## Fundamental of Accounting

### UNIT-I

### Introduction

Accounting is the common language used to communicate financial information in the world of business. Individuals, investors, managers, employees, civil servants, lawyers, regulators and other stakeholders are constantly dealing with business organisations. All of them should have good knowledge of accounting terms, principles and techniques. Accounting also provides information that is useful in making business and economic decisions.

### Meaning of Accounting

According to the American Institute of Certified Public Accountants (AICPA, Year 1961), accounting is the "art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the result thereof". According to the American Accounting Association (AAA, Year 1966), accounting is "the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of accounting". Thus, we may define accounting as the art and science of recording transactions of an organization's economic activities, measuring the end results arising thereof, and conveying the relevant information to a variety of stakeholders such as the management, shareholders, lenders, creditors, regulators, etc. In formal terms, accounting is called bookkeeping; in simple terms, accounting is "the language of business".

### NATURE OF ACCOUNTING

The various definitions and explanations of accounting has been propounded by different accounting experts from time to time and the following aspects comprise the nature of accounting:

**(i) Accounting as a service activity** Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions, in making reasoned choices among alternative courses of action. It means that accounting collects financial information for the various users for taking decisions and tackling business issues. Accounting in itself cannot create wealth though, if it produces information which is useful to others, it may assist in wealth creation and maintenance.

**(ii) Accounting as a profession** Accounting is very much a profession. A profession is a career that involve the acquiring of a specialised formal education before rendering any service. Accounting is a systematized body of knowledge developed with the development of trade and business over the past century. The accounting education is being imparted to the examinees by national and international recognised the bodies like The Institute of Chartered Accountants of India (ICAI), New Delhi in India and American Institute of Certified Public Accountants (AICPA) in USA etc. The candidate must pass a vigorous examination in Accounting Theory, Accounting Practice, Auditing and Business Law.

**(iii) Accounting as a social force In early days**, accounting was only to serve the interest of the owners. Under the changing business environment, the discipline of accounting and the accountant both have to watch and protect the interests of other people who are directly or indirectly linked with the operation of modern business. The society is composed of people as customer, shareholders, creditors and investors. The accounting information/data is to be used to solve the problems of the public at large such as determination and controlling of prices. Therefore, safeguarding of public interest can better be facilitated with the help of proper, adequate and reliable accounting information and as a result of it the society at large is benefited.

**(iv) Accounting as a language** Accounting is rightly referred the "language of business". It is one means of reporting and communicating information about a business. As one has to learn a new language to converse and communicate, so also accounting is to be learned and practised to communicate business events.

**(v) Accounting as science or art** Science is a systematised body of knowledge. It establishes a relationship of cause and effect in the various related phenomenon. It is also based on some fundamental principles. Accounting has its own principles e.g. the double entry system, which explains that every transaction has two fold aspect i.e. debit and credit. It also lays down rules of journalising. So we can say that accounting is a science. Art requires a perfect knowledge, interest and experience to do a work efficiently. Art also teaches us how to do a work in the best possible way by making the best use of the available resources. Accounting is an art as it also requires knowledge, interest and experience to maintain the books of accounts in a systematic manner. Everybody cannot become a good accountant. It can be concluded from the above discussion that accounting is an art as well as a science.

**(vi) Accounting as an information system** Accounting discipline will be the most useful one in the acquisition of all the business knowledge in the near future. You will realise that people will be constantly exposed to accounting information in their everyday life. Accounting information serves both profit-seeking business and non-profit organisations. The accounting system of a profit-seeking organisation is an information system designed to provide relevant financial information on the resources of a business and the effect of their use.

**OBJECTIVES OF ACCOUNTING**

The following are the main objectives of accounting :

**1. To keep systematic records :** Accounting is done to keep a systematic record of financial transactions. In the absence of accounting there would have been terrific burden on human memory which in most cases would have been impossible to bear.

**2. To protect business properties** : Accounting provides protection to business properties from unjustified and unwarranted use. This is possible on account of accounting supplying the following information to the manager or the proprietor:

(i) The amount of the proprietor's funds invested in the business.

(ii) How much the business have to pay to others? (

iii) How much the business has to recover from others?

(iv) How much the business has in the form of (a) fixed assets, (b) cash in hand, (c) cash at bank, (d) stock of raw materials, work-in-progress and finished goods?

Information about the above matters helps the proprietor in assuring that the funds of the business are not necessarily kept idle or underutilised.

**3. To ascertain the operational profit or loss :** Accounting helps in ascertaining the net profit earned or loss suffered on account of carrying the business. This is done by keeping a proper record of revenues and expense of a particular period. The Profit and Loss Account is prepared at the end of a period and if the amount of revenue for the period is more than the expenditure incurred in earning that revenue, there is said to be a profit. In case the expenditure exceeds the revenue, there is said to be a loss.

**4. To ascertain the financial position of the business:** The Profit and Loss Account gives the amount of profit or loss made by the business during a particular period. However, it is not enough. The businessman must know about his financial position i.e. where he stands ?, what he owes and what he owns? This objective is served by the Balance Sheet or Position Statement. The Balance Sheet is a statement of assets and liabilities of the business on a particular date. It serves as barometer for ascertaining the financial health of the business.

**5. Information System:** Accounting functions as an information system for collecting and communicating economic information about the business enterprise. This information helps the management in taking appropriate decisions. This function, as stated, is gaining tremendous importance these days.

## USERS OF ACCOUNTING INFORMATION

The basic objective of accounting is to provide information which is useful for persons inside the organisation and for persons or groups outside the organisation. Accounting is the discipline that provides information on which external and internal users of the information may base decisions that result in the allocation of economic resources in society.

I. **External Users of Accounting Information :** External users are those groups or persons who are outside the organisation for whom accounting function is performed. Following can be the various external users of accounting information:

1. **Investors**, Those who are interested in investing money in an organisation are interested in knowing the financial health of the organisation of know how safe the investment already made is and how safe their proposed investment will be. To know the financial health, they need accounting information which will help them in evaluating the past performance and future prospects of the organisation.

**2. Creditors.** Creditors (i.e. supplier of goods and services on credit, bankers and other lenders of money) want to know the financial position of a concern before giving loans or granting credit. They want to be sure that the concern will not experience difficulty in making their payment in time i.e. liquid position of the concern is satisfactory. To know the liquid position, they need accounting information relating to current assets, quick assets and current liabilities which is available in the financial statements.

**3. Members of Non-profit Organisations.** Members of non-profit organisations such as schools, colleges, hospitals, clubs, charitable institutions etc. need accounting information to know how their contributed funds are being utilised and to ascertain if the organisation deserves continued support or support should be withdrawn keeping in view the bad performance depicted by the accounting information and diverted to another organisation. In knowing the performance of such organisations, criterion will not be the profit made but the main criterion will be the service provided to the society.

**4. Government**. Central and State Governments are interested in the accounting information because they want to know earnings or sales for a particular period for purposes of taxation. Income tax returns are examples of financial reports which are prepared with information taken directly from accounting records. Governments also needs accounting information for compiling statistics concerning business which, in turn helps in compiling national accounts.

**5. Consumers.** Consumers need accounting information for establishing good accounting control so that cost of production may be reduced with the resultant reduction of the prices of goods they buy. Sometimes, prices for some goods are fixed by the Government, so it needs accounting information to fix reasonable prices so that consumers and manufacturers are not exploited. Prices are fixed keeping in view fair return to manufacturers on their investments shown in the accounting records.

**6. Research Scholars**. Accounting information, being a mirror of the financial performance of a business organisation, is of immense value to the research scholars who wants to make a study to the financial operations of a particular firm. To make a study into the financial operations of a particular firm, the research scholar needs detailed accounting information relating to purchases, sales, expenses, cost of materials used, current assets, current liabilities, fixed assets, long term liabilities and shareholders' funds which is available in the accounting records maintained by the firm.

**II Internal Users of Accounting Information.** Internal users of accounting information are those persons or groups which are within the organisation. Following are such internal users :

**1. Owners**. The owners provide funds for the operations of a business and they want to know whether their funds are being properly used or not. They need accounting information to know the profitability and the financial position of the concern in which they have invested their funds. The financial statements prepared from time to time from accounting records depicts them the profitability and the financial position.

**2. Management.** Management is the art of getting work done through others, the management should ensure that the subordinates are doing work properly. Accounting information is an aid in this respect because it helps a manager in appraising the performance of the subordinates. Actual performance of the employees can be compared with the budgeted performance they were expected to achieve and remedial action can be taken if the actual performance is not upto the mark. Thus, accounting information provides "the eyes and ears to management".

**3. Employees.** Employees are interested in the financial position of a concern they serve particularly when payment of bonus depends upon the size of the profits earned. They seek accounting information to know that the bonus being paid to them is correct.

## ROLE OF ACCOUNTING

Accounting plays an important and useful role by developing the information for providing answers to many questions faced by the users of accounting information :

(1) How good or bad is the financial condition of the business?

(2) Has the business activity resulted in a profit or loss ?

(3) How well the different departments of the business have performed in the past?

(4) Which activities or products have been profitable?

(5) Out of the existing products which should be discontinued and the production?

(6) Whether to buy a component from the market or to manufacture the same?

(7) Whether the cost of production is reasonable or excessive?

(8) What has been the impact of existing policies on the profitability of the business?

(9) What are the likely results of new policy decisions on future earning capacity of the business?

(10) In the light of past performance of the business how should it plan for future to ensure desired results?

Above mentioned are few examples of the types of questions faced by the users of accounting information. These can be satisfactorily answered with the help of suitable and necessary information provided by accounting.

Besides, accounting is also useful in the following respects :

(a) Increased volume of business results in large number of transactions and no businessman can remember everything. Accounting records obviate the necessity of remembering various transactions.

(b) Accounting records, prepared on the basis of uniform practices, will enable a business to compare results of one period with another period.

(c) Taxation authorities (both income tax and sales tax) are likely to believe the facts contained in the set of accounting books if maintained according to generally accepted accounting principles.

(d) Accounting records, backed up by proper and authenticated vouchers, are good evidence in a court of law.

(e) If a business is to be sold as a going concern, then the values of different assets as shown by the balance sheet helps in bargaining proper price for the business.

**LIMITATIONS OF FINANCIAL ACCOUNTING**

Advantages of accounting discussed in this lesson do not suggest that accounting is free from limitations. Any one who is using accounting information should be well aware of its limitations also.

Following are the limitations :

(a) Financial accounting permits alternative treatments No doubt accounting is based on concepts and it follows "generally accepted accounting principles", but there exist more than one principle for the treatment of any one item. This permits alternative treatments within the framework of generally accepted accounting principles. For example, the closing stock of a business may be valued by any one of the following methods : FIFO (First-in-first-out); LIFO (Last-in-first-out); Average price, Standard price etc., Application of different methods will give different results but the methods are generally accepted. So, the results are not comparable.

(b) Financial accounting is Influenced by personal judgements
Inspite of the fact that convention of objectivity is respected in accounting but to record certain events estimates have to be made which requires personal judgement. It is very difficult to expect accuracy in future estimates and objectivity suffers. For example, in order to determine the amount of depreciation to be charged every year for the use of fixed asset it is required to estimate (a) future life of the asset, and (b) scrap value of the asset. Thus in accounting we do not determine but measure the income. In other words, the income disclosed by accounting is not authoritative but approximation.

(c) Financial accounting ignores important non-monetary information Financial accounting takes into consideration only those transactions and events which can be described in money. The transactions and events, however important, if non-monetary in nature are ignored i.e., not recorded. For example, extent of competition faced by the business, technical innovations possessed by the business, loyalty and efficiency of the employees etc. are the important matters in which management of the business is highly interested but accounting is not tailored to take note of such matters

(d) Financial accounting does not provide timely information Financial accounting is designed to supply information in the form of statements (Balance Sheet and Profit and Loss Account) for a period, normally, one year. So the information is, at best, of historical interest and only postmortem analysis of the past can be conducted. The business requires timely information at frequent intervals to enable the management to plan and take corrective action.

(e) Financial accounting does not provide detailed analysis The information supplied by the financial accounting is in reality aggregate of the financial transactions during the course of the year. Of course, it enables to study the overall results of the business activity during the accounting period. For proper running of the business the information is required regarding the cost, revenue and profit of each product but financial accounting does not provide such detailed information product-wise.

**UNIT II**

**Generally Accepted Accounting Principles (GAAP)**

**Introduction** Accounting plays a crucial role in the business world by providing reliable financial information to stakeholders for informed decision-making. To maintain uniformity, comparability, and accuracy in financial statements, Generally Accepted Accounting Principles (GAAP) have been developed. These principles form the foundation of financial accounting and guide how transactions and events should be recorded and reported.

**Meaning of GAAP** GAAP refers to the standard framework of guidelines for financial accounting used in any given jurisdiction. It includes standards, conventions, and rules accountants follow in recording and summarizing transactions and preparing financial statements.

**Nature of GAAP** GAAP is essential in standardizing financial reporting to make it understandable and useful for users. The principles ensure consistency, transparency, and fairness.

**Important GAAP Principles**

1. **Business Entity Concept**: A business is treated separately from its owner.
2. **Going Concern Concept**: Assumes that the business will continue its operations in the foreseeable future.
3. **Money Measurement Concept**: Only transactions that can be measured in money are recorded.
4. **Cost Principle**: Assets are recorded based on historical cost.
5. **Dual Aspect Concept**: Every transaction affects at least two accounts.
6. **Revenue Recognition Principle**: Revenue is recognized when earned, not when received.
7. **Matching Principle**: Expenses should be matched with the revenues they help to generate.
8. **Accrual Principle**: Transactions are recorded when they occur, not when cash is received or paid.
9. **Conservatism Principle**: Anticipate losses but not profits.
10. **Consistency Principle**: Same methods and procedures should be applied consistently.

**2.2 Basic Terms in Accounting**

**Introduction** Accounting involves several fundamental terms that are essential to understanding and applying accounting practices.

**Key Terms**

1. **Transaction**: A financial event that can be measured in monetary terms.
2. **Assets**: Resources owned by a business (e.g., cash, inventory, machinery).
3. **Liabilities**: Obligations owed to outsiders (e.g., loans, creditors).
4. **Capital**: The owner's investment in the business.
5. **Drawings**: Withdrawals by the owner for personal use.
6. **Revenue**: Income generated from business activities.
7. **Expenses**: Costs incurred to earn revenue.
8. **Profit**: When income exceeds expenses.
9. **Loss**: When expenses exceed income.
10. **Debtor**: A person who owes money to the business.
11. **Creditor**: A person to whom the business owes money.
12. **Journal**: Book of original entry.
13. **Ledger**: Book where all journal entries are classified.

**2.3 Meaning and Types of Accounts**

**Meaning** An account is a systematic record of all transactions relating to a particular person, item, or category.

**Types of Accounts** (Traditional Classification)

1. **Personal Account**: Relates to persons or organizations.
    - Rule: Debit the receiver, Credit the giver.
2. **Real Account**: Relates to assets.
    - Rule: Debit what comes in, Credit what goes out.
3. **Nominal Account**: Relates to expenses and incomes.
    - Rule: Debit all expenses and losses, Credit all incomes and gains.

**Types of Accounts** (Modern Classification)

1. Asset Account
2. Liability Account
3. Capital Account
4. Revenue Account
5. Expense Account

**2.4 Double Entry System**

**Introduction** The Double Entry System is a fundamental concept in accounting that ensures every transaction has equal and opposite effects in at least two different accounts.

**Definition** It is a system where every transaction is recorded twice – once as a debit in one account and once as a credit in another.

**Principles**

- Every debit has a corresponding and equal credit.
- Maintains the accounting equation: Assets = Liabilities + Capital

**Example** If cash is received from a debtor:

- Debit: Cash Account (What comes in)
- Credit: Debtor's Account (Giver)

**Advantages**

1. Ensures accuracy.
2. Facilitates preparation of final accounts.
3. Helps in error detection through trial balance.
4. Provides complete information about all business transactions.

**2.5 Difference between Accounting and Bookkeeping**

| **Basis** | **Bookkeeping** | **Accounting** |
|---|---|---|
| Nature | Recording of transactions | Summarizing, analyzing, and interpreting |
| Purpose | To maintain records | To prepare financial statements |
| Scope | Narrow | Broad |
| Decision-Making | Not used for decision-making | Used for decision-making |
| Level of Work | Clerical | Analytical |

| | | |
|---|---|---|
| Users | Internal only | Internal and External |
| Output | Journal and ledger | Profit & Loss Account and Balance Sheet |

**Conclusion** Bookkeeping is the foundation for accounting. While bookkeeping is limited to recording transactions, accounting gives a complete picture of the financial performance and position of the business through analysis and interpretation.

## UNIT III

**Introduction**
In accounting, the process of recording business transactions begins with the journal. The journal is often referred to as the **book of original entry**, as every financial transaction is recorded here before being posted to the ledger.

**Meaning of Journal**
A **journal** is a chronological record of financial transactions. Each entry records the **date of transaction**, **accounts affected**, **amount debited and credited**, and a **brief narration** explaining the transaction.
**Definition**
Journal is the first stage in the accounting cycle where transactions are recorded in a detailed manner as per the double entry system of accounting.
**Format of a Journal Entry**

| **Date** | **Particulars** | **L.F.** | **Debit (₹)** | **Credit (₹)** |
|---|---|---|---|---|
| 01-01-2025 | Cash A/c Dr. | 101 | 10,000 | |
| | To Capital A/c | 102 | | 10,000 |
| | (Being capital introduced) | | | |

**Merits of Journal**
1. **Chronological Record**: Transactions are recorded in the order they occur, making it easier to trace activities.
2. **Complete Details**: Each journal entry provides full information, including narration.
3. **Facilitates Posting**: Helps in accurate transfer of entries to the ledger.
4. **Evidence in Legal Matters**: Journal entries can be used as proof in courts.
5. **Helps in Error Detection**: Mistakes are easier to identify when transactions are well-documented.

**Demerits of Journal**
1. **Time-consuming**: Recording all entries in detail is labor-intensive.
2. **Not Suitable for Large Businesses**: For high-volume transactions, subsidiary books are more efficient.

3. **Redundancy**: Transactions are recorded twice (journal and then ledger), which may be repetitive.
4. **Delay in Final Reporting**: Because journalizing is the first step, preparation of final accounts may be delayed.

**3.2 Ledger: Meaning, Merits & Demerits, Balancing**

**Introduction**

Once transactions are recorded in the journal, they are **classified** and **summarized** in the **ledger**. The ledger is often called the **principal book of accounts**.

**Meaning of Ledger**

A **ledger** is a book that contains all accounts (assets, liabilities, incomes, expenses, etc.) in a summarized and classified form. It helps to ascertain the balances of various accounts.

**Definition**

Ledger is the book where transactions are transferred from the journal and grouped into individual accounts. It forms the basis for preparing trial balance and financial statements.

**Format of Ledger Account**

| **Debit (Dr) Side** | **₹** | **Credit (Cr) Side** | **₹** |
|---|---|---|---|
| Date | Particulars | Amt | Date |

**Merits of Ledger**

1. **Classified Information**: Transactions are sorted under appropriate heads.
2. **Facilitates Trial Balance**: Helps in preparation of trial balance and final accounts.
3. **Account Balances**: Shows closing balances of accounts which help in financial analysis.
4. **Control Over Transactions**: Helps monitor various elements like expenses, revenues, debtors, etc.

**Demerits of Ledger**

1. **Does Not Show Full Details**: Unlike journal, ledger doesn't include narrations.
2. **Requires Careful Posting**: Incorrect posting can lead to misleading results.
3. **Depends on Journal**: Cannot function without accurate journal entries.

**Balancing of Ledger**

Balancing means calculating the difference between the debit and credit sides of an account to find the net balance. The balance is then carried forward to the next period.

- If **debit > credit**, it's a **debit balance**.
- If **credit > debit**, it's a **credit balance**.

Example:
If Cash Account has total debits of ₹50,000 and credits of ₹30,000:
**Balance c/d (Carried down) = ₹20,000 (Debit Balance)**

**3.3 Subsidiary Books**

**Introduction**

In businesses with a large number of transactions, recording all entries in a single journal becomes cumbersome. To address this, **subsidiary books** are maintained. These are special-purpose journals used to record repetitive transactions.

**Types of Subsidiary Books**

**1. Cash Book**

**Meaning**

A **Cash Book** is a specialized journal that records all **cash receipts** and **cash payments**, including bank transactions (in case of a two-column or three-column cash book).

**Types of Cash Book**

1. **Single Column Cash Book** – Only cash transactions.
2. **Double Column Cash Book** – Cash and Bank columns.
3. **Triple Column Cash Book** – Cash, Bank, and Discount columns.

**Merits**

- Facilitates real-time cash tracking.
- Helps in bank reconciliation.
- Reduces the load on journal entries.

**2. Purchases Book**

**Meaning**

This book records **credit purchases of goods** (not assets).

**Format**

| Date | Supplier Name | Invoice No. | Amount (₹) |
|---|---|---|---|

**Merits**

- Helps track all credit purchases systematically.
- Useful for controlling payables.

**3. Purchases Return Book**

**Meaning**

Also called the **Return Outward Book**, it records **goods returned** to suppliers due to defects, damage, or excess quantity.

**Format**

| Date | Supplier | Debit Note No. | Amount (₹) |
|---|---|---|---|

**Purpose**

Helps reduce liability and adjust accounts payable accordingly.

**4. Sales Book**

**Meaning**

This book records all **credit sales** of goods (not of fixed assets).

**Format**

| Date | Customer Name | Invoice No. | Amount (₹) |
|---|---|---|---|

**Merits**

- Streamlines the recording of revenues.
- Facilitates faster preparation of customer account balances.

**5. Sales Return Book**
**Meaning**
Also known as the **Return Inward Book**, it records goods **returned by customers** due to faults, damage, or incorrect delivery.
**Format**

| Date | Customer | Credit Note No. | Amount (₹) |
|---|---|---|---|

**Purpose**
Helps maintain accurate accounts receivable by adjusting the returns.

**Conclusion on Subsidiary Books**
Subsidiary books reduce the burden on the journal and help in categorizing similar transactions. They make bookkeeping more efficient, especially in large organizations with high transaction volume.

**UNIT IV**

**Trial Balance: Meaning and Objectives**
**Introduction**
After transactions are recorded in the journal and posted to the ledger, the next step in the accounting cycle is to ensure that total debits equal total credits. This is done through the preparation of a **Trial Balance**, which is an important step before preparing the final accounts.
**Meaning of Trial Balance**
A **Trial Balance** is a statement that shows the balances of all ledger accounts on a particular date, arranged in debit and credit columns. It is prepared to verify the **arithmetic accuracy** of the books of accounts and to ensure that the **debit equals credit** as per the double-entry system.
**Definition**
Trial Balance is defined as a statement that contains all the ledger balances on a particular date and serves as a proof of the arithmetical accuracy of the ledger.
**Format of Trial Balance**

| S. No. | Name of Account | L.F. | Debit (₹) | Credit (₹) |
|---|---|---|---|---|
| 1 | Cash A/c | 101 | 50,000 | |
| 2 | Capital A/c | 102 | | 50,000 |
| | **Total** | | 50,000 | 50,000 |

**Objectives of Preparing Trial Balance**
1. **To check arithmetical accuracy**: Ensures total debits equal total credits.
2. **To assist in preparation of final accounts**: Basis for preparing trading, profit & loss account and balance sheet.

3. **To locate errors**: Helps detect some accounting errors before final accounts are prepared.
4. **To summarize ledger accounts**: Provides a summarized list of all ledger balances.
5. **To provide a foundation for adjustments**: Adjustments for outstanding/prepaid items are made after trial balance.

### 4.2 Methods of Preparing Trial Balance

There are three primary methods to prepare a Trial Balance:

**1. Balance Method**

- Only the **net balances** (either debit or credit) of each ledger account are shown in the trial balance.
- Most commonly used method in practice.

**2. Total Method**

- The **total debit and total credit** amounts of each account (without netting) are recorded.
- Used less often due to duplication and confusion.

**3. Compound Method**

- Combines the **balance and total methods** by showing both total and balances of accounts.
- Useful for analysis but rarely used in final reporting.

### 4.3 Errors Revealed by Trial Balance

Though the Trial Balance checks arithmetical accuracy, it can reveal only certain types of errors. These errors affect the equality of debit and credit totals.

**Errors revealed by Trial Balance include:**

1. **Errors in Posting**
   - Wrong amount posted to either debit or credit side of ledger account.
2. **Errors in Casting**
   - Mistake in totaling subsidiary books (e.g., overcasting purchase book).
3. **Errors in Balancing**
   - Incorrect balance transferred from ledger account to trial balance.
4. **Error in Recording One Side of Transaction**
   - If only one side (either debit or credit) of a transaction is recorded.
5. **Wrong Total in Trial Balance**
   - Mistake in totaling debit or credit column of the trial balance.

Such errors cause the trial balance not to tally, and therefore, can be identified easily and rectified before final account preparation.

### 4.4 Errors Not Revealed by Trial Balance

There are certain errors which do not affect the equality of the debit and credit columns of the trial balance. These remain **hidden**, even if the trial balance agrees.

**Common Errors Not Revealed by Trial Balance:**

1. **Errors of Omission**
   - Entire transaction not recorded in the books (e.g., missed journal entry).
2. **Errors of Commission**

    - Correct amount posted to wrong account of the same type (e.g., Ram's A/c instead of Shyam's A/c).
3. **Errors of Principle**
    - Incorrect classification of expenditure or income (e.g., treating capital expenditure as revenue).
4. **Compensating Errors**
    - Two or more errors cancel each other out (e.g., one over-debit and one over-credit of same amount).
5. **Errors of Original Entry**
    - Wrong amount entered in the journal, but posted to ledger correctly as per the incorrect amount.
6. **Complete Reversal of Entries**
    - Debiting the account that should have been credited and vice versa.

These errors cannot be detected by the trial balance and usually come to light during audit or internal checking.

**4.5 Rectification of Errors**

**Introduction**

Errors, whether revealed or not by the trial balance, must be corrected to ensure that the accounting records reflect the true and fair view of the business transactions. The process of correcting these errors is known as **Rectification of Errors**.

**When are Errors Rectified?**

- **Before preparing Trial Balance**: Errors can be corrected by simply erasing and re-writing (if allowed).
- **After preparing Trial Balance but before Final Accounts**: Rectified by passing **journal entries**.
- **After preparing Final Accounts**: Rectified using **Profit & Loss Adjustment Account**.

**Methods of Rectifying Errors**

1. **Errors in Journal or Ledger Posting**
    - Correct entry is passed to nullify the wrong one.
2. **Use of Suspense Account**
    - If trial balance doesn't tally due to some unknown error, a temporary account called **Suspense A/c** is used to make it tally. When the actual error is found, suspense account is adjusted.

**Examples of Rectification Entries**

| Error | Rectification Entry |
| --- | --- |
| Wages paid ₹500 wrongly debited to Machinery A/c | Wages A/c Dr. ₹500 To Machinery A/c ₹500 |
| Sales to Ramesh ₹1,000 not recorded | Ramesh A/c Dr. ₹1,000 To Sales A/c ₹1,000 |

| Error | Rectification Entry |
| --- | --- |
| Purchase of goods from Suresh ₹2,000 posted to Mahesh | Mahesh A/c Dr. ₹2,000<br>To Suresh A/c ₹2,000 |

**Conclusion**

The rectification of errors is essential to maintain accuracy and reliability of accounting records. Errors, if not corrected, may lead to wrong financial statements, affecting decision-making.

**UNIT V**

**5.1 Meaning of Financial Statements**

**Introduction**

Every business aims to ascertain its financial position and performance at the end of an accounting period. For this purpose, a set of financial statements is prepared to provide a summary of financial activities. These statements serve as the final step in the accounting process.

**Meaning of Financial Statements**

**Financial Statements** are formal records that summarize the financial performance and position of a business. They include the **Trading Account**, **Profit and Loss Account**, and the **Balance Sheet**. These statements are prepared at the end of the accounting period, usually annually.

**Definition**

Financial Statements refer to the statements that exhibit the profitability and financial status of an enterprise for a particular period.

**Components of Financial Statements**

1. **Trading Account** – To determine gross profit or loss.
2. **Profit and Loss Account** – To determine net profit or loss.
3. **Balance Sheet** – To present financial position in terms of assets, liabilities, and capital.

**5.2 Need for Financial Statements**

**Introduction**

Financial statements are essential for internal management and external stakeholders to assess the performance and financial soundness of a business.

**Need and Importance of Financial Statements**

1. **To determine profitability**
   - Shows whether the business earned profit or incurred loss.
2. **To know financial position**
   - Helps ascertain what the business owns (assets) and owes (liabilities).
3. **For decision making**
   - Management uses these statements to plan future operations and make strategic decisions.
4. **For investors and creditors**
   - Investors assess whether to invest, while creditors evaluate the ability to repay debts.
5. **To ensure compliance**

- Mandatory under various laws like Companies Act, Income Tax Act, etc.

6. **To attract loans and investments**
   - Financial institutions rely on these statements before extending loans.
7. **For comparative analysis**
   - Helps in comparing financial performance over different periods or with other firms.

**5.3 Trading Account**

**Introduction**

The first step in the preparation of final accounts is the **Trading Account**. It is prepared to determine the **gross profit or gross loss** from the core trading activities of the business.

**Meaning of Trading Account**

A **Trading Account** shows the result of buying and selling goods. It compares **net sales** with **cost of goods sold (COGS)** to find out gross profit or loss.

**Formula**

**Gross Profit = Net Sales – Cost of Goods Sold**

**Cost of Goods Sold = Opening Stock + Purchases + Direct Expenses – Closing Stock**

**Items on the Debit Side**

- Opening Stock
- Purchases (less purchase returns)
- Wages and Salaries
- Carriage Inward, Freight, Octroi, etc.
- Direct expenses related to manufacturing or procurement

**Items on the Credit Side**

- Sales (less sales returns)
- Closing Stock

**Format (Simple)**

| **Dr. Trading Account for the year ended…** | **Cr.** |
|---|---|
| Particulars | ₹ |
| Opening Stock | XXX |
| Purchases | XXX |
| Less: Purchase Returns | (XX) |
| Wages | XXX |
| Carriage Inwards | XXX |
| Gross Profit c/d | XXX |
| **Total** | XXX |

**5.4 Profit and Loss Account**

**Introduction**

After preparing the trading account, the **Profit and Loss Account** is prepared to determine the **net profit or net loss** of the business from all operations, including indirect income and expenses.

**Meaning of Profit and Loss Account**

It is a financial statement that shows the net result of business operations during an accounting period after all **indirect expenses** and **other incomes** are considered.

**Formula**

**Net Profit = Gross Profit + Other Incomes – Indirect Expenses**

**Items on the Debit Side (Expenses)**

- Salaries
- Rent and Rates
- Insurance
- Depreciation
- Bad Debts
- Interest Paid
- Office and Administrative Expenses

**Items on the Credit Side (Incomes)**

- Gross Profit (from Trading Account)
- Commission Received
- Interest Received
- Discount Received
- Rent Received

**Format (Simple)**

| **Dr. Profit and Loss Account for the year ended…** | **Cr.** |
|---|---|
| Particulars | ₹ |
| Salaries | XXX |
| Rent | XXX |
| Depreciation | XXX |
| Interest Paid | XXX |
| Net Profit transferred to Capital A/c | XXX |
| **Total** | XXX |

## 5.5 Balance Sheet

**Introduction**

The final component of the financial statements is the **Balance Sheet**, which provides a snapshot of the company's financial position at a specific point in time.

**Meaning of Balance Sheet**

A **Balance Sheet** is a statement that shows the **assets**, **liabilities**, and **capital** of a business as on a particular date. It is based on the accounting equation: **Assets = Liabilities + Capital**

**Purpose of Balance Sheet**

- To know the financial strength of the business
- To assess liquidity and solvency
- To provide data for analysis by external stakeholders

**Structure of Balance Sheet**

1. **Assets**
    - Fixed Assets: Land, Building, Machinery, etc.
    - Current Assets: Cash, Debtors, Stock, Bills Receivable, etc.
2. **Liabilities**
    - Long-term Liabilities: Loans, Debentures
    - Current Liabilities: Creditors, Outstanding Expenses, Bills Payable
3. **Capital**
    - Opening Capital + Net Profit – Drawings

**Format (Simple)**

**Balance Sheet as on…**

**Liabilities**

Capital

Add: Net Profit

Less: Drawings

Creditors

Bills Payable

Outstanding Expenses

**Total**

**Conclusion**

The financial statements collectively provide a complete picture of the business's performance and position. While the **Trading Account** and **Profit & Loss Account** reflect profitability, the **Balance Sheet** showcases the financial standing of the business on a given date.