UNIT – 7

INTRODUCTION TO FINANCIAL ACCOUNTING

Accounting Definition: Accounting is a process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of the information.

Accounting Concepts:

1) Business Entity Concepts: Every business has a separate and distinct legal entity. Business records are separated from its owners, proprietors. Also, there should be clear distinction between personal transactions and business transaction.

2) Money measurement Concepts: Only the transactions that can be expressed in terms of money are recorded in the books of account.

3) Going Concern Concept: Every business enterprise will continue to operate forever. It not going to be liquidated or closed down in near future due to the death of owners or insolvency. Because of this assumption, the market price of assets become irrelevant and the concept of depreciation of fixed assets is exists.

4) Cost Concept: The asset is recorded at the cost at which they are acquired i.e. market values are ignored. The assets are shown as original cost less depreciation.

5) Realization/Accrual Concepts: The revenue is generated when actual sale is realized. For example, when a firm sells goods on March 31st 2009 on credit and if it receives cash from customer on April 22nd 2009 then the sale revenue is recognized in the month of April 2009.

6) Accounting Period Concept: Accounts are to be prepared for a defined period i.e. economic life of an enterprise must be divided into intervals called period accounting.

7) Matching Concept: The expenses of a given period must be related to the revenue during that period only.

8) Dual Aspect Concept: Every transaction has dual effects in the books i.e. it is recorded in the assets side as well as in the liability side.

Accounting Conventions:

1) Full Disclosure: The financial statement must disclose all the necessary and relevant information off course the information should be reliable also.

2) Consistency: Standard practices, rules and policies of accounting should be followed consistently over the years.

3) Materiality: Only the material information should be recorded. Immaterial or information that is not at all useful must not be recorded.

4) Conservatisms (Prudence): This is the policy of safe playing i.e. in the books no profit are anticipated but all possible losses are accounted.

Accounting Terminology:

1) Business: It is an activity which involves exchange of goods or services with the intension of earning income and profit.

2) Business transaction: Any exchange of money or money's worth as goods and services between two parties is called business transaction.

a) Cash transaction: when payment for business activity is made immediately, it is called a cash transaction.

b) Credit transaction: When payment is postponed to a future date, it is called credit transaction.

3) Capital: It is the amount invested by the proprietor in the business

4) Drawings: It is the value of cash or goods with drawn from the business by the owner for his personal use.

5) Goods: It reefers to commodities, articles, things in which a trader deals.

6) Debtor: A debtor is a person who owes something/money to the business

7) Creditor: A creditor is a person to whom the business owes money.

8) Expenses: It is the amount spent in conducting business activities. It is the expenditure, in return for some benefit.

9) Loss: A loss is an expenditure without any benefit to the concern

10) Income: It refers to the earnings of a business. It includes the sales of goods, interest received, commission received etc.

11) Debit: The left hand side of the account

12) Credit: The right hand side of the account

13) Asset: All such items that have value are known as assets. It refers to what a business owns, namely its plant, machinery, furniture, land and so on.

14) Tangible fixed assets: Tangible fixed assets can be touched and seen. Example are plant, machinery. etc.

15) Intangible fixed asset: such fixed assets that cannot be seen or touched are called intangible fixed assets. Ex: Trade mark, Patent rights

16) Current Asset: Current assets are expected to be realized in cash or consumed during business operations.

17) Bills Receivable: These refer to the acceptances received from the customers or business parties to pay an agreed amount of money. Acceptances received are called bills receivable.

18) Liabilities: What the firm has to pay legally, they are called liabilities. In other words, it refers to what the firm owes to outsiders.

19) Bills Payable: The acceptances given to the suppliers of goods or other business parties to pay an agreed amount of money are called bills payable. Acceptances given are called bills payable. Bills payable constitute part of current liabilities.

20) Overdraft: The facility sanctioned by a banker to a customer to draw more than what is deposited in the account, subject to a maximum limit of money is called overdraft. It may be for a short period or for a long period.

21) Outstanding expenses: These refer to the expenses yet to be paid.

22) Current liability: Current liabilities are those which are payable in the near future say less than an year.

23) Sales: Sales refer to the value of goods or services sold during a given accounting period sales may be cash or credit sales. In credit sales, the debtor promises to pay the firm at a future date.

24) Purchases: Purchases refer to the value of goods or services purchased during a given accounting period. Purchases may be cash purchases or credit purchases. In credit purchases, the firm agrees to pay the amount to the supplier at a future date.

25) Double-entry Book Keeping: This is a system of book-keeping where for every debit, there is a corresponding credit.

Types of Account and its rules:

1) Personal Accounts: Personal accounts indicate about the persons and firms.

Rule: Debit the Receiver
Credit the Giver

2) Real Account: Real accounts indicates about all assets

Rule: Debit what comes in
Credit what goes out

3) Nominal Account: Nominal accounts indicate about expenses, losses, incomes and gains.

Rule: Debit all losses and expenses
Credit all incomes and gains

Journal: This called the "Book of prime entry. The word journal is derived from the Latin word journ, which means a day. Hence, journal is also termed as a daybook wherein the day-to-day transactions are recorded in chronological order.

Journal Entry: The process of recording the business transactions in the journal is know as journalizing to divide business transactions into two aspects and recording I the journal is called journal entry. The first one is debit aspect and second one is credit aspect.

Problems:

1) Journalizing the transactions given below in the books of Prasad.

Date		Particulars
2008		
Jan	1	Prasad commenced business with cash Rs.30,000
	2	Cash sales Rs.4,000
	4	Bought machinery RS.15,000
	7	Sold goods to Raju Rs.10,000
	9	Purchased goods from Ramana Rs.8,000
	10	Goods returned by Raju Rs.5,000
	12	Paid for stationery Rs.1,000
	14	Carriage expenses Rs.500
	15	Bought furniture for proprietor's residence and paid cash Rs.7,000

17 Sold goods to Krishna for cash Rs.3,000

22 Received discount Rs.800

24 Paid for wages Rs.1,200

25 Deposited cash with bank Rs.10,000

30 Goods return to Ramana Rs. 2,000

Solution:

Journal Entries in books of Prasad for year ending 30th June 2008

Date	Particulars	L F	Debit Rs.	Credit Rs.
2008 June 1	Cash A/C Dr To Capital A/C (Being business Commenced)		30,000	30,000
2	Cash A/C Dr To Sales A/C (Being goods sold for cash)		4,000	4,000
4	Machinery A/C Dr To Cash A/C		15,000	15,000
7	Raju A/C Dr To Sales A/C (Being goods sold to raju for cash)		10,000	10,000
9	Purchases A/C Dr To Ramana A/C (Being goods purchases from Ramana)		8,000	8,000
10	Sales returns A/C Dr To Raju A/C (Being goods returned by raju)		5,000	5,000
12	Stationery A/C Dr To Cash A/C (Being Stationery purchased for cash)		1,000	1,000
14	Carriage Expenses A/C Dr To Cash A/C (Being carriage expenses paid)		500	500
15	Drawings A/C Dr To Cash A/C (Being goods used for his personal use)		7,000	7,000
17	Cash A/C Dr To Sales A/C (Being goods sold for cash)		3,000	3,000

22	Cash A/C Dr To Discount received A/C (Being discount received)		800	800
24	Wages A/C Dr To Cash A/C (Being wages paid by cash)		1,200	1,200
25	Bank A/C Dr To Cash A/C (Being cash deposited with bank)		10,000	10,000
30	Ramana A/C Dr To Purchase returns A/C (Being goods return to Ramana)		2,000	2,000

2) Journalise the following transactions, post them in the ledger and balance the accounts on 31st January.

1. John sarted business with a capital of RS.10,000
2. He purchased goods from Mohan on credit of Rs.2,000
3. He paid cash to Monhan Rs.1,000
4. He sold goods to Suresh Rs.2,000
5. He received cash from Suresh RS.3,000
6. He further purchased goods from Mohan Rs.2,000
7. He paid cash to Monhan Rs.1,000
8. He further sold goods to Suresh Rs.2,000
9. He received cash from Suresh Rs.1,000

Solution:

Journal Entries

Date	Particular		L.F	Debit Rs.	Credit Rs.
1	Cash A/C To Capital A/C (Being commencement of business)	Dr		10,000	10,000
2	Purchase A/C To Monhan A/C (Being purchase of goods on Credit)	Dr		2,000	2,000
3	Mohan A/C To Cash A/C (Being paymen of cash to Mohan)	Dr		1,000	1,000
4	Suresh A/C To Sales A/C (Being goods sold to suresh)	Dr		2,000	2,000
5	Cash A/C To Suresh A/C (Being cash received from Suresh)	Dr		3,000	3,000
6	Purchase A/C To Mohan A/C (Being purchase of goods from Mohan)	Dr		2,000	2,000
7	Mohan A/C To Cash A/C (Being payment of cash to Mohan)	Dr		1,000	1,000

8	Suresh A/C Dr To Sales A/C (Being goods sold to suresh)		2,000	2,000
9	Cash A/C Dr To Cash A/C (Being cash received from Suresh)		1,000	1,000

Ledger: The ledger is the principal book of accounts where similar transaction relating to a particular person or thing is recorded.

It is book of final entry. All business transactions are first recorded in journal and final recorded in the ledger. The process of transferring the transactions from journal to the ledger is called as posting.

Dr Cash A/C Cr

Date	Particulars	JF	Amount	Date	Particulars	JF	Amount
Jan-1	To Capital A/C		10,000	Jan-3	By Mohan A/C		1,000
Jan-5	To Suresh A/C		3,000	Jan-7	By Mohan A/C		1,000
Jan-9	To Suresh A/C		1,000	Jan-31	By Balance c/d		12,000
			14,000				14,000
Feb-1	To Balance b/d		12,000				

Dr Capital A/C Cr

Date	Particulars	JF	Amount	Date	Particulars	JF	Amount
Jan-31	To Balance c/d		10,000	Jan-3	By Cash A/C		10,000
			10,000				10,000
				Feb-1	By Balance b/d		10,000

Dr Purchase A/C Cr

Date	Particulars	JF	Amount	Date	Particulars	JF	Amount
Jan-2	To Mohan A/C		2,000				
Jan-6	To Mohan A/C		2,000	Jan-31	By Balance c/d		4,000
			4,000				4,000
Feb-1	To Balance b/d		4,000				

Dr Mohan A/C Cr

Date	Particulars	JF	Amount	Date	Particulars	JF	Amount
Jan-3	To Cash A/C		1,000	Jan-2	By Purchases A/c		2,000
Jan-7	To Cash A/C		1,000	Jan-6	By Purchases A/C		2,000
Jan-31	To Balance c/d		2,000	Jan-31			
			4,000				4,000
Feb-1	To Balance b/d		4,000				

Suresh A/C

Dr Cr

Date	Particulars	JF	Amount	Date	Particulars	JF	Amount
Jan-4	To Sales A/C		2,000	Jan-5	By Cash A/C		3,000
Jan-8	To Suresh A/C		2,000	Jan-9	By Cash A/C		1,000
			4,000				4,000

Sales A/C

Dr Cr

Date	Particulars	JF	Amount	Date	Particulars	JF	Amount
Jan-31	To Balance c/d		4,000	Jan-4	By Suresh A/C		2,000
				Jan-8	By Suresh A/C		2,000
			4,000				4,000
				Feb-1	To Balance b/d		4,000

Trial Balance: After posting the accounts in the ledger, a statement is prepared to show separately the debit and credit balances. Such a statement is called as the trial balance. Trial balance is prepared to verify the arithmetical accuracy whether the total debit and credit are equal or not.

3) From the following information prepare the trial balance

Sl.No.	Particulars	Amount
1	Capital	42,100
2	Furniture	800
3	Discount received	800
4	Bad debts	1,000
5	Drawings	900
6	Purchases	17,620
7	Rent Paid	1,120
8	Sales	35,320
9	Creditor	1,800
10	Sales returns	400
11	Purchases returns	600
12	Advertisement	500
13	Salaries	1,800
14	Investments	1,125
15	Discount allowed	100
16	Cash in hand	14,175
17	Cash at bank	41,600
18	Discount received	520

Solution:

TRIAL BALANCE

Sl.No	Particulars	LF	Debit Amount	Credit Amount
1	Capital		-	42,100
2	Furniture		800	-
3	Discount received		-	800
4	Bad debts		1,000	-
5	Drawings		900	-
6	Purchases		17,620	-
7	Rent Paid		1,120	-
8	Sales		-	35,320
9	Creditor		-	1,800
10	Sales returns		400	-
11	Purchases returns		-	600
12	Advertisement		500	-
13	Salaries		1,800	-
14	Investments		1,125	-
15	Discount allowed		100	-
16	Cash in hand		14,175	-
17	Cash at bank		41,600	-
18	Discount received		-	520
			81,140	81,140

Final Accounts: Final accounts mean accounts which are prepared at the final stage to give the financial position of the business. The financial position is judged by means of preparing a balance sheet of the business. The balance sheet is prepared from the trading and profit and loss account or income statement. Thus the final account is constituted with income statement and balance sheet. These are

1. Trading Account
2. Profit and Loss Account/Income statement
3. Balance Sheet

1) Trading Account: Trading account shows the effect of buying selling of goods/services during an accounting period. The statement indicates gross profit or gross loss

Gross profit = Net sales – Cost of goods sold

Proforma:

Dr Trading A/C Cr

Particulars	Amount	Amount	Particulars	Amount	Amount
To Opening Stock		-------	By Sales	------	
To Purchases	-------		**Less**: Sales Returns	------	-----
Less: Purchase Returns	-------	--------			
To Wages		-------	By Closing stock		------
To Freight		-------			
To Carriage inwards		-------			
To Gross Profit (Transfer to P/L A/C)		-------			
		-------			--------

2) Profit and Loss Account: Profit and loss account shows net profit or net loss for the end of a given period.

From the gross profit or gross loss transferred from trading account, deduct all expenses relating to office, selling and distribution departments. Add all non-operating income such as commission or rent received, interest received etc.

Proforma:

Dr Profit and loss A/C Cr

Expenses and losses	Amount	Amount	Incomes and Profits	Amount	Amount
To Salaries		-----	By Gross Profit		-------
To Rent		-----	By Discount Received		-------
To Insurance		-----			
To Carriage outwards		-----	By Commission Received		-------
To Telephone charges		-----			
To Depreciation		-----	By Profit on sale of fixed asset		-------
To Bad debts		-----			
To Advertising		-----			
To Lighting		-----			
To Interest on Loan		-----			
To Discount allowed		-----			
To Samples		-----			
To Net Profit		-----			
(Transfer to B/S)					
		--------			--------

3) Balance Sheet: It shows the financial positions of the business on a particular date. On left hand side of balance sheet shows total liabilities and on the right hand side total assets of business is shown. The balance sheet of a company shall be either in a horizontal form or a vertical form. Horizontal form is most widely accepted by the company.

Proforma:

Dr Balance Sheet Cr

Liabilities	Amount	Amount	Assets	Amount	Amount
Capital	-----		Plant	------	
Add: Net profit	-----		**Less**: Depreciation	------	--------
	------				
Less: Drawing	------	--------	Machinery	------	
			Less: Depreciation	------	--------
Over draft		--------			
Sundry creditors		--------	Furniture	-------	
Bills payable		--------	**Less**: Depreciation	-------	--------
Outstanding expenses		--------			
			Stock		--------
			Sundry Debtors	--------	
			Less: Bad debts	--------	--------
			Bills receivable		--------
			Cash in hand		--------
			Cash at bank		--------
			Prepaid expenses		--------
Total		---------	Total		---------

Adjustments:

1) Outstanding Expenses or Accrual Expenses: In of outstanding expense, it must be added to the concerned account in trading or profit and loss account and again this item should be shown in the balance sheet liabilities.

2) Prepaid Expenses: In case any of the expenses is prepaid, it must be deducted from the concerned head in trading or P/L account. Again, it will be show in balance sheet as an asset.

3) Provision for depreciation: Depreciation refers to the reduction in value of the asset. It must deduct from the concerned asset. Again, it will be shown in the profit loss account.

$$\text{Depreciation} = \frac{\text{Cost of asset} - \text{Scrap value}}{\text{life of asset}}$$

4) Closing Stock: In case closing stock¸ it must be shown in trading account, again it is shown in balance sheet asset side.

5) Provision for Bad Debts: A bad debt is debt, which is irrecoverable, and hence it will be written off as a loss. It must be deducted from debtors and again it shown in profit and loss account debit side.

6) Income received in advance or Unearned income: This appears as z deduction from the concerned income in profit and loss account and again in balance sheet as liability.

Problems:

1) From the following trial balance and adjustments of Suresh, prepare trading and profit and loss account for the year ending 30th June, 2006 and balance sheet as on that date.

Trial Balance

Particulars	Debit Rs.	Credit Rs.
Suresh's Drawings	14,000	
Furniture	5,200	
Land and buildings	40,000	
Opening Stock	44,000	
Debtors	37,200	
Purchases	2,20,000	
Sales returns	4,000	
Discounts	3,200	
Taxes and insurance	4,000	
General expenses	8,000	
Salaries	18,000	
Commission	4,400	
Carriage	3,600	
Bad debts	1,600	
Suresh capital		60,000
Bank overdraft		8,400
Creditors		31,600
Rent from tenants		2,000
Sales		3,00,000
Discounts		4,000
Provision for doubtful debts		1,200
Total:	4,07,200	4,07,200

Adjustments:

1. Closing stock Rs.70,000
2. Write off depreciation Rs.10% per annum on land and buildings
3. Taxes yet to be paid Rs.200
4. Prepaid salaries Rs.1,000
5. Provision for bad debts Rs.600
6. Rent received in advance Rs.1000

Solution:

Dr **Trading A/C of Mr.Suresh for year ending of 30th June, 2006** Cr

Particulars	Amount	Amount	Particulars	Amount	Amount
To Opening Stock		44,000	By Sales	3,00,000	
To Purchases	2,20,000		**Less**: Sales Returns	4,000	2,96,000
Less: Purchase Returns	-------	2,20,000			
To Carriage		3,600	By Closing stock		70,000
To Gross Profit (Transfer to P/L A/C)		98,400			
		3,66,000			3,66,000

Dr **Profit and Loss A/C of Mr.Suresh for year ending of 30th June, 2006** Cr

Expenses and losses	Amount	Amount	Incomes and Profits	Amount	Amount
To Salaries	18,000		By Gross Profit		98,400
Less: prepaid salaries	1,000	17,000	By Discount Received		4,000
To Tax and Insurance	4,000		By Provision for bad debts		1,200
Add: Outstanding	200	4,200			
			By Rent received	2,000	
To General expenses		8,000	**Less**: Rent received in advance	1,000	1,000
To Discount allowed		4,000			
To Depreciation on land		1,800			
To Bad debts	1600				
Add: Bad debts new	200	3,200			
To Advertising		4,400			
To Commission		62,200			
To Net Profit (Transfer to B/S)					
		1,04,600			1,04,600

Dr **Balance Sheet A/C of Mr.Suresh for year ending of 30th June, 2006** Cr

Liabilities	Amount	Amount	Assets	Amount	Amount
Capital	60,000		Land & Building	40,000	
Add: Net profit	62,000		**Less**: Depreciation	4,000	36,000
	1,22,000				
Less: Drawing	14,000	1,08,000	Stock		70,000
			Sundry Debtors	37,200	
Over draft		8,400	**Less**: Bad debts	200	37,000
Sundry creditors		31,600			
Outstanding Tax		200	Furniture		5,200
Rent received in advance		1,000	Prepaid Salaries		1,000
Total		1,49,200	Total		1,49,200

2) The following figures have been extracted from the records of Fancy stores a proprietary concern as on 31-12-2008.

Furniture	15,000	Insurance	6,000
Proprietors capital	54,000	Rent	22,000
Cash in hand	3,000	Sundry debtors	60,000
Opening stock	50,000	Sales	6,00,000
Fixed deposit	1,34,600	Advertisement	10,000
Drawing	5,000	Postages and Telephone	3,400
Provision for bad debts	3,000	Bad debts	2,000
Cash at bank	10,000	Printing and stationary	9,000
Purchases	3,00,000	General charges	13,000
Salaries	19,000	Sundry creditors	40,000
Carriage inwards	41,000	Deposit from customers	6,000

Prepare trading, profit and loss account and balance sheet after taking into consideration the following information.

a) Closing stock as on 31st March was Rs.10,000

b) Salary of Rs.2,000 is yet to paid to an employee.

Solution:

Dr **Trading A/C of Ms.Fancy Stores for year ending of 31-12- 2006** Cr

Particulars	Amount	Amount	Particulars	Amount	Amount
To Opening Stock		50,000	By Sales	6,00,000	
To Purchases	3,00,000		**Less**: Sales Returns	-------	6,00,000
Less: Purchase Returns	-------	3,00,000	By Closing stock		10,000
To Carriage inwards		41,000			
To Gross Profit (Transfer to P/L A/C)		2,19,000			
		6,10,000			6,10,000

Dr **Profit and Loss A/C of Ms.Fancy Stores for year ending of 31-12-2006** Cr

Expenses and losses	Amount	Amount	Incomes and Profits	Amount	Amount
To Salaries	19,000		By Gross Profit		2,19,000
Add: Outstanding	2,000	21,000	By Provision for bad debts		3,000
To Insurance		6,000			
To Rent		22,000			
To Advertising		10,000			
To Bad debts		2,000			
To Telephone charges		3,400			
To Printing & stationery		9,000			
To General Charges		13,000			
To Net Profit (Transfer to B/S)		1,35,600			
		2,22,000			2,22,000

Dr **Balance Sheet A/C of Ms.Fancy Stores for year ending of 31-12- 2006** Cr

Liabilities	Amount	Amount	Assets	Amount	Amount
Capital	54,000		Cash in hands		3,000
Add: Net profit	1,35,600		Cash at bank		10,000
	1,89,600		Sundry debtors		60,000
Less: Drawing	5,000	1,84,600	Furniture		15,000
			Fixed deposits		1,34,600
Sundry creditors		40,000	Closing Stock		10,000
Outstanding Salaries		2,000			
Deposits from customers		6,000			
Total		2,32,600	Total		2,32,600