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HEALTH MEDIA management
ENGINEERING mathematics
DESIGN GEOGRAPHY EDUCATION
ART PHYSICS
BIOTECHNOLOGY agriculture
CHEMISTRY history
MECHANICS LANGUAGE
psychology

Preparatory Course in Commerce

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Chapter 1

Accounting Terms

Account

An account is a record used to properly classify the activity recorded in the General Ledger.

Account balance

An account balance is the sum of debit entries minus the sum of credit entries in an account. If positive, the difference is called a debit balance; if negative, a credit balance.

Accounting

Accounting is recording and reporting of financial transactions, including the origination of the transaction, its recognition, processing, and summarization in the financial statements.

Accounts Payable

Accounts Payable is an amount owed by the college for delivered goods or completed services. Accounts Payable is a liability. Certain expenses are paid through Accounts Payable, see *What is an Expense* above.

Accounts Receivable

Account Receivable is an amount owed to the college from a completed transaction of sales or services rendered. For example-student account balances. Accounts Receivable is an asset.

Accrual Basis

Accrual basis is a method of accounting that recognizes revenue when earned, rather than when collected and expenses when incurred rather than when paid. The college uses the accrual basis for its accounting.

Amortization

gradual reduction of amounts in an account over time, either assets or liabilities

Asset

An asset is what the college owns. For example- land, property, buildings, equipment, cash in bank accounts, other investments and accounts receivable.

Audit

An audit is a formal examination and official endorsement of the accuracy of the financial statements of the college by an independent certified public accountant (CPA). Based on GAAP and FASB rules the college is required to have an audit performed each fiscal year. Audited financial statements are available on the Controller's Office website at: <http://www.brynmawr.edu/controller/generalaccounting.shtml#audited>.

Balance Sheet

A Balance Sheet is a summary report of the college's assets, liabilities and fund balance (net assets) on a specific date.

Budget

A budget is an estimate of activity for a fiscal year or period. A budget can be created for a department or a project.

Credit

A credit is an entry on the right side of a double-entry accounting system that represents the reduction of an asset or expense or the addition to a liability or revenue.

Cost of Good Sold

Cost of Goods Sold (CGS) is the cost of items purchased for resale. For example-the bookshop purchases textbooks to sell in the bookshop, Un Common Grounds buy rolls that will be used to make sandwiches that will be sold in Un Common Grounds

Capital Stock – found in the equity portion of the balance sheet describing the number of shares sold to shareholders at a predetermined value per share, also called “common stock” or “preferred stock”

Capital Surplus – found in the equity portion of the balance sheet accounting for the amount shareholders paid that is greater or lesser than the “capital stock” amount

Capitalized Expense – expenses that are accumulated, not expensed as incurred, to be amortized over a period of time; i.e. the development cost of a new product

Chart of Accounts - a listing of a company's accounts and their corresponding numbers

Cash-Basis Accounting - a method in which income and expenses are recorded when they are paid.

Cash Flow - a summary of cash received and disbursed showing the beginning and ending amounts

Closing the Books/Year End Closing – the process of reversing the income and expense for a fiscal or calendar year and netting the amount into “retained earnings”

Cost Accounting - a type of accounting that focuses on recording, defining, and reporting costs associated with specific operating functions

.Debit A debit is an entry on the left side of a double-entry accounting system that represents the addition of an asset or expense or the reduction to a liability or revenue.

Double-Entry Accounting

Double-entry accounting is a method of recording financial transactions in which each transaction is entered in two or more accounts and involves two-way, self-balancing posting. Total debits must equal total credits. The college uses this method of accounting.

Expense

An expense is funds paid by the college. For example-paychecks to employees, reimbursements to employees, payments to vendors for goods or services.

FASB

FASB stands for Financial Accounting Standards Board which is an independent, private, non-governmental authority for the establishment of accounting principles in the United States.

Financial Statements

Financial Statements are a series of reports showing a summary view of the various financial activities of the college at a specific point in time. Each statement tells a different story about the financial activity of the college.

Fiscal Year

A fiscal year is a period of 12 consecutive months chosen by an entity as its accounting period which may or may not be a calendar year. The college's fiscal year is June 1st to May 31st.

Fixed Asset

A fixed asset is any tangible item with a useful life of more than one year and a unit cost of \$5,000 or more. For example-campus buildings and major equipment. A fixed asset is an asset.

Fund Balance (net assets)

Fund balance represents the net assets of the college. To arrive at this number take total assets minus total liabilities. Any excess revenue over expenses or cumulative appreciation or depreciation on investments will become a net asset at the end of the fiscal year

General Ledger

The general ledger is the collection of all asset, liability, fund balance (net assets), revenue and expense accounts.

Goodwill – an intangible asset reflecting the value of an entity in excess of its tangible assets

Income Statement - a summary of income and expenses

Inventory – merchandise purchased for resale at a profit

Inventory Valuation – the method to set the book value of unsold inventory: i.e. “LIFO,” last in, first out; “FIFO,” first in, first out; “average,” an average cost over a given period, “last cost,” the cost based on the last purchase; “standard,” a “deemed” amount related to but not tied to a specific purchase, “serialized,” based on a uniquely identifiable serial number or character of each inventory item

Invoice – the original billing from the seller to the buyer, outlining what was purchased and the terms of sale, payment, etc.

Income Statement

An Income Statement is a summary report that shows revenues and expenses over a specific period of time, typically a month, quarter or fiscal year.

Journal Entry

A journal entry is a group of debit and credit transactions that are posted to the general ledger. All journal entries must net to zero so debits must equal credits.

Job Costing - system of tracking costs associated with a job or project (labor, equipment, etc) and comparing with forecasted costs

Liability

A liability is what the college owes. For example-loans, taxes, payables, long term debt from a bond issue, funds held by the college for a third party such as a student group.

Net Income (loss)

Net Income (loss) is the amount the college, a department or a project made or lost for a specific period of time. To arrive at this number take total revenues minus total expenses.

Restricted Fund

A restricted fund is a fund established to account for assets whose income must be used for purposes established by donors or grantors. The college's restricted funds are fund 2, 3, 4, 5, 6, 7 and 9.

Revenue

Revenue is funds collected by the college; it can also be called income. For example-tuition, fees, rentals, income from investments

Subsidiary Ledger

A subsidiary ledger is a group of accounts containing the detail of debit and credit entries. For example-detail information contained in Accounts Payable.

Unrestricted Fund

An unrestricted fund is a fund of the college that has no restrictions as to use or purpose. The college's unrestricted fund is Fund 1.

Chapter 2

Accounting And Its Types

Accounting

Accounting, or **accountancy**, is the measurement, processing and communication of financial information about economic entities. Accounting, which has been called the "language of business", measures the results of an organization's economic activities and conveys this information to a variety of users including investors, creditors, management, and regulators. Practitioners of accounting are known as accountants.

Accounting is a **systematic** way to record transactions. An **account** (in bookkeeping) refers to assets, liabilities, income, expenses, and equity, as represented by individual ledger pages, to which changes in value are chronologically recorded with debit and credit entries. These entries, referred to as postings, become part of a **book of final entry or ledger**. Examples of common financial accounts are cash, accounts receivable, mortgages, loans, PP&E, common stock, sales, services, wages, and payroll.

A chart of accounts provides a listing of all financial accounts used by particular business, organization, or government agency.

The system of recording, verifying, and reporting such information is called accounting. Practitioners of accounting are called accountants.

Accounting can be divided into several fields including financial accounting, management accounting, auditing, and tax accounting. Financial accounting focuses on the reporting of an organization's financial information, including the preparation of financial statements, to external users of the information, such as investors, regulators and suppliers; and management accounting focuses on the measurement, analysis and reporting of information for internal use by management. The recording of financial transactions, so that summaries of the financials may be presented in financial reports, is known as bookkeeping, of which double-entry bookkeeping is the most common system.

Accounting is facilitated by accounting organizations such as standard-setters, accounting firms and professional bodies. Financial statements are usually audited by accounting firms, and are prepared in accordance with generally accepted accounting principles(GAAP). GAAP is set by various standard-setting organizations such as the Financial Accounting Standards Board (FASB) in the United States and the Financial Reporting Council in the United Kingdom.^[10] As of 2012, "all major economies" have plans to convergetowards or adopt the International Financial Reporting Standards (IFRS).

Etymology

Both the words accounting and accountancy were in use in Great Britain by the mid-1800s, and are derived from the words **accompting** and **accountantship** used in the 18th century In Middle English (used roughly between the 12th and the late 15th century) the verb "to account" had the form **accounten**, which was derived from the Old French word **aconter**, which is in turn related to the Vulgar Latin word **computare**, meaning "to reckon". The base of **computare** is **putare**, which "variously meant to prune, to purify, to correct an account, hence, to count or calculate, as well as to think.

The word "accountant" is derived from the French word **compter**, which is also derived from the Latin word **computare**. The word was formerly written in English as "accomptant", but in process of time the word, which was always pronounced by dropping the "p", became gradually changed both in pronunciation and in orthography to its present form.

Accounting and accountancy

Accounting has variously been defined as the keeping or preparation of the financial records of an entity, the analysis, verification and reporting of such records and "the principles and procedures of accounting"; it also refers to the job of being an accountant.

Accountancy refers to the occupation or profession of an accountant, particularly in

The history of accounting is thousands of years old and can be traced to ancient civilisations. The early development of accounting dates back to ancient Mesopotamia, and is closely related to developments in writing, counting and money; there is also evidence for early forms of bookkeeping in ancient Iran, and early auditing systems by the ancient Egyptians and Babylonians. By the time of the Emperor Augustus, the Roman government had access to detailed financial information.

Double-entry bookkeeping developed in medieval Europe, and accounting split into financial accounting and management accounting with the development of joint-stock companies. Accounting began to transition into an organized profession in the nineteenth century with local professional bodies in England merging to form the Institute of Chartered Accountants in England and Wales in 1880.

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Types of Accounting

Accounting is a vast and dynamic profession and is constantly adapting itself to the specific and varying needs of its users. Over the past few decades, accountancy has branched out into different types of accounting to cater for the diversity of needs of its users.

1. Financial
2. Management
3. Governmental
4. Tax
5. Forensic
6. Project
7. Social

1. **Financial Accounting**, or financial reporting, is the process of producing information for external use usually in the form of financial statements. Financial Statements reflect an entity's past performance and current position based on a set of standards and guidelines known as GAAP (Generally Accepted Accounting Principles). GAAP refers to the standard framework of guideline for financial accounting used in any given jurisdiction. This generally includes accounting standards (e.g. International Financial Reporting Standards), accounting conventions, and rules and regulations that accountants must follow in the preparation of the financial statements.

Financial accounting focuses on the reporting of an organization's financial information to external users of the information, such as investors, regulators and suppliers. It measures and records business transactions and prepares financial statements for the external users in accordance with generally accepted accounting principles (GAAP). GAAP, in turn, arises from the wide agreement between accounting theory and practice, and change over time to meet the needs of decision-makers.

Financial accounting produces past-oriented reports—for example the financial statements prepared in 2006 reports on performance in 2005—on an annual or quarterly basis, generally about the organization as a whole.

2. Management Accounting produces information primarily for internal use by the company's management. The information produced is generally more detailed than that produced for

external use to enable effective organization control and the fulfillment of the strategic aims and objectives of the entity. Information may be in the form budgets and forecasts, enabling an enterprise to plan effectively for its future or may include an assessment based on its past performance and results. The form and content of any report produced in the process is purely upon management's discretion.

Cost accounting is a branch of management accounting and involves the application of various techniques to monitor and control costs. Its application is more suited to manufacturing concerns. Management accounting focuses on the measurement, analysis and reporting of information that can help managers in making decisions to fulfil the goals of an organization. In management accounting, internal measures and reports are based on cost-benefit analysis, and are not required to follow GAAP.

Management accounting produces future-oriented reports—for example the budget for 2006 is prepared in 2005—and the time span of reports varies widely. Such reports may include both financial and nonfinancial information, and may, for example, focus on specific products and departments.

3. Governmental Accounting, also known as *public accounting or federal accounting*, refers to the type of accounting information system used in the public sector. This is a slight deviation from the financial accounting system used in the private sector. The need to have a separate accounting system for the public sector arises because of the different aims and objectives of the state owned and privately owned institutions. Governmental accounting ensures the financial position and performance of the public sector institutions are set in budgetary context since financial constraints are often a major concern of many governments. Separate rules are followed in many jurisdictions to account for the transactions and events of public entities.

4. Tax Accounting refers to accounting for the tax related matters. It is governed by the tax rules prescribed by the tax laws of a jurisdiction. Often these rules are different from the rules that govern the preparation of financial statements for public use (i.e. GAAP). Tax accountants therefore adjust the financial statements prepared under financial accounting principles to account for the differences with rules prescribed by the tax laws. Information is then used by tax professionals to estimate tax liability of a company and for tax planning purposes.

5. Forensic Accounting is the use of accounting, auditing and investigative techniques in cases of litigation or disputes. Forensic accountants act as expert witnesses in courts of law in civil and criminal disputes that require an assessment of the financial effects of a loss or the detection of a financial fraud. Common litigations where forensic accountants are hired include insurance claims, personal injury claims, suspected fraud and claims of professional negligence in a financial matter (e.g. business valuation).

6. Project Accounting refers to the use of accounting system to track the financial progress of a project through frequent financial reports. Project accounting is a vital component of project management. It is a specialized branch of management accounting with a prime focus on ensuring the financial success of company projects such as the launch of a new product. Project accounting can be a source of competitive advantage for project-oriented businesses such as construction firms.

7. Social Accounting, also known as Corporate Social Responsibility Reporting and Sustainability Accounting, refers to the process of reporting implications of an organization's activities on its ecological and social environment. Social Accounting is primarily reported in the form of Environmental Reports accompanying the annual reports of companies. Social Accounting is still in the early stages of development and is considered to be a response to the growing environmental consciousness amongst the public at large

Types of accounts

Based on nature

An account may be classified as real, personal or as a nominal account

Type	Represent	Examples
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Real	Physically tangible things in the real world and certain intangible things not having any physical existence	Tangibles - Plant and Machinery, Furniture and Fixtures, Computers and Information Processing Equipment etc. Intangibles - Goodwill, Patents and Copyrights, Cash Accounts
Personal	Business and Legal Entities, Bank Accounts	Individuals, Partnership Firms, Corporate entities, Non-Profit Organizations, any local or statutory bodies including governments at country, state or local levels
Nominal	Temporary Income and Expenditure Accounts for recognition of the implications of the financial transactions during each fiscal year till finalisation of accounts at the end	Sales, Purchases, Electricity Charges

Example: A sales account is opened for recording the sales of goods or services and at the end of the financial period the total sales are transferred to the revenue statement account (Profit and Loss Account or Income and Expenditure Account).

Similarly expenses during the financial period are recorded using the respective Expense accounts, which are also transferred to the revenue statement account. The net positive or negative balance (profit or loss) of the revenue statement account is transferred to reserves or capital account as the case may be.

Based on periodicity of flow

The classification of accounts into real, personal and nominal is based on their nature i.e. physical asset, liability, juristic entity or financial transaction.

The further classification of accounts is based on the periodicity of their inflows or outflows in the context of the fiscal year.

Income is immediate inflow during the fiscal year.

Expense is the immediate outflow during the fiscal year.

An asset is a long-term inflow with implications extending beyond the financial period and by the traditional view could represent unclaimed income. Alternatively, an asset could be valued at the present value of its future inflows.

Liability is long term outflow with implications extending beyond the financial period and by the traditional view could represent unamortised expense. Alternatively, a liability could be valued at the present value of future outflows.

Type of accounts	Long term inflows	Long term outflows	Short term inflows	Short term outflows
Real accounts	Assets			
Personal accounts	Assets	Liability		

Nominal accounts			Incomes	Expenses
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Items in accounts are classified into five broad groups, also known as the elements of the accounts: Asset, Liability, Equity, Revenue, Expense.

The classification of Equity as a distinctive element for classification of accounts is disputable on account of the "Entity concept", since for the objective analysis of the financial results of any entity the external liabilities of the entity should not be distinguished from any contribution by the shareholders.

Chapter 3

Basic Concepts In Accounting - The Balance Sheet

Some Basic Concepts

The Money Measurement Concept

An accounting record is made only of information that can be expressed in monetary terms. It does not reflect how strong the management is, the staff relationship or the reputation of the organization. However, in a public listed company, such information will be reflected in its profit and loss conditions and subsequently in its share value. The major disadvantage of this concept is its historical nature. The value appeared in an accounting record is the value recorded at the time when it is incurred. The value has no clear indication of its purchasing power at the time when one is using the information.

The Entity Concept

Accounts are kept for entities as distinguished from the persons who are associated with these entities. When a person puts \$2M into his business, the "business" owes the person \$2M. This concept extends to units within an organization. The head quarter is one entity and a service centre is another. When money is transferred from the head quarter to the service unit, the accountant would have to "credit" the head quarter and "debit" the service unit. This concept is fundamental in "debits" and "credits" which many beginning accountants sometimes find difficult. For example, your organization has 4 separate bank accounts. In the accounting books, you have a "cash account" and 4 "bank accounts". When you put \$1,000 into bank A from your cash box, you credit the "cash account" and debit the account of Bank A. Bank A "owes" \$1,000 to the cash account \$1,000, not to you.

The Going-concern Concept

Unless there is good evidence to the contrary, account assumes that an entity will continue to operate for an indefinitely long period in the future. In other words, we do not assume that the entity is going to be liquidated within a short period of time or will be bought out by another enterprise. For example, the assets in the balance sheet do not reflect their "realizable" value. It simply reflects the remainder of cost minus depreciation as far as the law permits. For showing a better profit and loss statement to a potential investor, the business would prefer a slower rate of depreciation. That is why in the beginning years of a business they may prefer to use a longer depreciation period and for business making profits they would like to increase the rate of depreciation. For many non-profit organizations, these are not much of their concern and thus they depreciate their assets to a value of \$1 in the same year of purchase, just to keep them in the books.

The cost concept

The value of assets is recorded as the acquisition cost. The market value, current worth or replacement cost is not recorded. Sometimes, in accounting reports, we find the item "Good will" which reflects the value of an intangible and valuable economic resource purchased by the enterprise. Sometimes, people think that "good will" is the accountant's appraisal of what the company's name and reputation worth.

The Dual-aspect concept

Similar to the accounting practice of double-entry system (debit one account and credit another account at the same time), an asset is always coupled with an equity.

Assets are economic resources controlled by an entity whose cost at the time of acquisition could be objectively measured.

Equities:

owner's equity or capital (Some people choose to classify this as a form of liability)

Liabilities - the claims of creditors.

Assets = Equities (or Assets = Liabilities)

The Conservatism Concept

It states that when accountants have a reasonable choice as to how a given event should be recorded, they ordinarily choose the alternative which results in a lower, rather than higher, asset amount.

The Balance Sheet

Current Assets (cash, marketable securities/unit funds/accounts receivable/inventory/ prepaid expenses, etc.)

They include cash and other assets that are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business or within one year.

Accounts receivable normally refers to amounts owed to the entity by its customers/clients. An amount owed to the entity other than a customer/client would appear under the heading of other receivables. If the amount owed is evidenced by a written promise to pay, it is listed as notes receivable. Sometimes, there will be provisions called "allowance for doubtful debts accounts".

Non-recurrent/Fixed Assets

These items mainly include land or building property and equipment. The acquisition cost and the accumulated depreciation are usually included in the balance sheet.

Current Liabilities (accounts payable, notes payable, bank drafts payable, estimated tax liability, accrued expenses payable, deferred income, bonds payable, etc.)

Current liabilities are obligations that are expected to be satisfied either by the use of current assets or by the creation of other current liabilities.

Accounts payable are the claims of suppliers related to goods or services they have furnished to the entity for which they have not yet been paid.

Accrued expenses payable are the converse of prepaid expenses which should be paid and not yet paid.

Deferred income represents the liability that arises because the entity has received advance payment for a service it has agreed to render in the future.

Non-current liabilities/other liabilities/long-term debt - Payment due in some future period beyond the next year.

Equity (Owner's equity, Retained Earnings)

Some organizations use "surplus" instead of retained earnings in the balance sheet.

Basic Accounting ALL accounting transactions are entered as journal entries consisting of the Account name, and either a debit (left side) amount or credit (right side) amount. For each entry the debits and credits must balance, and overall on the trial balance (lists all the debits and credits for all the accounts) must always balance.

- **There are 5 main classes of Accounts**
 - **Assets:** Anything of value that the business owns. This includes tangible assets such as cash, accounts receivable, inventory, buildings, and machinery, as well as intangible assets such as copyrights, trademarks, and goodwill. Asset accounts normally have a Debit (left side) balance. In transaction entries, a debit to an asset account shows an increase in its amount, while a credit (right side) indicates a decrease in the asset value.
 - Example: Buying Equipment for Cash. One asset (Equipment) increases, and therefore it is Debited. Cash, which is also an asset, is decreased with a Credit.

Equipment (debit)	\$40,000
Cash (credit)	\$40,000

- **Liabilities:** Debts and obligations that the business owes. This includes accounts payable, payroll liabilities, and long term debts (such as bonds). Liabilities accounts normally have a Credit (right side) balance. In transaction entries, a credit to a liability account signifies an increase in its amount, while a debit (left side) indicates a decrease in the liability value.
 - Example: Buying Inventory on credit. Merchandise Inventory (an asset) increases with a debit, and Accounts Payable (a liability) also increases with a credit.

Merchandise Inventory (debit)	\$100,000
Accounts Payable (credit)	\$100,000

- **Equity:** This is essentially the value that accrues (accumulates) to the owners (shareholders, sole trader...). This ranges from Partner 1's capital, Partner 1's profits, retained earnings, etc. Equity accounts normally have a Credit (right side) balance. In transaction entries in the journals, a credit to an equity account signifies an increase in its amount, while a debit (left side) indicates a decrease in the equity value. Always keep the accounting equation in mind:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

Since Assets normally have a Debit balance and both liabilities & equity normally have a credit balance, therefore applying the equation above, we always check that the trial balance has a NET value of Zero (the total debits and credits should match).

- **Revenue:** This is the entire amount of income made through the sale of goods/services, and is sometimes referred to as Income or Sales. Depending on the nature of the goods / services being sold, companies track this account either as one big account (e.g. Sales) or as many separate accounts (e.g. Sales Prod 1, Sales Prod 2, Freight Income etc.). Revenue accounts normally have a Credit (right side) balance, and therefore a credit to a revenue account signifies an increase in its amount, while a debit (left side) indicates a decrease in the revenue amount. A decrease of revenue would take place in circumstances such as for example sales returns and discounts (explained further down).
 - Example: Recording cash sales. Cash is debited because it is an increase in an asset account, and Sales is credited because a Revenue account is increased.

Cash (debit)	\$112,000
Sales (credit)	\$112,000

- **Expenses:** These are the general costs of doing business. This would include operating expenses such as Salaries Expense, Rent Expense, and Advertising Expense, as well as non-operating expenses such as Loss on Sale of Assets. Expense accounts normally have a Debit (left side) balance. In transaction entries, a debit to an expense account signifies an increase in its amount, while a credit indicates a decrease (which rarely occurs, unless an error needs to be corrected).
 - Example: The company rents office space at \$15,000 per month. Rent Expense is debited, and Cash is credited.

Rent Expense (debit)	\$15,000
Cash (credit)	\$15,000

- Some very important aspects to remember in addition to the above:
 - **Depreciation, Amortization, and Depletion** are used to allocate the cost of an asset over its useful life. Depreciation is the allocation over time of tangible assets, Amortization is the allocation over time of intangible assets and Depletion is the

allocation over time of natural resources. **Accumulated depreciation** is a contra-asset account (with a normal Credit balance) used to keep a running total of the depreciation to date. The book value of any asset at any time is the Original Cost less any accumulated depreciation. Contra-asset accounts are listed in the assets section of the balance sheet along with the corresponding asset account, making it easier to see what the assets original cost was and what it is presently valued at. Allowance for Uncollectible Accounts Receivable is also a contra-asset account with a normal credit balance which is netted against the Accounts Receivable account.

- **Sales Returns and Allowances & Sales Discounts** are **contra-revenue accounts**, and the normal balance of this account is a Debit. These are used to offset the revenue credit balance.
- **Cost of Goods Sold (COGS)**: This account is used to track how much you paid for goods / material that was held in inventory until it was sold. COGS normally is a debit balance. This account is recorded in entries when a sale is made, and COGS is debited for the cost, while inventory is credited (asset account=>decreased) for the cost.

Credit Notes/memo/refunds are used to refund customers if they return products bought from the company. The entry for this transaction is usually :

Revenue (Debit)	sale price
Inventory (Debit)	Cost of product
COGS (Credit)	Cost of product
Cash or A/R (Credit)	sale price

- a summary :

assets (current asset (cash in bank + accounts receivables - allowance for bad debts) + (non-current asset - accumulated depreciation))
 = liability (current liability + non-current liability)
 + equity (capital + (issued share equity + retained earnings)

+ change in equity (income (revenue + gains) - expenses (operating + depreciation + bad debt) - drawings)

Chapter 4

Accounting Rules and Principles

Accounting is the mechanism used to record activities and transactions that occur within a business.. In its simplest terms, Accounting is the "language of business." However, in order to have an understandable record, a standard set of rules for accounting within the U.S. has been established. These rules are called the **Generally Accepted Accounting Principles (GAAP)**, and all U.S. businesses are expected to follow them.

The **first general rule** of accounting is that every transaction is recorded. It has been said that businesses that do not record transactions, or incorrectly record transactions, are committing fraud, although this is not necessarily the case. Fraud is part of a much broader area called material misstatement which also can include error. An error is not necessarily fraud under the law. While there are exceptions to this rule, the guidance for applying those exceptions is specifically defined by GAAP, and is applicable to all businesses.

The **second general rule** of accounting is that transactions are recorded using what is called a "double-entry" accounting method. Originally developed in Italy in the 1400s, double-entry means that for a complete record of a transaction, two entries are made. **For example, if you have \$5 in cash, and want to buy some gasoline for your lawn mower, you take your portable gas can and your money to the gas station and exchange \$5 in cash for \$5 in gas. This transaction is recorded as an increase in the asset "gas" for \$5 and a corresponding reduction in the asset "cash" for \$5. In this example, one transaction contained two entries.** This takes a little time to get used to, but it is a critical concept in basic accounting. Double entry is tied to the concept of Debits and Credits, which you will learn about in the next section. The act of recording transactions is commonly referred to as making journal entries. In a few more paragraphs, we'll discuss what a journal entry looks like.

The **third general rule** of accounting is that every recorded transaction is captured in a log called the "General Journal."

In general, "Accounting is the art of recording, classifying, summarizing and interpreting a business transaction."

To make this easier, we can follow the golden rules of accounting. Accounts are one of three basic types:

Type	Represent	Examples
Personal	Accounts related to <i>individuals, firms, organizations, or companies</i>	Individuals; partnership firms; corporate entities; Capital; Drawings; non-profit organizations; any local or statutory bodies including governments at the country, state or local levels
Real	Accounts related to <i>assets of a tangible or intangible nature</i>	<ul style="list-style-type: none"> • Tangibles - Plants and machinery, furniture and fixtures, computers and information processing equipment • Intangibles - Goodwill, patents, copyrights, trademarks, purchase
Nominal	Temporary income and expenditure accounts for <i>recognition of the implications of financial transactions during each fiscal term till finalization of accounts at term end</i>	rent, salary, discount, utilities, dividends

Example: The *Sales* account is opened for recording the sales of goods or services. At the end of the financial period, the total sales are transferred to the revenue statement account (*Profit and Loss Account* or *Income and Expenditure Account*).

Similarly, expenses during the financial period are recorded using the respective *Expense* accounts, which are also transferred to the revenue statement account. The

net positive or negative balance (profit or loss) of the revenue statement account is transferred to reserves or capital account as the case may be.

THE GOLDEN RULES OF ACCOUNTING:

Type	Debit	Credit
Personal	The receiver	The giver
Real	What comes in	What goes out
Nominal	All expenses and losses	All income and gains (profits)

The Nature of Accounts: Definitions

An '**account**' is a specific location for recording transactions of a like kind. For example, in the gas-for-cash transaction above, two accounts are used, a "Cash" account and a "Gas" account. Unused by that example, but described is an account for "Equipment" which would include the portable gas can and the lawn mower.

The basic types of accounts are:

'**Assets:**' items of value that the company owns or has right to. Examples include: cash, real estate, equipment, money or services that others owe you, and even intangible items such as patents and copyrights.

'Liabilities:' obligations that are owed to other parties. Examples include: wages payable, taxes due, and borrowed money (also called debt).

'Equity:' the ownership value of a company. Examples include: common stock and retained earnings (we'll describe retained earnings below in "Financial Statements")

'Revenues:' the mechanisms where income enters the company (note that revenue and income are not the same thing--they are used here to describe each other in basic terms only).

'Expenses:' the costs of doing business. Examples include: salary expense, rent, utilities expense, and interest on borrowed money.

'Income:' in U.S. business and financial accounting, the term 'income' is also synonymous with revenue; however, many people use it as shorthand for net income, which is the amount of money that a company earns after covering all of its costs.

Basic Accounting Principles

Historical Cost Principle: Assets and liabilities should be recorded at the price at which they were acquired. This is to ensure a reliable price; market values can fluctuate and be different between differing opinions, so the price of acquisition is used.

Matching Principle: Expenses should be matched with revenues. The expense is recorded in the time period it is incurred, which means the time period that the expense is used to generate revenue. This means that you can pay for an expense months before it is actually recorded, as the expense is matched to the period the revenue is made.

Revenue Recognition Principle: Revenues should not be recorded until the earnings process is almost complete and there is little uncertainty as to whether or not collection of payment will occur. This means that revenue is recorded when it is earned, which means the job is complete.

Basic Accounting Principles and Guidelines

Since GAAP is founded on the basic accounting principles and guidelines, we can better understand GAAP if we understand those accounting principles. The following is a list of the ten main accounting principles and guidelines together with a highly condensed explanation of each.

1. Economic Entity Assumption

The accountant keeps all of the *business* transactions of a sole proprietorship separate from the business owner's *personal* transactions. For *legal* purposes, a sole proprietorship and its owner are considered to be one entity, but for accounting purposes they are considered to be two separate entities.

2. Monetary Unit Assumption

Economic activity is measured in U.S. dollars, and only transactions that can be expressed in U.S. dollars are recorded.

Because of this basic accounting principle, it is assumed that the dollar's purchasing power has not changed over time. As a result accountants ignore the effect of inflation on recorded amounts. For example, dollars from a 1960 transaction are combined (or shown) with dollars from a 2013 transaction.

3. Time Period Assumption

This accounting principle assumes that it is possible to report the complex and ongoing activities of a business in relatively short, distinct time intervals such as the five months ended May 31, 2013, or the 5 weeks ended May 1, 2013. The shorter the time interval, the more likely the need for the accountant to estimate amounts relevant to that period. For example, the property tax bill is received on December 15 of each year. On the income statement for the year ended December 31, 2012, the amount is known; but for the income statement for the three months ended March 31, 2013, the amount was not known and an estimate had to be used.

It is **imperative** that the time interval (or period of time) be shown in the heading of each income statement, statement of stockholders' equity, and statement of cash flows. Labeling one of these **financial statements** with "December 31" is not good enough—the reader needs to know if the

statement covers the *one week* ended December 31, 2012 the **month** ended December 31, 2012 **the three months** ended December 31, 2012 or the **year ended** December 31, 2012.

4. Cost Principle

From an accountant's point of view, the term "cost" refers to the amount spent (cash or the cash equivalent) when an item was **originally** obtained, whether that purchase happened last year or thirty years ago. For this reason, the amounts shown on financial statements are referred to as *historical* cost amounts.

Because of this accounting principle asset amounts are *not* adjusted upward for inflation. In fact, as a general rule, asset amounts are not adjusted to reflect *any* type of increase in value. Hence, an asset amount does not reflect the amount of money a company would receive if it were to sell the asset at today's market value. (An exception is certain investments in stocks and bonds that are actively traded on a stock exchange.) If you want to know the current value of a company's long-term assets, you will not get this information from a company's financial statements—you need to look elsewhere, perhaps to a third-party appraiser.

5. Full Disclosure Principle

If certain information is important to an investor or lender using the financial statements, that information should be disclosed within the statement or in the notes to the statement. It is because of this basic accounting principle that numerous pages of "footnotes" are often attached to financial statements.

As an example, let's say a company is named in a lawsuit that demands a significant amount of money. When the financial statements are prepared it is not clear whether the company will be able to defend itself or whether it might lose the lawsuit. As a result of these conditions and because of the full disclosure principle the lawsuit will be described in the notes to the financial statements.

A company usually lists its significant accounting policies as the first note to its financial statements.

6. Going Concern Principle

This accounting principle assumes that a company will continue to exist long enough to carry out

its objectives and commitments and will not liquidate in the foreseeable future. If the company's financial situation is such that the accountant believes the company will *not* be able to continue on, the accountant is required to disclose this assessment.

The going concern principle allows the company to defer some of its prepaid expenses until future accounting periods.

7. Matching Principle

This accounting principle requires companies to use the **accrual basis of accounting**. The matching principle requires that expenses be matched with revenues. For example, sales commission's expense should be reported in the period when the sales were made (and not reported in the period when the commissions were paid). Wages to employees are reported as an expense in the week when the employees worked and not in the week when the employees are paid. If a company agrees to give its employees 1% of its 2013 revenues as a bonus on January 15, 2014, the company should report the bonus as an expense in 2013 and the amount unpaid at December 31, 2013 as a liability. (The expense is occurring as the sales are occurring.)

Because we cannot measure the future economic benefit of things such as advertisements (and thereby we cannot match the ad expense with related future revenues), the accountant charges the ad amount to expense in the period that the ad is run.

8. Revenue Recognition Principle

Under the accrual basis of accounting (as opposed to the **cash basis of accounting**), **revenues** are recognized as soon as a product has been sold or a service has been performed, regardless of when the money is actually received. Under this basic accounting principle, a company could earn and report \$20,000 of revenue in its first month of operation but receive \$0 in actual cash in that month.

For example, if ABC Consulting completes its service at an agreed price of \$1,000, ABC should recognize \$1,000 of revenue as soon as its work is done—it does not matter whether the client pays the \$1,000 immediately or in 30 days. Do not confuse **revenue** with a **cash receipt**.

9. Materiality

Because of this basic accounting principle or guideline, an accountant might be allowed to violate another accounting principle if an amount is insignificant. Professional judgement is needed to decide whether an amount is insignificant or immaterial.

An example of an obviously immaterial item is the purchase of a \$150 printer by a highly profitable multi-million dollar company. Because the printer will be used for five years, the *matching* principle directs the accountant to expense the cost over the five-year period.

The **materiality** guideline allows this company to violate the matching principle and to expense the entire cost of \$150 in the year it is purchased. The justification is that no one would consider it misleading if \$150 is expensed in the first year instead of \$30 being expensed in each of the five years that it is used.

Because of materiality, financial statements usually show amounts rounded to the nearest dollar, to the nearest thousand, or to the nearest million dollars depending on the size of the company.

10. Conservatism

If a situation arises where there are two acceptable alternatives for reporting an item, conservatism directs the accountant to choose the alternative that will result in less net income and/or less asset amount. Conservatism helps the accountant to "break a tie." It does not direct accountants to be conservative. Accountants are expected to be unbiased and objective.

The basic accounting principle of conservatism leads accountants to anticipate or disclose losses, but it does not allow a similar action for gains. For example, *potential* losses from lawsuits will be reported on the financial statements or in the notes, but *potential* gains will not be reported.

Also, an accountant may write inventory *down* to an amount that is lower than the original cost, but will not write inventory *up* to an amount higher than the original cost.

Chapter 5

Journal, Ledger And Trail Balance

Journal

The term "journal" is also used in business:

- A journal is a book or computer file in which monetary transactions are entered the first time they are processed. This journal lists transactions in chronological sequence by date prior to a transfer of the same transactions to a ledger in the procThe following example illustrates how to record journal entries:**Example**
- Company A was incorporated on January 1, 2010 with an initial capital of 5,000 shares of common stock having \$20 par value. During the first month of its operations, the company engaged in following transactions:

Date	Transaction
Jan 2	An amount of \$36,000 was paid as advance rent for three months.
Jan 3	Paid \$60,000 cash on the purchase of equipment costing \$80,000. The remaining amount was recognized as a one year note payable with interest rate of 9%.
Jan 4	Purchased office supplies costing \$17,600 on account.
Jan 13	Provided services to its customers and received \$28,500 in cash.
Jan 13	Paid the accounts payable on the office supplies purchased on January 4.
Jan 14	Paid wages to its employees for first two weeks of January, aggregating \$19,100.
Jan 18	Provided \$54,100 worth of services to its customers. They paid \$32,900 and promised to pay the remaining amount.
Jan 23	Received \$15,300 from customers for the services provided on January 18.
Jan 25	Received \$4,000 as an advance payment from customers.
Jan 26	Purchased office supplies costing \$5,200 on account.
Jan 28	Paid wages to its employees for the third and fourth week of January: \$19,100.
Jan 31	Paid \$5,000 as dividends.
Jan 31	Received electricity bill of \$2,470.
Jan 31	Received telephone bill of \$1,494.

Jan 31 Miscellaneous expenses paid during the month totaled \$3,470

The following table shows the journal entries for the above events.

	Account	Debit	Credit
Jan 1	Cash	100,000	
	Common Stock		100,000
Jan 2	Prepaid Rent	36,000	
	Cash		36,000
Jan 3	Equipment	80,000	
	Cash		60,000
	Notes Payable		20,000
Jan 4	Office Supplies	17,600	
	Accounts Payable		17,600
Jan 13	Cash	28,500	
	Service Revenue		28,500
Jan 13	Accounts Payable	17,600	
	Cash		17,600
Jan 14	Wages Expense	19,100	
	Cash		19,100
Jan 18	Cash	32,900	
	Accounts Receivable	21,200	
	Service Revenue		54,100
Jan 23	Cash	15,300	
	Accounts Receivable		15,300
Jan 25	Cash	4,000	
	Unearned Revenue		4,000
Jan 26	Office Supplies	5,200	
	Accounts Payable		5,200
Jan 28	Wages Expense	19,100	
	Cash		19,100

Jan 31	Dividends	5,000	
	Cash		5,000
Jan 31	Electricity Expense	2,470	
	Utilities Payable		2,470
Jan 31	Telephone Expense	1,494	
	Utilities Payable		1,494
Jan 31	Miscellaneous Expense	3,470	
	Cash		3,470

- At the end of the period, all the journal for the period are posted to the ledger accounts.

Ledger

A **ledger** is the principal book or computer file for recording and totaling monetary transactions by account, with debits and credits in separate columns and a beginning balance and ending balance for each account.

Overview

The ledger is a permanent summary of all amounts entered in supporting journals which list individual transactions by date. Every transaction flows from a journal to one or more ledgers. A company's financial statements are generated from summary totals in the ledgers.^[2]

Ledgers include:

- Sales ledger, records accounts receivable. This ledger consists of the financial transactions made by customers to the company.
- Purchase ledger records money spent for purchasing by the company.
- General ledger representing the 5 main account types: assets, liabilities, income, expenses, and equity.

For every debit recorded in a ledger, there must be a corresponding credit so that the debits equal the credits in the grand totals.

Ledger Posting

Ledger posting is the method of transferring the credit and debit entries from the journal entries to the ledger. In the ledger a separate account is opened in every account. All the credit and debit entries are accordingly entered or recorded. Finally, the accounts are correctly balanced. That is, the total of all debit entries are adjusted against the total of all the credit entries and the balance is carried forward to the coming fiscal year. In case of real accounts and personal accounts the balances in the **nominal account** are moved to the profit and loss and trading account.

Example

The ledger accounts shown below are derived from the journal entries of Company A.

Asset Accounts

Cash		Accounts Receivable	
\$100,000	\$36,000	\$21,200	\$15,300
28,500	60,000		
32,900	17,600		
15,300	19,100		
4,000	19,100		
	5,000		
	3,470		
\$20,430		\$5,900	
Office Supplies		Prepaid Rent	
\$17,600		\$36,000	

5,200	
\$22,800	

\$36,000	

Equipment

\$80,000	
\$80,000	

Liability Accounts

Accounts Payable

\$17,600	\$17,600
	5,200
	\$5,200

Utilities Payable

	\$2,470
	1,494
	\$3,964

Notes Payable

	\$20,000
	\$20,000

Unearned Revenue

	\$4,000
	\$4,000

Equity Accounts

Common Stock

	\$100,000
	\$100,000

Revenue, Dividend and Expense Accounts

Service Revenue

	\$28,500
	54,100
	\$82,600

Wages Expense

\$19,100	
19,100	
\$38,200	

Electricity Expense

\$2,470	
\$2,470	

Dividend

\$5,000	
\$5,000	

Miscellaneous Expense

\$3,470	
\$3,470	

Telephone Expense

\$1,494	
\$1,494	

The ledger accounts step of accounting cycle completes here. The next step is the preparation of unadjusted trial balance.

A **trial balance** is a list of all the General ledger accounts (both revenue and capital) contained in the ledger of a business. This list will contain the name of the nominal ledger account and the value of that nominal ledger account. The value of the nominal ledger will hold either a debit

balance value or a credit balance value. The debit balance values will be listed in the debit column of the trial balance and the credit value balance will be listed in the credit column. The profit and loss statement and balance sheet and other financial reports can then be produced using the ledger accounts listed on the trial balance.

The name comes from the purpose of a trial balance which is to prove that the value of all the debit value balances equal the total of all the credit value balances.

The trial balance is usually prepared by a bookkeeper or accountant who has used daybooks to record financial transactions and then post them to the nominal ledgers and personal ledger accounts. The trial balance is a part of the bookkeeping system and uses the classic 'T' account format for presenting values.

Trial balance limitations

A trial balance only checks the sum of debits against the sum of credits. That is why it does not guarantee that there are no errors. The following are the main classes of errors that are not detected by the trial balance.

- An **error of original entry** is when both sides of a transaction include the wrong amount.^[1] For example, if a purchase invoice for £21 is entered as £12, this will result in an incorrect debit entry (to purchases), and an incorrect credit entry (to the relevant creditor account), both for £9 less, so the total of both columns will be £9 less, and will thus balance.
- An **error of omission** is when a transaction is completely omitted from the accounting records.^[1] As the debits and credits for the transaction would balance, omitting it would still leave the totals balanced. A variation of this error is omitting one of the ledger account totals from the trial balance.
- An **error of reversal** is when entries are made to the correct amount, but with debits instead of credits, and vice versa. For example, if a cash sale for £100 is debited to the Sales account, and credited to the Cash account. Such an error will not affect the totals.
- An **error of commission** is when the entries are made at the correct amount, and the appropriate side (debit or credit), but one or more entries are made to the wrong account of the correct type. For example, if fuel costs are incorrectly debited to the postage account (both expense accounts). This will not affect the totals.

- An **error of principle** is when the entries are made to the correct amount, and the appropriate side (debit or credit), as with an error of commission, but the **wrong** type of account is used. For example, if fuel costs (an expense account), are debited to stock (an asset account). This will not affect the totals.
- **Compensating errors** are multiple unrelated errors that would individually lead to an imbalance, but together cancel each other out.
- A **Transposition Error** is an error caused by switching the position of two adjacent digits. Since the resulting error is always divisible by 9, accountants use this fact to locate the misentered number. For example, a total is off by 72, dividing it by 9 gives 8 which indicates that one of the switched digits is either more, or less, by 8 than the other digit. Hence the error was caused by switching the digits 8 and 0 or 1 and 9. This will also not affect the totals.

Chapter 6

Bank Reconciliation

Bank **reconciliation** is a process that explains the difference between the bank balance shown in an organization's bank statement, as supplied by the bank, and the corresponding amount shown in the organization's own accounting records at a particular point in time.

Such differences may occur, for example, because a cheque or a list of cheques issued by the organization has not been presented to the bank, a banking transaction, such as a credit received, or a charge made by the bank, has not yet been recorded in the organization's books, or either the bank or the organization itself has made an error.

It may be easy to reconcile the difference by looking at very recent transactions in either the bank statement or the organization's own accounting records (cash book) and seeing if some combination of them tallies with the difference to be explained. Otherwise it may be necessary to go through and match every single transaction in both sets of records since the last reconciliation, and see what transactions remain unmatched. The necessary adjustments should then be made in the cash book, or any timing differences recorded to assist with future reconciliations.

For this reason, and to minimize the amount of work involved, it is good practice to carry out such reconciliations at reasonably frequent intervals. Reconciliations are generally performed by specialized accounting software though the understanding of what occurs is important for a successful reconciliation. Also, **Bank reconciliation statement** is a statement prepared on a particular day to reconcile the bank balance as per Cash book or Bank statement showing entries causing difference between the two balances.

Example

The following is a worked example of a bank reconciliation problem. To understand this example fully, you should have a good knowledge of general accounting principles.

Question

The following was obtained from the records of ABC Computers of 30 September 2009

Bank reconciliation statement on 31 August 2009 (Previous month)

		£	£
Balance as per bank statement			12200
Outstanding deposit:			2100
Total			14300
Outstanding cheques:	No: 100	2200	
	No: 107	740	
	No: 109	540	(3480)
Total			10820 (Opening balance for cash book)

Cash Book for September 2009						
Date	Details	Amount (£)	Cheque	Date	Details	Amount (£)
3	Sales and VAT	3700	110	3	Water and Electricity	

4	A Jones	2400			and VAT	400
10	Deposit	3100	111	4	S Payne	21100
15	Sales and VAT	850	112	9	J Kooste	350
30	Deposit	1670	113	10	Purchases and VAT	2700
			114	12	Salaries	4200
			115		Donation	500
			116	20	Purchases and VAT	3150
			118		J Goosen	600
	Pencil Total	11720			Pencil Total	33000

Bank Statement for September 2009

		Debit	Credit	Balance	
Date		£	£	£	
1	Balance			12200	Cr
4	Cheque 111	21100		8900	Dr
	Deposit		3700	5200	Dr
	Deposit		2100	3100	Dr
5	Deposit		2400	700	Dr
	SF	60		760	Dr
	DO	1400		2160	Dr
10	Cheque 113	2070		4230	Dr
	Cheque 110	400		4630	Dr
	Deposit		3100	1530	Dr

	Cheque 112	350		1880	Dr
	Cheque 614	2180		4060	Dr
	CB	20		4080	Dr
	Cheque 109	540		4620	Cr
	SF	100		4720	Dr
12	Cheque 115	500		5220	Dr
15	Deposit		850	4370	Dr
20	Cheque 118	600		4970	Dr
	Deposit		4050	920	Dr

Additional information:

1. Cheque 100 was drawn on the 10 March 2008 to pay a payable. (This cheque is therefore regarded as "stale" for this example - some countries may have different requirements for stale cheques)
2. ABC Computers signed a debit order for the monthly installments on their motor vehicle bought from Speedy Car Sales.
3. Cheque 614 was not drawn by ABC Computers. (Therefore must be taken out of the bank reconciliation)
4. According to the paid cheques, cheque 112 was drawn for £350 and cheque 113 was drawn for £2070.
5. A receivable deposited the amount of £4050 owed by him directly into ABC Computers bank account.

Required:

1. Complete the cash book for September 2009 by starting with the pencil totals.
2. Prepare the bank reconciliation statement as at 30 September 2009.

Solution

Compare all amounts in the cash book for *September 2009* with the amounts that are present on the bank statement to see if they are the same. All correct amounts should be crossed off on both statements as they do not contain errors. Any erroneous amounts should be marked so that they can be addressed.

Erroneous amounts may include:

1. Reversed numbers i.e. 164 to 614
2. Outstanding cheques
3. Payments received that have not yet been reflected
4. Errors on cheques
5. Date discrepancies (though amounts and figures may be correct)

Prepare the following two statements for any bank reconciliation:

Cash book (Bank account) of ABC Computers	Dr		Cr
Balance b/f	10820		
Pencil total	11720	Pencil total	33000
Payable (Cheque 100)	2200	Speedy Car Sales	1400
Purchases and VAT (Cheque 113)	630	Bank Charges and VAT (60+20+100)	180
Receivable	4050		
Balance c/f	5160		
	34580		34580
		Balance b/f	5160

Bank reconciliation statement

Bank reconciliation	Debit	Credit
Balance as per bank statement	1100	
Err oneous cheque (614)		2180
Error on cheque 112 (£530-£350)		180
Outstanding deposit		1670
Outstanding cheques:		
Cheque 114	4200	
Cheque 116	3150	
Cheque 106	740	
Credit balance as per cash book		5160
	9190	9190

Chapter 7

Subsidiary Books and Trail Balance

Subsidiary book may be defined as a book of prime entry in which transactions of a particular category are recorded. In other words, in order to save time and energy, the transactions which are of similar character are recorded in separate books; these are called subsidiary books or subdivision of journal. A number of subsidiary books are opened to record all business transactions. In practical system of book-keeping, subsidiary books are:

Subsidiary books are the books of original entry that are maintained under the modern methods of book-keeping for recording the various transactions.

Subsidiary books are also called primary records because the first entry of transaction is made in subsidiary books. On the basis of subsidiary books postings are made into concerned account afterwards.

Cash Book:

Transactions held in cash or by cheque are recorded in this book. There are two sides in a cash book. In the left hand side all cash receipts are recorded and in the right hand side all cash payments are recorded. Cash Book is of five types: single column cash book, double column cash book, triple column cash book, bank cash book and petty cash book. In the single column cash book only receipt of cash and payment of cash are recorded.

In the double column cash book, receipt of cash, receipt of cash discount, payment of cash and cash discount allowed are recorded. In the triple column cash book along with the transactions which are recorded in double column cash book, cheque received and cheque paid are recorded. In the bank cash book the receipt of cheque, payment of cheque, cash discount allowed and cash discount received are recorded. In the petty cash book only small payments of cash are recorded by the petty cashier.

Purchase Book:

All credit purchase of goods are written in this book. Cash purchase of goods and credit purchase of assets are not recorded in this book. Other names of purchase book are purchase day book, purchase journal, bought journal, inward invoice book etc.

Sales Book:

All sales of goods are written in this book. Cash sale of goods and credit sale of assets are not recorded in this book. Other names of Sales Book are Sales Day Book, Sales Journal, Sold book, Outward Invoice Book etc.

Purchase Return Book:

It may be necessary to return some goods that the firm has bought on credit for a variety of reasons. All returns of such goods are recorded primarily in Return Outward Book. This book is also known as Purchase Return Book.

Sales Return Book:

Goods may be returned by the customers for a variety of reasons. All goods returned from customers are recorded in Sales Return Book. This book is also known as Return Inward Book.

Bills Receivable Book:

When credit sales of goods are made the purchaser gives his guarantee to make payment in future in the form of bill. When the seller receives such bill, it is Bill Receivable for him as he will receive payment in future against such bill. In case a business house receives a number of bills, a Bills Receivable Book is maintained to record all such bills.

Bills Payable Book:

When credit purchases are made by a firm it gives a guarantee to the seller to make payment in future in the form of a bill. This bill is said to be Bills Payable for the firm as he will pay for the bill in future. A Bills Payable Book is opened to record all such bills.

Journal Proper:

It is a subsidiary book maintained to record the transaction which cannot be recorded in other special subsidiary books. Usually the transactions of infrequent character are recorded in the journal proper. The entries like adjustment entries, opening entries, closing entries, transfer entries, purchase and sale of assets on credit, interest on capital, interest of drawing etc. are recorded in journal proper.

Some Examples of Subsidiary Books

Purchase Book

In purchase book the transactions relating to credit purchase of goods are recorded. But cash purchases and purchase of fixed assets are not recorded in this book. This book is also known as Purchase Journal or Bought Day Book. At the end of a certain period, the total of Purchase Book is posted to the debit side of Purchase Account and the suppliers' accounts will be credited with the respective amounts in the ledger book.

Cash purchases of the goods are recorded in cash book and not in the purchase book

Following is the format of purchase book:

Purchase Book				
Date	Particulars	Inward Invoice No.	L.F.	Amount
(1)	(2)	(3)	(4)	(5)

Column (1) : In this column the date on which particular transaction takes place are recorded.

Column (2) : In this column, the entire account name or the names of the suppliers of goods are recorded.

Column (3) : In this column, Inward Invoice No. is in respect of the transactions are recorded.

Column (4) : L.F is the ledger folio in which the page number of the ledger is shown

Column (5) : In this column the net amount of the invoice is recorded.

Exercise : 1

Prepare a Purchase Book from the following particulars :

2008

Dec 1 : Bought from J.N Stores, 100 bags of rice at Rs. 120

Dec 6 : Bought from Dhanan Sugar Mills 20 bags of sugar at Rs. 300 per bag

Dec 10 : Bought from Raju Flour Mill, 10 bags of wheat flour at Rs. 200 per bag

“ 14 : Bought from Korangoni Tea Co. 10 cases of tea at Rs. 150 per case

“ 20 : Bought from Coca Coffee Ltd., 100 Kgs. of Coffee t Rs. 30 per Kg

Solution :1

PurchasesBook				
Date	Particulars	Inward Invoice No.	L.F.	Amount
2008				
Dec. 1	J.N Stores	1		12000
" 6	Dhanan Sugar Mills	2		6000
" 10	Raju Flour Mill	3		2000
" 14	Korangoni Tea Co.	4		1500
Dec 20	Coca Coffee Ltd	5		3000
				24500

PURCHASE RETURNS BOOK

The book which is used for recording goods return to the seller is called “Purchase Return Book”.

The transactions relating to return of goods to the supplier which were purchased on credit are recorded in Purchase Return Book. The goods may be returned due to not confronting to the specifications or defective goods or for any other reason. It is also known as Returns Outward Book. The total of this book, after a certain period, is credited to Returns Outward Account and the suppliers’ accounts, to which goods were returned, are debited with the respective amounts in the ledger book.

The format of the Purchase Return Book is given as:

Purchase Return Book				
Date	Particulars	Debit Note No.	L.F.	Amount

Exercise : **2**

Prepare a Purchase Return Book from the following particulars:

2008

Oct 1 : Returned goods worth Rs. 300 to Rahul and Co., Chennai

“ 9 : Returned goods worth Rs. 100 to Raju, Kolkata

“ 15 : Allowance claimed from Ashok and Co., for shortage Rs. 150

Section : 2 Purchase Return Book				
Date	Particulars	Debit Note No.	L.F.	Amount Rs.
2008				
Oct 1	Rahul and Co. Chennai	1		300
Oct 9	Raju, Kolkata	2		100
Oct 15	Ashok and Co.	3		150
				550

Sales Book

This book is meant for recording credit sale of goods. Cash sale of goods and sale of articles other than goods are not recorded in this book. This book is also known as Sales Journal or Sold Day Book. When the trader sells goods on credit then he should keep record in sales book to know how much goods have been sold, when and to whom. At the end of a certain period, the total of Sales Book is posted to the credit side of Sales Account and the customers' accounts will be debited with the respective amounts in the ledger book

Following is a sample example of purchase Book:

Sales Book				
Date	Particulars	Outward Invoice No.	L.F.	Amount
(1)	(2)	(3)	(4)	(5)

Column (1) : In this column, date of the transactions is recorded.

Column (2) : In this column, the entire account name or the names of the suppliers of goods are recorded.

Column (3) : In this column, Outward Invoice No. is recorded which is meant for recording the serial no. of each outward invoice.

Column (4) : L.F is the Ledger Folio in which the page number of the ledger is shown

Column (5) : In this column the net amount of the invoice is recorded.

Exercise:

3

Prepare a Sales Return Book from the following particulars:
2008

Feb 1 : Sold to Rishi & Co., Bangalore, 10 bags of rice at Rs. 220 per bag.

“ 7 : Sold to Kumar, Chennai, 10 bags of sugar at Rs. 350 per bag

“ 12 : Sold to Sashi & Sashi Co., Bombay, 10 bags of wheat at Rs. 70 per bag

“ 18 : Sold to Rakesh & Co., Kolkata, 10 bags of groundnut at Rs. 200 per bag

“ 25 : Sold to Chand & Co., Bangalore, 10 bags of wheat flour at Rs. 150 per bag

Solution : 3				
Sales Book				
Date	Particulars	Outward Invoice No.	L.F.	Amount
2008				
Feb 1	Rishi & Co., Bangalore	1		2200
.. 7	Kumar, Chennai	2		3500
.. 12	Sashi & Sashi Co., Bombay	3		700
.. 18	Raskesh & Co. Kolkata	4		2000
.. 25	Chand & Co., Bangalore	5		1500
				9900

Sales Return Book

When goods sold on credit are returned by the customers, they are recorded in Sales Return Book or Returns Inward Book. At the end of a certain period, the total of this book is debited to Returns Inward Account and the customers' accounts, who have returned the goods, are credited with the respective amounts in the ledger book. The format of the Sales Return Book is given as:

Sales Return Book				
Date	Particulars	Credit Note No.	L.F.	Amount Rs.

Exercise:

4

Prepare a Sales Return Book from the following particulars:
2008

June 1 : Ram & Co. returned goods worth Rs. 200
“ 10 : Allowance granted to Kishore for breakage Rs. 150
“ 15 : Allowance granted to Kumar for over charge Rs. 70
“ 20 : Lilliput & Co. returned goods worth Rs. 250

Solution : 4

Sales Return Book				
Date	Particulars	Credit Note No.	L.F.	Amount Rs.
2008				
June 1	Ram & Co.	1		200
.. 10	Kishore	2		150
.. 15	Kumar	3		70
.. 20	Lilliput & Co.	4		250
				670

BILLS RECEIVABLE BOOK

This book is used to record all promissory notes given and Bills of Exchange accepted by customers for the amounts due from them. A promissory note contains an unconditional promise in writing, to pay a certain sum of money only to a certain person on a specific future date.

BILLS PAYABLE BOOK

This book is used to record all promissory notes given and Bills of Exchange accepted by the business for the amounts due to suppliers. A bill of exchange is an instrument in writing, containing an unconditional order to pay a certain sum of money only to a certain person on a specific future date.

What is a Trial Balance?

Purpose of Trial Balance

Example of Trial Balance

Limitations of Trial Balance

Trial Balance is a list of closing balances of ledger accounts on a certain date and is the first step towards the preparation of financial statements. It is usually prepared at the end of an accounting period to assist in the drafting of financial statements. Ledger balances are segregated into debit balances and credit balances. Asset and expense accounts appear on the debit side of the trial balance whereas liabilities, capital and income accounts appear on the credit side. If all accounting entries are recorded correctly and all the ledger balances are accurately extracted, the total of all debit balances appearing in the trial balance must equal to the sum of all credit balances.

Purpose of a Trial Balance

Trial Balance acts as the first step in the preparation of financial statements. It is a working paper that accountants use as a basis while preparing financial statements. Trial balance ensures that for

every debit entry recorded, a corresponding credit entry has been recorded in the books in accordance with the double entry concept of accounting. If the totals of the trial balance do not agree, the differences may be investigated and resolved before financial statements are prepared. Rectifying basic accounting errors can be a much lengthy task after the financial statements have been prepared because of the changes that would be required to correct the financial statements. Trial balance ensures that the account balances are accurately extracted from accounting ledgers. Trail balance assists in the identification and rectification of errors.

EXAMPLE

Example

Following is an example of what a simple Trial Balance looks like:

ABC		LTD
Trial Balance as at 31 December 2011		
Account Title	Debit	Credit
	\$	\$
Share Capital		15,000
Furniture & Fixture	5,000	
Building	10,000	
Creditor		5,000
Debtors	3,000	
Cash	2,000	
Sales		10,000
Cost of sales	8,000	

General and Administration Expense	2,000	
Total	<u>30,000</u>	<u>30,000</u>

Title provided at the top shows the name of the entity and accounting period end for which the trial balance has been prepared.

Account Title shows the name of the accounting ledgers from which the balances have been extracted.

Balances relating to assets and expenses are presented in the left column (debit side) whereas those relating to liabilities, income and equity are shown on the right column (credit side).

The sum of all debit and credit balances is shown at the bottom of their respective columns.

Limitations of a trial balance

Trial Balance only confirms that the total of all debit balances match the total of all credit balances. Trial balance totals may agree in spite of errors. An example would be an incorrect debit entry being offset by an equal credit entry. Likewise, a trial balance gives no proof that certain transactions have not been recorded at all because in such case, both debit and credit sides of a transaction would be omitted causing the trial balance totals to still agree. Types of accounting errors and their effect on trial balance are more fully discussed in the section on Suspense Accounts.

Chapter 8

Concept of Capital And Revenue

Concept of Capital and Revenue

The main objective of accounting is to ascertain the true profit or loss and to reveal the financial position of a business at the end of financial year.

To achieve the objectives, the business must take a clear distinction between its capital and revenue items. The distinction between capital and revenue items is essential for their correct treatment in the final accounts. Any incorrect treatment of those two items in the final accounts adversely affects the operating results and financial position of the business.

Capital is the wealth invested by an investor for producing additional wealth. The original figure of wealth is known as capital. Making of additional wealth with the investment of original capital is known as revenue. Thus, capital is the source of the basis of revenue. In other words, capital is invested in the business to earn revenue. For example, a trader has started a business with \$ 1,00,000 and earns a profit of \$ 30,000 during the year. The original investment of the trader, i.e. \$ 1,00,000 is the capital and the profit of \$ 30,000 earned by the investor out of the investment is the revenue.

Capital items concerned with the payment for assets and receipt from the owners and outsiders. It is the item of the balance sheet. It is of long-term nature and its benefit is long-lasting. In fact, capital items are assets, liabilities and capital that determine the financial strength of the business.

Revenue item is concerned with the payment for producing or buying goods and receipt from sale of goods and services. Those revenue incomes and expenditures are the items of trading and profit and loss accounts. It is of short-term nature. Its benefit expires within the year. In fact, revenue items are incomes and expenses, which determine the operating result (profit or loss) of the business.

The following capital and revenue concepts are relevant for accounting purpose

- * Capital and revenue expenditures
- * Capital and revenue receipts
- * Capital and revenue losses
- * Capital and revenue profits
- * Capital and revenue reserves

Capital and Revenue Expenditure

Expenditure on fixed assets may be classified into Capital Expenditure and Revenue Expenditure. The distinction between the nature of capital and revenue expenditure is important as only capital expenditure is included in the cost of fixed asset.

Capital Expenditure

Capital expenditure includes costs incurred on the acquisition of a fixed asset and any subsequent expenditure that increases the earning capacity of an existing fixed asset.

The cost of acquisition not only includes the cost of purchases but also any additional costs incurred in bringing the fixed asset into its present location and condition (e.g. delivery costs).

Capital expenditure, as opposed to revenue expenditure, is generally of a one-off kind and its benefit is derived over several accounting periods. Capital Expenditure may include the following:

Purchase costs (less any discount received)

Delivery costs

Legal charges

Installation costs

Up gradation costs

Replacement costs

As capital expenditure results in increase in the fixed asset of the entity, the accounting entry is as follows:

Debit Fixed Assets

Credit Cash/Payable

Revenue Expenditure

Revenue expenditure incurred on fixed assets include costs that are aimed at 'maintaining' rather than enhancing the earning capacity of the assets. These are costs that are incurred on a regular basis and the benefit from these costs is obtained over a relatively short period of time. For example, a company buys a machine for the production of biscuits. Whereas the initial purchase and installation costs would be classified as capital expenditure, any subsequent repair and maintenance charges incurred in the future will be classified as revenue expenditure. This is so because repair and maintenance costs do not increase the earning capacity of the machine but only maintains it (i.e. machine will produce the same quantity of biscuits as it did when it was first put to use).

Revenue costs therefore comprise of the following:

Repair costs

Maintenance charges

Repainting costs

Renewal expenses

As revenue costs do not form part of the fixed asset cost, they are expensed in the income statement in the period in which they are incurred. The accounting entry to record revenue expenditure is therefore as follows:

Debit Revenue Expense (Income Statement)

Credit Cash/Payable

Capital Receipts

An amount received in the form of capital from the owner and as loan from outsiders is known as capital receipts. Besides, cash received by selling shares, debentures and permanent assets is also capital receipt. It is of non-recurring type of receipt. It is treated as obligation of the business and shown on liabilities side of the balance sheet.

Items relating to capital receipts

- * Amount received from the owner as capital.
- * Amount received through the sale of shares and debentures.
- * Amount of loan received
- * Amount received from the sale of old assets.
- * Other receipts of non-recurring nature.

Revenue Receipts

Revenue receipt is an amount which is received from the regular transaction of a business. It is the amount received from the sale of goods and services. It is the main source of income. It is a regular type of income. It is shown on the credit side of the trading and profit and loss accounts.

Items relating to revenue receipts

- * Amount received from the sale of goods and services.
 - * Amount received by way of discount, commission, rent, interest and dividend.
 - * Amount received from the sale of waste paper and packing cases.
- Differences Between Capital Receipts And Revenue Receipts

Following are the differences between capital receipts and revenue receipts.

Source

Capital receipt is the amount received from the sale of assets, shares and debentures. Revenue receipt is the amount received from the sale of goods and services.

Nature

Capital receipt is of non-recurring nature. Revenue receipt is of recurring nature.

Impact

Main items of capital receipt are capital and loan, which affect financial position of the business. Main items of revenue receipt are sale of merchandise, discount and commission, which affect operating results of the business.

Treatment

Capital receipt is shown on the liabilities side of the balance sheet. Revenue receipt is shown on the credit side of the trading and profit and loss accounts.

Concepts of Capital Profit and Revenue Profit

The profit that arises on the sale of fixed assets is called capital profit. When a fixed asset bought for Rs 2,00,000 is sold for Rs 3,00,000 the profit on sale of such fixed assets is capital profit.

Similarly when shares are sold at a higher price, such profit may also be termed as capital profit.

When shares are issued at premium, such premium is also a capital receipt.

Profits earned from sources other than fixed assets and which are earned in the normal course of business are called revenue profits.

Sale of goods costing Rs 50,000 for Rs 75,000, the difference Rs 25,000 is a revenue profit.

CAPITAL AND REVENUE LOSSES

Losses incurred in the normal course of business may be treated as revenue losses. For example, loss of stock due to natural calamities like flood, fire, any type of accident, theft, misappropriation and so on.

Any loss which cannot be classified as revenue loss may be treated as capital loss.

Capital Reserve, Reserve Capital And Revenue Reserve

Concept And Meaning Of Capital Reserve And Revenue Reserve And Their Related Items

Concept And Meaning Capital Reserve

The reserve which is created out of the capital profit is known as capital reserve. Capital reserve is created out of the profit of some specific transactions of capital nature. It is not available for the distribution to shareholders as dividend. It is used to meet capital loss. Capital reserve is shown on the liabilities side of the balance sheet. Sometimes, it can be used to issue fully-paid bonus shares.

Items of capital profit out of which capital reserve is created:

- * Profit on revaluation of assets and liabilities.
- * Profit on sale of assets
- * Profit on sale of shares and debentures
- * Profit on forfeiture of shares
- * profit on redemption of debentures
- * profit on purchasing running business

Concept And Meaning Of Revenue Reserve

Revenue reserve is created out of the revenue profit earned in the normal course of the business. It refers to the undistributed revenue profit. It can be distributed as dividend to the shareholders.

Revenue reserve helps to strengthen the financial position of the company and also helps to declare uniform rate of dividend.

Items relating to revenue reserve

- * General reserve
- * Dividend equalization fund
- * Sinking fund
- * Research and development fund

Capital reserve, revenue reserves and reserve capital

Capital reserve is a reserve created by a company with a view to face contingencies like inflation, instability etc. in times of rising price. Normally, capital reserves are the reserves raised through non-trading activities and relates to company. For example, to boost investors' confidence during inflation time, the book value of the company can be increased using revaluation of assets reserve. In the same way, the company can allocate certain portion of their profit for capital redemption reserves for purchasing their own company shares when the share market is in downtrend thus keeping the value of the share in check protecting the shareholders interest which is called buy back of shares. Also any profit on purchase of business, forfeiture of shares, gain on reissue of forfeited shares and debenture premium may be put under capital reserve under different heads. These capital reserves can be used to write off fictitious assets subject to certain conditions. Normally Capital reserve cannot be used for distribution of dividend.

Reserve Capital

It is the capital which is not yet called up. Against the authorized capital of any company, certain calls will be due for subscriptions when called. The company can call for subscriptions as and when it needs. This type of capital in reserve is called reserve capital and it is entirely different from capital reserve.

Revenue reserves

These are the reserves created out of profit from trading activities. e.g. retained earnings and profit loss account under liabilities side etc. This can be distributed as dividend and also as bonus shares normally.

Chapter- 9

Trading, Profit and Loss Account and Balance sheet

Trading, profit and loss account

Trading Account:

A **trading account** is an account which contains, " in summarized form, all the transactions, occurring, throughout the trading period, in commodities in which he deals" and which gives the gross trading result. In short, trading account is the account which is prepared to determine the gross profit or the gross loss of a trader.

The trading account calculates the amount of profit earned from buying and selling goods in a particular time period (usually one year).

The Trading account for Big Books Ltd appears below.

Trading account for Big Books Ltd for year ended 31/12/01

	€	€
Sales		250,000
LESS COST OF SALES		
Opening stock	20,000	
Purchases	150,000	
Goods available	170,000	
Less closing stock	30,000	
Cost of sales		140,000
Gross profit		110,000

An explanation of each of the terms in the Trading Account follows.

Trading account for Big Books Ltd for year ended 31/12/01: this is the title of the account. It informs the user of the name of the business and the time period which has been used to measure gross profit.

Sales: The amount of money earned by the business selling books in the past year. Money earned by the business is known as Income or Revenue. Sales returns/returns in may have to be subtracted.

LESS COST OF SALES: this is a heading, which indicates that a calculation is going to be completed. This calculation will work out the cost of all the books that were sold in the year. It is calculated as follows

Cost of sales = opening stock + purchases - closing stock.

Opening stock: This is the value of stock left over from the previous year. This stock will be the first to be sold in the new year.

Purchases: This is the cost of all the new games bought during the year. (Two additional costs may be added to purchases, carriage in and import duty). Purchase returns/returns out may have to be subtracted.

Goods available: This represents the total cost of all the books that were available to be sold during the year. It is calculated by adding the opening stock and purchases.

Closing stock: This is the value of all the books left in the shop and the storeroom at the end of the year. It is subtracted from opening stock and purchases, as it does not form part of the goods sold during the year.

Cost of sales: This is the answer to the calculation of the cost of sales.

Gross profit: This measures the profit the business makes by buying and selling books. It is calculated as follows:

Gross profit = Sales – Cost of Sales

The Profit and Loss Account

The profit and loss account calculates the profit the business has earned after allowing for all the expenses incurred in running the business.

The profit and loss account for Big Books Ltd appears below.

Profit and loss account for Big Books Ltd for year ended 31/12/01

	€	€
Gross Profit		110,000
LESS EXPENSES		
Administration expenses	40,000	
Distribution expenses	20,000	
Financial expenses	10,000	70,000
Net Profit		40,000

Profit and loss account for Big Books Ltd for year ended 31/12/01: This is the title of the account. It informs the user of the name of the business and the time period that has been used to measure net profit.

Gross Profit: the profit the business made buying and selling books. If the business earned additional income by means other than trading it could be added to gross profit. For example, if the business was able to rent space in the building the rent received could be added to gross profit. Interest received and commissions received are common entries.

LESS EXPENSE: This is a heading, indicating the total of all business expenses are to be calculated.

Administration expenses: These are the costs associated with running the business such as wages, insurance, light and heat and depreciation.

Distribution expenses: These are the costs associated with selling the goods and delivering them. They include advertising, delivery van repairs and petrol.

Financial expenses: These are the costs associated with borrowing money such as interest on the overdraft and the mortgage.

Net profit: This is the profit that is owed to the owner(s). In the case of a company the shareholders may be paid a dividend from available profits. The profit that remains is reinvested in the business and is added to the capital in the balance sheet.

Club Accounts

A club is an organisation set up to further the interests of its members.

Unlike a business, clubs do not intend to make a profit. Therefore to measure their financial performance each year they prepare an INCOME and EXPENDITURE Account. In this account the clubs expenditure on the day-to-day running costs (do not include the cost of assets) is subtracted from its income (subscriptions, raffle income, collections, canteen profit). It may be necessary to prepare a canteen trading account to calculate the canteen profit.

If INCOME exceeds EXPENDITURE it is called surplus income and if EXPENDITURE exceeds INCOME it is called excess expenditure.

The club will produce a balance sheet in the same way as a private limited company with one exception. In the 'Financed By' section there is no Ordinary Share Capital — instead there is an Accumulated Fund, which represents the finance supplied by the members over the years.

Balance sheet: a statement of a business's wealth on a particular date.

Balance Sheet:

A **balance sheet** is a statement drawn up at the end of each trading period stating therein all the assets and liabilities of a business arranged in the customary order to exhibit the true and correct state of affairs of the concern as on a given date.

Assets: the resources owned by the business.

Liabilities: the amount of money owed by the business to the suppliers of finance.

Capital: the money invested in the business by the owner. It is a liability, as money is owed by the business to a supplier of finance.

Fixed assets: resources owned by the business. They are used to help run the business and are not intended for resale. Usually they are kept for a number of years and depreciation is recorded in the books to reflect their decline in value

Current assets: resources owned by the business, which will change their form within one year.

Current liabilities: amounts of money owed by the business, which must be repaid within one year.

Working capital: the name given to the difference between the current assets and the current liabilities. A positive working capital means the business has enough current assets to pay off its current liabilities.

Long-term liabilities: amounts of money owed by the business, which will be repaid over a long period of time.

Capital: the money owed to the owners as a result of their original investment.

Reserves: profits which have been retained in the business in order to provide finance.

Capital employed: the total of long-term liabilities plus capital and reserves. This represents the total amount the business owes to the suppliers of long-term capital.

The trading account: calculates the amount of profit earned from buying and selling goods in a particular time period.

Gross profit: measures the profit the business makes by buying and selling goods. It is calculated as follows: $\text{Gross profit} = \text{Sales} - \text{Cost of Sales}$.

Profit and loss account: calculates the profit the business has earned after allowing for all the expenses incurred in running the business.

Net profit: the profit that the business has earned after allowing for all the expenses incurred in running the business.

Having proved the arithmetical accuracy of ledger by means of trial balance we should proceed to ascertain our profit or loss for a period, in order to determine the profit or loss of a business and its financial position, **final accounts** at the end of a particular period are prepared. The term "**final accounts**" means statements which are finally prepared to show the profit earned or loss suffered by the firm and financial state of affairs of the firm at the end of the period concerned. In order to know the profit or loss earned by a firm, income statement or trading and profit and loss account is prepared. This statement is also called "statement of operations." While the financial position is judged by means of preparing a balance sheet of the business. This statement is also called "position statement" or "statement of financial condition". In this section of the website we shall study the method of preparing these two statements.

The basis of these statements is trial balance. The trial balance includes all the accounts from the ledger. the nature of which may be either, personal, real, or nominal. It should be noted that from the trial balance only nominal accounts are transferred to the profit and loss account. The real or personal accounts go to the balance sheet.

Difference Between Trading Account and Profit and Loss Account:

The main **difference between trading account and profit and loss account** is that the gross profit or loss which is derived from the trading account shows the trend of the business and the profit and loss account reflects on the management of the business the final outcomes of the concern.

Balance Sheet

A balance sheet also known as the statement of financial position tells about the assets, liabilities and equity of a business at a specific point of time. It is a snapshot of a business.

A balance sheet is an extended form of the accounting equation. An accounting equation is:

$$\mathbf{Assets = Liabilities + Equity}$$

Assets are the resources controlled by a business, equity is the obligation of the company to its owners and liabilities are the obligations of parties other than owners.

A balance sheet is named so because it lists all resources owned by the company and shows that it is equal to the sum of all liabilities and the equity balance.

A balance sheet has two formats: account form and report form.

An account form balance sheet is just like a T-account listing assets on the debit side and equity and liabilities on the right hand side. A report form balance sheet lists assets followed by liabilities and equity in vertical format.

The following example shows a simple balance sheet based on the post-closing trial balance of Company A.

Company A

Balance Sheet

As on December January 31, 2011

ASSETS		LIABILITIES AND EQUITY	
Current Assets:		Liabilities:	
Cash	\$20,430	Accounts Payable	\$5,200
Accounts Receivable	5,900	Utilities Payable	3,964
Office Supplies	4,320	Unearned Revenue	1,000
Prepaid Rent	24,000	Interest Payable	150
Total Current Assets	\$54,650	Notes Payable	20,000
Non-Current Assets:		Total Liabilities	\$30,314
Equipment	\$80,000	Common Stock	100,000
Accumulated Depreciation	-1,100	Retained Earnings	3,236
Net Non-Current Assets	\$78,900		
Total Assets	\$133,550	Total Liabilities and Equity	\$133,550

Chapter 10

Final Accounts with Adjustments

Concept and Meaning of Final Account

Final Account is the final process of accounting. Final account is prepared to show the final result of the company in a specific period. Final account is also known as financial statement. Profit and loss account and balance sheet are included in final account. Profit and loss account shows the profitability achieved during the accounting period and balance sheet reflects the composition of various assets, liabilities, and share holder's equity on the accounting period.

When a person starts a business he wishes to know the financial performance of his business. A convenient and universally accepted method of knowing this is to ascertain the profit or loss at yearly intervals (1st April to 31st March) and the financial position of the business on a given date. He can ascertain these by preparing the Final Accounts, which is prepared on the basis of the Trial Balance. The preparation of Final Accounts is the last step in the accounting cycle and that is why they are called Final Accounts.

Final Accounts include the preparation of

- i) Trading and Profit and Loss Account ; and
- ii) Balance sheet.

Final accounts are the means of conveying the profitability and financial position to management, owners and interested outsiders of the business. Final accounts have to be prepared every year, to make a continuous assessment of the business for a completed period. It must be kept in mind that expenses and incomes for the full accounting period are to be taken into account.

Suppose, the firm closes its books on 31st March and rent for the month of March has not been paid, this expense (rent) has been incurred and yet to be paid. Therefore, it would be proper to include the rent for the month (March) along with the rent of the year to know the true profit. In a firm there will be a number of items, both expenses and incomes, which have to be adjusted. If such items are not adjusted, the final accounts will not reveal the true and fair picture of the

business performance. All such items which need to be brought into books of account at the time of preparing final accounts are called “adjustments”.

Journal entries passed to effect the required adjustments are known as adjusting entries.

1.1 Adjustments

Some important and common items, which need to be adjusted at the time of preparing the final accounts are discussed below.

- | | |
|--------------------------------|----------------------------|
| 1. Closing stock | 7. Interest on drawings |
| 2. Outstanding expenses | 8. Interest on loan |
| 3. Prepaid Expenses | 9. Interest on investment |
| 4. Accrued incomes | 10. Depreciation |
| 5. Incomes received in advance | 11. Bad Debts |
| 6. Interest on capital | 12. Provision for bad and |
| doubtful debts | 13. Provision for |
| discount on debtors | |
| | 14. Provision for discount |
| on creditors. | |

given outside the trial balance.

Note : All adjustments are

1.1.1 Closing Stock

The unsold goods in stock at the end of the accounting period is called as closing stock. This is to be valued at cost or market price whichever is lower.

Example: The value of closing stock shown outside the trial balance on 31.3.2004 is Rs.1,00,000.

Adjusting Entry				
Date	Particulars	LF	Debit Rs.	Credit Rs.
2004 Mar 31	Closing stock A/c To Trading A/c (closing stock recorded)	Dr	1,00,000	1,00,000

Value of closing stock will appear

- i) on the credit side of trading account and
- ii) on the assets side of balance sheet.

Trading account for the year ending 31st March, 2004			
Dr.		Cr.	
Particulars	Rs.	Particulars	Rs.
		By Closing Stock	1,00,000

Balance Sheet as on 31st March, 2004			
Liabilities	Rs.	Assets	Rs.
		Closing Stock	1,00,000

1.1.2 Outstanding Expenses

Expenses which have been incurred but not yet paid during the accounting period for which the final accounts are being prepared are called as outstanding expenses.

Example: Trial balance shows salaries paid Rs.22,000.

Adjustment: Salary for March 2004, Rs.2,000 not yet paid.

Adjusting Entry				
Date	Particulars	LF	Debit Rs.	Credit Rs.
2004 Mar 31	Salaries A/c Dr To Salaries outstanding A/c (March salary outstanding)		2,000	2,000

Outstanding expenses will be shown

- i) on the debit side of Profit and Loss account by way of additions to the particular expenses and
- ii) on the liabilities side of the Balance Sheet.

Profit and Loss account for the year ending 31 st March, 2004					
Dr.			Cr.		
Particulars	Rs.	Rs.	Particulars	Rs.	Rs.
To Salaries A/c	22,000				
Add: Outstanding	2,000				
		24,000			

Balance Sheet as on 31 st March, 2004			
Liabilities	Rs.	Assets	Rs.
Outstanding Salaries	2,000		

1.1.3 Prepaid Expenses

Expenses which have been paid in advance are called as prepaid (unexpired) expenses.

Example: Trial Balance for the period ending 31st March, 2004 shows Rs.15,000 as insurance premium. Adjustment: Prepaid Insurance premium Rs.7,500.

Adjusting Entry				
Date	Particulars	LF	Debit Rs.	Credit Rs.
2004 Mar 31	Prepaid Insurance Premium A/c Dr To Insurance Premium A/c (Insurance premium paid in advance)		7,500	7,500

Prepaid expenses will be shown

- i) on the debit side of the Profit and Loss account by way of deduction from the particular expenses and
- ii) on the assets side of the Balance Sheet.

Profit & Loss Account for the year ending 31 st March, 2004					
Dr.	Particulars	Rs.	Rs.	Particulars	Cr.
	To Insurance premium A/c	15,000			
	Less: Prepaid	7,500			
			7,500		

Balance Sheet as on 31 st March, 2004			
Liabilities	Rs.	Assets	Rs.
		Prepaid Insurance premium	7,500

1.1.4 Accrued Incomes or Outstanding Incomes

Income which has been earned but not received during the accounting period is called as accrued income.

Example: Credit side of Trial Balance (31.3.2004) shows commission received Rs.8,000.

Adjustment: Commission accrued but not yet received Rs.2,000.

Adjusting Entry				
Date	Particulars	LF	Debit Rs.	Credit Rs.
2004 Mar 31	Accrued commission A/c To Commission A/c (commission earned but not received)	Dr	2,000	2,000

Accrued income will be shown

- i) on the credit side of Profit and Loss account by way of addition to particular income and
- ii) on the assets side of the Balance Sheet

Profit & Loss Account for the year ending 31 st March, 2004					
Dr.			Cr.		
Particulars	Rs.	Rs.	Particulars	Rs.	Rs.
			By Commission received	8,000	
			Add: Accrued Commission	2,000	
					10,000

Balance Sheet as on March 31, 2004			
Liabilities	Rs.	Assets	Rs.
		Accrued Commission	2,000

1.1.5 Incomes Received in Advance

Income received during a particular accounting period for the work to be done in future period is called as income received in advance.

Example: Trial Balance for the period ending 31st March, 2004 shows Rent received Rs.25,000.
Adjustment: Rent received in advance Rs.5,000.

Adjusting Entry				
Date	Particulars	LF	Debit Rs.	Credit Rs.
2004 Mar 31	Rent received A/c Dr To Rent received in advance A/c (rent received in advance)		5,000	5,000

Incomes received in advance will be shown

- i) on the credit side of the Profit and Loss account by way of deducting from the particular income and
- ii) on the liabilities side of the Balance sheet.

Profit & Loss Account for the year ending 31 st March, 2004					
Dr.			Cr.		
Particulars	Rs.	Rs.	Particulars	Rs.	Rs.
			By Rent received	25,000	
			Less: Rent received in advance	5,000	
					20,000

Balance Sheet as on 31 st March, 2004			
Liabilities	Rs.	Assets	Rs.
Rent received in advance	5,000		

1.1.6 Interest on Capital

In order to see whether the business is really earning profit or not, it is desirable to charge interest on capital at a certain rate.

Example: As per Trial Balance, capital as on 31.3.2004 is Rs.4,00,000. Adjustment: Provide 6% interest on capital.

To bring interest on capital to Profit and Loss account, the following transfer entry is required.

- i) on the credit side of Profit and Loss account and
- ii) on the liabilities side of the Balance Sheet by way of addition to the drawings which are ultimately deducted from the capital.

Profit & Loss Account for the year ending 31 st March, 2004			
Dr.			Cr.
Particulars	Rs.	Particulars	Rs.
		By Interest on drawings	1,500

Balance Sheet as on 31st March, 2004					
Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Capital	4,00,000				
Less: Drawings					
30,000					
Interest on drawings	1,500	31,500			
		3,68,500			

Chapter 11

Examples of Final Accounts

Prepare trading and profit and loss account and balance sheet.

Example 1:

From the following balances extracted from the books of X & Co., prepare a trading and profit and loss account and balance sheet on 31st December, 1991.

	\$		\$
Stock on 1st January	11,000	Returns outwards	500
Bills receivables	4,500	Trade expenses	200
Purchases	39,000	Office fixtures	1,000
Wages	2,800	Cash in hand	500
Insurance	700	Cash at bank	4,750
Sundry debtors	30,000	Tent and taxes	1,100
Carriage inwards	800	Carriage outwards	1,450
Commission (Dr.)	800	Sales	60,000
Interest on capital	700	Bills payable	3,000
Stationary	450	Creditors	19,650
Returns inwards	1,300	Capital	17,900

The stock on 21st December, 1991 was valued at \$25,000.

Solution:

X & Co.

Trading and Profit and Loss Account

For the year ended 31st December, 1991

To Opening stock	11,000		By Sales	60,000
To Purchases	39,000		Less returns	1,300
			i/w	
Less returns o/w	500			58,700
	<u>38,500</u>		By Closing	25,000
			stock	
To Carriage inwards	800			
To Wages	2,800			
To Gross profit c/d	30,600			
	<u>83,700</u>			<u>83,700</u>
To Stationary	450		By Gross profit	30,600
			b/d	
To Rent and rates	1,100			
To Carriage	1,450			
outwards				
To Insurance	700			
To Trade expenses	200			
To Commission	800			
To Interest on	700			
capital				
To Net profit				
transferred to capital	25,200			
a/c				
	<u>30,600</u>			<u>30,600</u>

X & Co.

Balance Sheet

As at 31st December, 1991

Liabilities	\$	Assets	\$
Creditors	19,650	Cash in hand	500
Bills payable	3,000	Cash at bank	4,750
Capital	17,900	Sundry debtors	30,000
Add Net profit	25,200	Bill receivable	4,500
	<u>43,100</u>	Stock	25,000
		Office equipment	1,000
	<u>65,750</u>		<u>65,750</u>

Example 2:

The following trial balance was taken from the books of Habib-ur-Rehman on December 31, 19

....

Cash	13,000	
Sundry debtors	10,000	
Bill receivable	8,500	
Opening stock	45,000	
Building	50,000	
Furniture and fittings	10,000	
Investment (Temporary)	5,000	
Plant and Machinery	15,500	
Bills payable		9,000
Sundry creditors		20,000
Habib's capital		78,200
Habib's drawings	1,000	
Sales		100,000
Sales discount	400	
Purchases	30,000	
Freight in	1,000	
Purchase discount		500
Sales salary expenses	5,000	
Advertising expenses	4,000	
Miscellaneous sales expenses	500	
Office salary expenses	8,000	
Misc. general expenses	1,000	
Interest income		1,000
Interest expenses	800	
	<hr/>	<hr/>
	2,08,700	2,08,700
	<hr/>	<hr/>

Closing stock on December 31, 19 ... was \$10,000

Required: Prepare income statement/trading and profit and loss account and balance sheet from the above trial balance in report form.

Solution:

Habib-ur-Rehman

Income Statement/Profit and Loss Account

For the year ended December 31, 19.....

Gross sales		100,000	
Less: Sales discount		400	
		<hr/>	
Net Sales			99,600
 <u>Cost of Goods Sold:</u>			
Opening stock		45,000	
Purchases	30,000		
Add: Freight in	1,000		
	<hr/>		
	31,000		
Less purchase discount	500		
	<hr/>		
Net purchases		30,500	
		<hr/>	
Cost of goods available for sale		75,500	
Less closing stock		10,000	
		<hr/>	
Cost of goods sold			65,500
			<hr/>
Gross profit			34,100
 <u>Operating Expenses:</u>			
<i>Selling Expenses:</i>			
Sales salary expenses	5,000		

Advertising expenses	4,000	
Misc. selling expenses	500	
	—————	9,500
<i>General Expense:</i>		
Office salaries expenses	8,000	
Misc. general expenses	1,000	
	—————	9,000
		—————
Total operating expenses		18,500
		—————
Net profit from operations		15,600
 <u>Other Expenses and Incomes:</u>		
Interest income	1,000	
Interest expenses	800	
	—————	
Net increase		200
		—————
Net income		15,800
		—————

Habib-ur-Rehman

Balance S

heet

As at December 31, 19.....

ASSETS

Current Assets:

Cash	13,000
Sundry debtors	10,000

Bills receivable	8,500	
Stock on Dec. 31, 19 ..	10,000	
Investment	5,000	
		<hr/>
Total Current Assets		46,500
Fixed Assets:		
Buildings	50,000	
Plant and Machinery	15,500	
Furniture and fittings	10,000	
		<hr/>
Total Fixed Assets		75,500
		<hr/>
Total Assets		122,000
		<hr/>

LIABILITIES:

Current Liabilities:

Sundry creditors	20,000	
Bills payable	9,000	
		<hr/>
Total Current Liabilities		29,000

Fixed Liabilities:

Habit's capital	78,200	
Net income for the year	15,800	
		<hr/>
	94,000	
Less: Drawings	1,000	
		<hr/>
		93,000
		<hr/>
Total Liabilities and Capital		122,000

Chapter 12

Rectification of Errors

Rectification Of Accounting Errors

Once an error is located, it should be properly corrected. The correction of accounting errors in a systematic manner is called the rectification of errors. In other words, the process of systematically correcting the accounting errors is known as rectification of errors. The presence of accounting errors affects accuracy of the profit and loss and the financial position of the business shown by the final accounts, therefore, no error should be left uncorrected.

Methods Of Rectification Of Accounting Errors

The following method should be followed to rectify the accounting errors

1. Rectification of errors located before preparation of trial balance
2. Rectification of errors after preparation of trial balance

1. Rectification Of Errors Located Before Preparation Of Trial Balance

Errors may be detected in the process of closing books and accounts for preparation of trial balance. The errors detected in the process may be either one-sided errors or two-sided errors. However, once such errors are located they must be rectified immediately.

*** Rectification Of One-sided Errors Located Before Preparation Of Trial Balance**

One-sided errors are those errors which affect only one side of an account. Wrong totaling of subsidiary books, posting a wrong amount, posting on the wrong side are some of the examples of one-sided errors. Since two accounts are not involved in these errors, journal entry can not be passed for rectifying such errors. The one-sided error is rectified by making an additional posting on the affected side of the ledger account.

*** Rectification Of Two-sided Errors Located Before Preparation Of Trial Balance**

The errors that affect two or more accounts are called two-sided errors. Correction of such two-sided errors needs to make rectification journal entries since such errors involve two or more accounts. Therefore, one account is debited and another account is credited to rectify two-sided errors. The rules of debit and credit are applied to rectify these errors.

The following three steps are taken to rectify the two-sided errors.

- a. Identify correct entry
- b. Rewrite wrong entry
- c. Find rectifying entry by making adjustment of correct entry and wrong entry

2. Rectification of Errors After Preparation Of Trial Balance

Sometimes, errors may be detected after an accounting year is over. Those are the errors detected after preparation of trial balance. The errors detected after the completion of accounting year may be one-sided and two-sided errors. Rectification of the errors seen after preparation of trial balance can be made by preparing rectifying journal entries in the subsequent year only.

Double entry system is followed to rectify the errors detected after preparation of trial balance.

Two accounts are affected by the two-sided errors. Therefore, one account is debited and another affecting account is credited for such errors. But one-sided errors are rectified by opening 'Suspense Account'.

Rectification of Error

In financial accounting, every single event occurring in monetary terms is recorded. Sometimes, it just so happens that some events are either not recorded or it is recorded in the wrong head of account or wrong figure is recorded in the correct head of account.

Whatever the reason may be, there is always a chance of error in the books of accounts. These errors in accounting require rectification. The procedure adopted to rectify errors in financial accounting is called

"Rectification of error".

HOW TO RECTIFY THESE ERRORS

One way of rectification is that we can simply erase or overwrite the incorrect entry and replace it with the correct one. But this practice is not allowed in accounting. We have to Rectify / correct the mistake by recording another entry.

TYPES OF ERRORS

Before going to the rectification process, let's first see the different kinds of errors that can appear in our books of accounts:

ERROR OF OMISSION

One of the most common errors is that an event escapes recording. This means that an event occurred but we did not record it. For example, we discussed about bank charges being deducted by banks without our knowledge or our payments made by banks on our standing orders etc. There can be other reasons as well. Such errors are called ERRORS OF OMISSION.

ERROR OF COMMISSION

Then, there is a chance that the event is classified and recorded correctly but within wrong classification of account. For example, a payment to Mr. A, who is a debtor, is recorded in the account of Mr. B, who is also a debtor. Now the classification is correct but entry is posted in the wrong account. Such errors are called ERRORS OF COMMISSION.

ERROR OF PRINCIPLE

Then there are errors in which an entry is recorded in the wrong class of account. For example a purchase of fixed asset, say, a vehicle is recorded in an expense account. These errors are called **ERRORS OF PRINCIPLE**.

ERROR OF ORIGINAL ENTRY

The errors in which recording is in correct account but the figure is incorrect are called **ERRORS OF ORIGINAL ENTRY**. For example, a receipt of Rs. 50,000 from a debtor is recorded as Rs. 5,000 in his account.

REVERSAL OF ENTRY

Then, there are errors in which the entry is reversed by mistake. This means that the account that should have been debited is credited and vice versa. These errors are called **REVERSAL OF ENTRY**.

RECTIFYING THE ERRORS

Now, we will rectify all these types of entries:

1. ERROR OF OMISSION

This is the easiest error to rectify. You have to record the entry that was omitted by mistake. It is important to note here that the rectifying entry will be posted on the date on which the error was discovered. But we will give a note in the narration of the voucher that the event took place on such date.

Example

A purchase of Rs. 15,000 from ABC on April 15, was omitted by mistake
Rectification Entry on the date of discovery:

Debit:

Purchase Account

15,000

Credit:

ABC Account

15,000

Narration:

Rectification of omission of recording purchase to ABC on April 15.

2. ERRORS OF COMMISSION / ERROR OF PRINCIPLE

In both these cases, the effect given to incorrect account is reversed and effect is given to the correct account.

Example

Purchase of an asset for Rs. 20,000 is recorded in the expense account.

Rectification:

Debit:

Asset Account

50,000

Credit:

Relevant Expense Account

50,000

Narration: Rectification of purchase of asset incorrectly recorded as expense.

ERROR OF ORIGINAL ENTRY

If the entry recorded is of lesser amount than the required amount, then an entry of the balance amount is passed. On the other hand, if the entry recorded is of a greater amount than the required amount, a reverse entry is passed of the balance amount that cancels the effect of the error.

Example

1) A receipt of cash Rs. 5,000 from B is recorded as Rs. 500

2) A receipt of cash Rs. 5,000 from B is recorded as Rs. 50,000

Rectification

In

the first instance, the recorded figure is less by Rs. 4,500. The rectification entry will, therefore, be:

Debit:

Cash Account

4,500

Credit:

B Account

4,500

In

the second instance, the recorded figure exceeds by Rs. 45,000 from the desired figure. The rectification

will, therefore, be a reverse entry of Rs. 45,000:

Debit:

B Account

45,000

Credit:

Cash Account

45,000

REVERSAL OF ENTRY

If a reverse entry is recorded by mistake, then two entries are required to rectify it, one to reverse the effect

of mistake and the other to record correct entry or

we can pass one entry with double amount that serves the purpose of both the entries.

Example

A payment of Rs. 10,000 made to Mr. D is recorded on the receipt side of the cash book and credit is given

to D's account.

Rectification

We can correct this mistake by two entries:

Debit:

Mr. D Account

10,000

Credit:

Cash Account

10,000

This will reverse the effect of mistake:

Debit:

Mr. D Account

10,000

Credit:

Cash Account

10,000

And this will record the transaction correctly:

Or

We can record it through one entry:

Debit:

Mr. D Account

20,000

Credit:

Cash Account

20,000

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