as at the end of the period for the statement is prepared. Also this balance should be in accordance with the cash / bank book.

We will now summarize the steps for preparation of Receipts and Payments Account as follows:

1) Enter the opening cash and bank balances from the cash / bank book on the debit (receipt) side;

2) Group all the similar kind of receipts (capital or revenue) into major heads in accordance with the chart of account and enter them on the debit side;

3) Group all the similar kind of payments (capital or revenue) into major heads in accordance with the chart of account and enter them on the credit side;

4) Calculate the difference between the total on the debit side and the total of credit side. Generally the total of the debit side exceeds the total of the credit side and the balancing figure is shown on the credit side. However, in case of overdraft bank balance the credit side may exceed debit side and consequently the balance will be reflected on the debit side.

Whichever side the balance is reflected, it should be exactly as per the cash / bank book

The main features of the Receipt and Payment Account are:

- It is a summarized version of the Cash Book classified under major heads of accounts instead of reporting the transactions date wise.
- All receipts and payments (whether of revenue or capital nature) are included.
- It only reflects the actual inflow and outflow of funds.
- It does not include entries passed for provisions like salary payable, rent payable and depreciation.
- It therefore from the above that the surplus or deficit of the NPO during the reporting period would not get reflected in the Receipt and Payments Account. Rather, this information can be obtained from the Income and Expenditure Account which we will study in the next part of this unit.

Format of Receipts and Payments Account

Date	Receipts	Amount Rs.	Date	Payment	Amount Rs. Ps.
1/4/XX	Opening balance	xxxx		Costs of generating voluntary receipts	xxxx
	Voluntary receipts	xxxx		Fundraising costs	xxxx
	Activities for generating funds	xxxx		Investment management costs	xxxx
	Investment dividends / interest	xxxx		Cost of Charitable activities	xxxx
	Charitable activities	xxxx		Governance costs	xxxxx
	Other receipts	xxxx	31/3/xx	Closing balance	xxxxx
	TOTAL	**XXXX**		**TOTAL**	**XXXX**

What information can be obtained from Receipts and Payment Account?

- The Receipts and Payments Account shows us all cash and bank transactions including the loan given and received during the year.

  For instance, a trustee of a trust took a loan of Rs.5, 00,000 from the trust on 1st April 2001 and returned the entire amount of Rs.5, 00,000 on 31st march 2002.The loan was interest free. Then again on 1st April, 2002, he took another loan of. Rs.5,00,000 and returned the same on 31st march, 2003.This loan cannot be figured out from the balance sheet or Income and expenditure .As per the accounting practices, this transaction would come in the receipts and Payment Account.

- The Receipts and Payment Account also serves another useful purpose. Looking at the Receipts and Payment Account, one can easily know the extent of funds utilized by the organization.

- It is also very easy to know the sale proceeds of assets and the payment made for procurement of assets.

- The total amount of grants / donations can also be known.
- One can also use the details of payments for analyzing the pattern of payments made by the organization

3.4.2 Income and Expenditure Account

An Income and Expenditure account is a final account like Profit and Loss Account, which shows the classified summary of revenue incomes and revenue expenses for the accounting period, along with surplus (i.e. excess of income over expenditure) or deficit (i.e. excess of expenditure over income) which is then transferred to the Capital Fund in the balance sheet.

Income & Expenditure can be considered as two different baskets, all the incomes shall be in one basket and all the expenses in the other. The accounts which cannot be assigned to any of these baskets shall directly find a place in the Balance Sheet. Therefore it is an account basically to close all such account of revenue nature and whose utility is finished within the year / period concerned. Income and Expenditure Account in an NPO is equivalent to the Profit and Loss Account which is drawn up to ascertain the profit earned by a “for-profit” organization. It is a nominal account and records losses and expenses on the debit side and profits and gains on the credit side.

While preparing the Income and Expenditure Account, it should be ensured that all expenses and income, pertaining to the relevant accounting period are accounted for, whether incurred/received or not or received/incurred in advance in earlier years. In other words even if funds have not physically received or paid, they shall be considered in the income and expenditure account if they pertain to the period for which the income and expenditure account is prepared.

Therefore, only income and expenses pertaining to the period for which it is prepared shall be considered as part of income and expenditure account. That is to say the capital receipt and expenditure should not be included in the Income and Expenditure Account. Instead, it should be taken directly on the Assets/Liabilities side of the Balance Sheet, as the case may be. The balance of the Income and Expenditure Account will either be a surplus or a deficit and it will be transferred to General Fund Account in the Balance Sheet.

The steps to be followed for preparation of Income and Expenditure Account are summarized as follows:

1) Ascertain the items pertaining to revenue income and revenue expenses from the trial balance.
2) Next, ascertain all the revenue incomes pertaining to the period for which the Income and Expenditure Account is prepared (whether actually received during the current period or receivable or received in past). Enter them on the credit side.
3) Similarly, ascertain all the revenue expenses pertaining to the current period and enter them on the debit side.
4) Ascertain the non-cash expenses (e.g. depreciation on fixed assets) enter them on the debit side.
5) Calculate the difference between the total of the debit side and total of the credit side. If the total of the credit exceeds the total of the debit side, show the surplus (i.e. excess of income over expenditure) on the debit side. If the total of the debit side exceeds the total of the credit side, show the deficit (i.e. excess of expenditure over income) on the credit side of the Income and Expenditure Account.

Format for Income and Expenditure account

Particulars	Current Year	Previous Year
Income		
Contribution	xxxx	xxxx
Foreign contribution	xxxx	xxxx
Indian Contribution	xxxx	xxxx
Income from investments	xxxx	Xxxx
Other incomes	xxxx	Xxxx
Total A	**XXXX**	**XXXX**
Expenditures		
Programme Expenditure		
- Activity one		
- Activity two		

- Activity three		
Administrative expenses	xxxx	xxxx
Salary and wages	xxxx	xxxx
Electricity	xxxx	xxxx
Rent	xxxx	xxxx
Traveling	xxxx	xxxx
Conveyance	xxxx	xxxx
Vehicle maintenance	xxxx	xxxx
Repairs and maintenance	xxxx	xxxx
Total B	**XXXX**	**XXXX**
Excess of income over expenditure **'C' (A-B)**		
Total	**XXXX**	**XXXX**

We have explained based on horizontal format (debit and credit) but format provided is vertical. Needs to be changed?

Information Available in the Income & Expenditure Account:

For a good analyst, a decently prepared Income & Expenditure account is sometimes better than an annual narrative report. It can give the following information:

a) How much the organization received from different sources?

- Grants
- Donations
- Interest
- Income from other sources such as sale of assets etc.

b) Through a comparison of this year's figures with the previous year's figures,

- Whether the income of the NPO is rising or stagnating
- Which categories of expenses are growing at a higher rate than others.
- What is the operating income / deficit, and the causes of these
- In case, of excess of income over expenditure, is this leading to accumulation of reserves

- In case of excess of expenditure over income, how is the same being funded. Further, in such a scenario, is there a threat to the long term sustainability of the programmes or the organization.

e) Through a comparison of Narrative/ Activity report of the organization with the Income & Expenditure account, whether they relate with each other.

f) One can also calculate the ratio of programme expenses to administration expenses, to assess the efficiency of work done by the organization.

3.4.3 Distinction between Income and Expenditure Account and Profit and Loss account:

Basis of Distinction	Income and Expenditure Account	Profit and Loss Account
Object	To ascertain excess of income over expenditure or excess of expenditure over income.	To ascertain net profit or net loss
Who Prepares?	This account is prepared by non-profit organizations.	This account is prepared by trading institutions.
Basis of preparation	This account is prepared on the basis of cash book	This account is prepared on the basis of trial balance
Balance	The balance of this account represents surplus or deficit	The balance of this account represents net profit or net loss.

3.4.4 Distinction between Receipt and Payment Account & Income and Expenditure Account:

S.No.	Particulars	Receipt & Payment Account	Income & Expenditure Account
1.	**Opening Cash and bank balance**	It starts with opening cash and bank balances, unless it is prepared for a new project/ programme/ organization.	No opening cash and bank balances are included.
2.	**Receipt and payments(Revenue or capital nature) items**	All actual receipts and payments (whether of a revenue or capital nature) made in the relevant accounting period are included.	Only transaction of revenue nature pertaining to the relevant accounting period whether incurred / received or not or received or incurred in advance in earlier year are included.
3.	**Outstanding Expenses, Accrued Income**	Not included	Included
4.	**Prepaid Expenses, Income Received in Advance**	Included since actual receipts and payments made in the relevant accounting period are considered	Not included
5.	**Provisions**	Not included	Included
6.	**Closing cash and bank balances**	It ends with closing cash and bank balances unless all receipts stand utilized at the end of the relevant accounting period.	It ends with a surplus or deficit, unless expenditure equals income or vice versa during the relevant

			accounting period.

3.4.5 Balance Sheet:

Balance Sheet is a statement of the financial state of affairs of an organization as at a particular date. The objective of the Balance Sheet is to show in a summary form, the financial state of affairs of the organization as disclosed by the books and to that end it exhibit the assets, liabilities, funds etc. as they exist on as at that date.

After transferring entries relating to income and expenditure from the Trial Balance to the Income and Expenditure Account, entries pertaining to assets and liabilities are taken to the Balance Sheet which is prepared on a particular date.
The assets and liabilities in the Balance Sheet are usually classified into the following major categories:

Assets	Liabilities
Fixed assets (suitably classified)	General Fund (unrestricted funds)
Investments	Restricted funds (earmarked for specific purposes)
Cash and bank balances	Assets fund
Loans and advances	Unutilized grants
Other current assets	Loans (secured / unsecured)
Losses and expenditure (to be carried over)	Current liabilities

The surplus / deficit as shown by the Income and Expenditure Account is added / deducted from the General Fund Account shown on the liabilities side of the Balance Sheet or exhibited separately under the head "Losses and Expenditure (to be carried over)" on the assets side of the Balance-Sheet, if there is no balance in the General Fund Account.

Format of a balance sheet

The balances sheet can either be prepared in a horizontal format or in a vertical format. The Companies Act specifies the format in which the Companies are required to present their financial statements. However, as Companies Act is not applicable to all NPOs, the format for preparation of balance sheet is not standardized.

Further, another inherent reason for following different formats by various NPOs is that, there are various projects implemented by the NPOs and at the same time there are multiple funding agencies. Therefore, the NPOs prepare Balance Sheet in a format which suits their information requirements, unless there is a statutory or legal prescription in this regard. **One of the generic formats of a balance sheet is as follows:**

……. Name of the NPO				
Consolidated Balance Sheet as at 31st March 2 0XX				
		31st March		
Liabilities	**Schedule Reference**	**XXX**	**XXIX**	
		Rs.	**Rs.**	
Corpus Fund		xxx	xxx	
Funds				
Unrestricted Funds				
General Funds		xxx	xxx	
Designated Funds		xxx	xxx	
Restricted Funds		xxx	xxx	
Current Liabilities		xxx	xxx	
Total		**XXX**	**XXX**	
Assets				
Fixed Assets		xxx	xxx	
Investments		xxx	xxx	
Current Assets Loans and Advances		xxx	xxx	

Accounting Policies & Notes forming				
integral part of the accounts				

The balance sheet reflects the status of an organization in a consolidated manner to give an overview of the position of assets and liabilities on a given date. Wherever it is felt that further details or breakup need to be provided for any item, then it is advisable to include these as schedules to the balance sheet, rather than cluster it with a number of relatively small items. This is true for other financial statements as well, including the Receipts and Payments account and the Income and Expenditure Account. Instances of schedules generally prepared include those for bank accounts, fixed assets, investments, grants received, and staff costs.

Information available in Balance Sheet:

We have already learnt that there are various stakeholders interested in the financial statements. Now let us try to understand that what kind information is available from the balance sheet.

a) Availability of Reserve and Funds:

The governing body will be able to get complete information as to the extent of reserves and funds available with the organization as at the end of the accounting period in the form of General Fund, Trust Fund or Corpus Fund.

b) Earmarked Funds:

Certain funds are earmarked for defined purposes. The use of such funds is restrictive for certain defined purposes only. Contributions and transfers towards such funds are directly creditable to the respective fund balance. From the Balance Sheet, one can know such earmarked funds of the organization and their specific utilization.

c) Status of Revolving Fund Loans:

Revolving Fund Loans are often treated as one time expenditure in the accounts and thereafter managed by the community. In such a case, these loans do not appear on the assets side of the Balance sheet.

d) How much cash:

Cash in hand is important for day to day expenditure. But large amount of cash increases the risk of theft and misuse. A large balance may indicate improper financial management.

e) How much bank balance:

Good financial practice suggests that organizations should have minimum bank balance in the savings bank account on the basis of the requirement of funds. The balance funds should be invested in term deposits which will fetch more interest for the Organization.

f) Loan and Advances:

From the balance sheet the stakeholders also get the information regarding the amount of loans and advances taken by the organization as well as taken by the organization. This may help them in decision with regards to further financial requirements and also to review the status of the loans and advances outstanding.

g) Purchase of Fixed Assets:

NPOs purchase assets against programme funds either for the beneficiaries in accordance with the grant agreement or for the office purpose. The assets procured for distribution to beneficiaries are generally written off during the year of procurement and the assets purchased for the office are capitalized and reflected in the balance sheet.

3.4.6 Notes To The Financial Statements

This forms the last part of the financial statements.

Accounts are always based on certain assumptions and framework of specific policies, which may vary from organization to organization. The prime objective of preparing financial statement is to present a true and fair view of the state of affairs of the organization. To provide clarity to the statements and to know the modus operandi behind their preparation suitable notes are always given for the benefit of the user. Notes are also required to be given to state accounting treatment of statutory nature such as valuation of inventory or change in method of accounting. Therefore notes to accounts become so very important, because unless the facts/assumptions behind the transactions are known it is not possible for anybody to form any authentic opinion. The followings are few normally used notes while compiling the financial statements.

a) Basis of preparation of financial statements and accounting standards:

Under this heading, one needs to disclose the basis of accounting followed by the Organization i.e. cash basis or accrual basis of accounting. Also the Accounting Standards followed by the organization needs to be disclosed. If the accounting standards are mandatory for certain organization and are not followed, then the reasons for such deviation and the financial impact of such decisions are also required to be disclosed.

b) Accounting Policies:

- **Fixed Assets:** The cost at which the assets are capitalized. The threshold limit for capitalization of assets.
- **Depreciation:** The Method of charging depreciation i.e. written down method or straight line method should be disclosed. Also if the rates of depreciation as per Income Tax Act are applied, then the same fact should be disclosed. If any other rates are applied then such other rates are required to be disclosed.
- **Foreign Currency transactions**: The rate applied to all the grants, voluntary donations and gifts received in foreign currency.
- **Investments:** The facts that whether the investments are made in accordance with the provisions of Section 11(5) of Income Tax Act or not should be disclosed. Whether they are reported at cost or at market price should also be disclosed. If there is diminution in the value of any of such investments, then the same should also be disclosed as part of notes to accounts.

c) Restrictions:

The organization also needs to disclose the restrictions, if any, on the utilization of each fund balances and of specific assets.

d) Fair Value:

Disclosure regarding the fair value of the non-monetary grants and donations received by the Organization should also be made in the notes to accounts.

e) Commitment and Contingent Liabilities:

If there is any committed funding or expenditures, the same should be disclosed in the notes to account. The contingent liabilities should also be disclosed in the notes to account.

f) Previous year figures:

Notes to account should also state that the previous year's figures have been regrouped/reclassified, whenever considered necessary to make them comparable with the current year figures.

3.5 AUDITED FINANCIAL STATEMENTS

As we have already understood, the accounting process in any organization ends with the preparation of the financial statements. However, as these statements are prepared by the organization itself, they need to be audited and certified. In India, the Chartered Accountants are authorized to certify the financial statements. Thus, there arises the need for conducting the audit of the books of account on the basis of which the audited financial statements are generated. Further, as per the provisions of the Income Tax Act and Foreign Contribution Regulation Act also, it is mandatory for the organizations to get their accounts audited for their respective purposes.

In this section we will just introduce the topic of audit. The detailed discussion on audit is covered as part of a separate course material.

The 'Framework of Statements on Standard Auditing Practices and Guidance Notes on Related Services', issued by the Institute of Chartered Accountants of India, states that the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified reporting framework. The phrase used to express the auditor's opinion is 'give a true and fair view". The audit of financial statements of and NPO has the same objective.

In forming the audit opinion, the auditor obtains sufficient appropriate audit evidence to be able to draw conclusions on which to base his opinion. The audit's opinion enhances the credibility of financial statements by providing a high, but not absolute, level of assurance. Absolute assurance in auditing in not attainable as a result of such factors as the need for judgment, the use of test checks, the inherent limitations of any accounting and internal control systems and the fact that most of the evidence available to the auditor is persuasive, rather than conclusive, in nature.

In addition to this, funding agencies also often require a certified statement of grant, reflecting the total funds received as per the books of account, total funds utilized and the closing balance as at a specified period. Therefore in addition to the statutory requirements, Organizations are also required to get the accounts of specific funding agencies audited and submit a certified statement to the funding agencies.

3.6 SUMMARY

We will now summarize the learning of this unit.

1) There are various sources from which the NPOs receive funds and therefore they require to maintain fund accounting. And hence we have tried to understand in brief the types of funds.
2) Then we proceeded with understanding the characteristics of general purpose financial statements followed by preparation of financial statements.
3) Preparation of financial statements included preparation of Receipts and Payment Account, Income and Expenditure Account and Balance Sheet.
4) Receipts and Payment Account is the summary of the cash book which does not consider the receivables and payables though it considers the receipts and payments made in advance. That is to say it considers the funds movement whether in the form of cash or through bank.
5) An Income and Expenditure account is a final account like Profit and Loss Account, which shows the classified summary of revenue incomes, revenue expenses and losses for current accounting period along with surplus (i.e. excess of income over expenditure) or deficit (i.e. excess of expenditure over income) which is transferred then to the Capital Fund in the balance sheet.
6) Then we tried to differentiate the Income & Expenditure Account with the Profit and Loss Account and the Receipts and Payment Account.
7) Then we tried to understand that the Balance Sheet is a statement of the financial state of affairs of an organization as at a particular date. The objective of the Balance Sheet is to show in a summary form, the

financial state of affairs of the organization as disclosed by the books and to that end it exhibit the assets, liabilities, funds etc. as they exist on as at that date.

8) Accounts are always based on certain assumptions and framework of specific policies, which may vary from organization to organization. To provide clarity to the statements and to know the modus operandi behind their preparation suitable notes are always given for the benefit of the user. Therefore we then tried to understand various points to be reported under noted of the financial statements.

9) We concluded this unit by understanding that these statements are required to be audited and certified. Therefore, there is a need for conducting the audit of the books of account.

3.7. SELF ASSESSMENT EXERCISE:

1) ……………….. is the written report which quantitatively describes the financial health of the Organization

a) Donor reports	**b)** Cash flow statement
c) Financial statement	**d)** None

2) One of the following is not the characteristics of the general purpose financial statements.

a) understandable	**b)** Material
c) Relevant	**d)** Biased

3) The financial statements reflect view of the state of affairs of the Organization

a) True	**b)** Correct
c) True and correct	**d)** True and fair

4) ………….. is the summary of the cash book

a) Receipts and Payment Account	**b)** Income and Expenses Account
c) Profit and Loss Account	**d)** Balance Sheet

5) Which of the following is not considered for the purpose of income and Expenditure Account:

a) Revenue receipts	**b)** Revenue payment
c) Capital receipts	**d)** All

6) In which of the following the opening cash and bank balances are included

a) Receipts and Payment Account	**b)** Income and Expenditure Account
c) Both	**d)** None

7) Which of the following is not included in the Receipts and Payment Account

a) Prepaid income	**b)** Income received in advance
c) Outstanding expenses	**d)** All

8) Entries pertaining to ………………… are taken to balance sheet

a) income and expenses	**b)** Assets and liabilities
c) Both	**d)** None

9) State whether the following statements are true or false. In case of false statement, write the correct statement

a) The general purpose financial statements meet all the information requirements of all the stakeholders.

b) Materiality depends on the size and nature of the transaction

c) Receipts and Payment Account considers only the revenue receipts and payments.

d) Receipts and Payments Account does not reflect any surplus or deficit.

e) Even if funds are not physically received or paid, they shall be considered in the income and expenditure account if they pertain to the period for which it is prepared.

f) The objective of the Balance Sheet is to show in a summary form, the financial state of affairs of the organization as disclosed by the books

ANNEXURE 1

Performa of Receipt Voucher

<table>
<tr><td colspan="4">Name of the Organization

RECEIPT VOUCHER</td><td colspan="2">No:
Date:
Project:
Funding agency:</td></tr>
<tr><td colspan="6">Credit</td></tr>
<tr><td colspan="3">A/c Head</td><td>A/c Code</td><td colspan="2">Amount (Rs)</td></tr>
<tr><td colspan="3"></td><td></td><td colspan="2"></td></tr>
<tr><td colspan="3"></td><td></td><td colspan="2"></td></tr>
<tr><td colspan="3"></td><td></td><td colspan="2"></td></tr>
<tr><td colspan="3"></td><td></td><td colspan="2"></td></tr>
<tr><td colspan="3"></td><td></td><td colspan="2"></td></tr>
<tr><td colspan="4">Total (Rs)</td><td colspan="2"></td></tr>
<tr><td colspan="6">Debit</td></tr>
<tr><td colspan="3">CASH</td><td colspan="3">CH/PO/DD</td></tr>
<tr><td colspan="3"></td><td colspan="3">Date</td></tr>
<tr><td colspan="3"></td><td colspan="3">Drawn On</td></tr>
<tr><td>Rupees in words</td><td colspan="4"></td><td rowspan="4">PAID THE ABOVE SUM

Signature</td></tr>
<tr><td>Received from</td><td colspan="4"></td></tr>
<tr><td>Being</td><td colspan="4"></td></tr>
<tr><td>Prepared by</td><td>Verified by</td><td colspan="3">Approved by</td></tr>
</table>

ANNEXURE 2

Performa of Payment Voucher

Name of the Organization **PAYMENT VOUCHER**	**No:** **Date:** **Project:** **Funding agency:**

Debit

A/c Head	A/c Code	Amount (Rs)	Total (Rs)

Credit

A/c Head	A/c Code	Amount (Rs)	Total (Rs)

<table>
<tr><td>Rupees in words</td><td colspan="2"></td><td rowspan="3">RECEIVED THE ABOVE SUM

Signature</td></tr>
<tr><td>Being</td><td colspan="2"></td></tr>
<tr><td>Prepared by</td><td>Verified by</td><td>Approved by</td></tr>
</table>

Annexure 3

Performa of Petty Cash Voucher

<table>
<tr><td colspan="2">Name of the organization

PETTY CASH VOUCHER</td><td>V.No
Date:
Project:
Funding agency:</td></tr>
<tr><td>Account Head</td><td>Description</td><td>Amount</td></tr>
<tr><td></td><td></td><td></td></tr>
<tr><td></td><td></td><td></td></tr>
<tr><td></td><td></td><td></td></tr>
<tr><td></td><td></td><td></td></tr>
<tr><td></td><td></td><td></td></tr>
<tr><td></td><td></td><td></td></tr>
<tr><td></td><td></td><td></td></tr>
<tr><td colspan="3">Total (in words)</td></tr>
<tr><td colspan="3">Prepared by ------------------ Authorized by ------------------- Received by ----------</td></tr>
</table>

ANNEXURE 4

Performa of Journal Voucher

<table>
<tr><td colspan="4">Name of the Organization

JOURNAL VOUCHER</td><td>Jv.No
Date:
Project:
Funding agency:</td></tr>
<tr><td rowspan="2">S.no</td><td rowspan="2">Account Head</td><td rowspan="2">Account code</td><td>Debit</td><td>Credit</td></tr>
<tr><td>Rs</td><td>Rs</td></tr>
<tr><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td></td><td></td><td></td><td></td><td></td></tr>
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<tr><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td></td><td></td><td>Total</td><td></td><td></td></tr>
<tr><td colspan="5">Being</td></tr>
<tr><td colspan="5">Rupees in words</td></tr>
<tr><td colspan="5">Prepared by   Verified by
Approved by</td></tr>
</table>

ANNEXURE 5

Bank Reconciliation Statement

Particulars	Amount (Rs)	Amount (Rs)
Bank Balance as per Cash Book		**xxxx**
Add:		
1. Cheques issued but not presented for payments	xxxx	
2. Cheques and cash directly deposited by the customer into the bank	xxxx	
3. Interest, dividend and other amount collected and credited by bank	xxxx	
4. Amount wrongly credited in pass book	xxxx	
5. Cheques issued but dishonored by bank	xxxx	
Total		**xxxx**
Less:		
1. Cheques deposited for collection but not credited by banker	xxxx	
2. Bank charges etc debited in pass book only	xxxx	
3. Amount wrongly debited in pass book only	xxxx	
Total		**xxxx**
Balance as per pass book		**xxxx**

- **Alternatively the BRS can also be started with Balance as per pass book. In such case the treatment for all the above mentioned examples would be reverse.**

- **Further there would be instances of overdraft balance as per pass book which again requires inverse treatment for the above mentioned examples.**
- **This would ideally be prepared at least once in a month for all the bank accounts of an organization.**

ANNEXURE 6

Inventory / Stock Register

Date	Description	Opening balance	Purchase					Issue			Balance	
			Bill No	V.no	Qty	Rate	Amount	Date	Particulars	Qty	Balance	Remarks

ANNEXURE 7

Fixed Assets Register

Date of purchase	Name of supplier	B.No	V.No	Details of Model/Brand	Total cost (Rs)	Identification code	location	Project/ Donor	Sales		
									Date	Sale proceed	Receipt V.No

ANNEXURE 8

Depreciation Schedule

Particulars	Gross block				Rate of depreciation%	Depreciation				Net block	
	As on (date)	Addition	Deletion	As on (date)		As on (date)	For the period	On deletions	As on date	As on date	As on date
Land and Building											
Cameras											
Computers											
Furniture and fittings											
Electrical items											
Non - electrical items											