

SRI CHANDRASEKHARENDRA SARASWATHI VISWA MAHAVIDYALAYA

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DEPARTMENT OF COMMERCE



B. Com. IN COMMERCE

ODL Mode (Semester Pattern)

Financial Accounting

Course Designed and Prepared Committee

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B. Com
Self-Learning Material (SLM)

Course: Financial Accounting

Objective

To Impart basic accounting knowledge as applicable to commerce, trade and business

Unit – I

Meaning and Scope of Accounting, Basic Accounting concepts and conventions – Objectives of Accounting – Accounting Transactions – Double Entry Book Keeping – Journal, Ledger, Preparation of Trial Balance – Preparation of Cash Book

Unit – II

Preparation of Final Accounts of a sole trading concern – Adjustments Receipt and Payments Account, Income and Expenditure Account and Balance sheet of Non-Trading Organisations.

Unit – III

Errors - Classification of Errors – Rectification of Errors – Preparation of Suspense Account Bank Reconciliation Statement

Unit – IV

Depreciation – Meaning, causes, Types – Straight Line Method – Written Down Value Method, Insurance Policy Method, Sinking Fund Method & Annuity Method, Insurance Claims – Average Clause (Loss of Stock & Loss of Profit)

Unit – V

Single Entry – Meaning, Features, Defects, Difference between Single Entry and Double Entry System – Statement of Affairs Method – Conversion Method

Text Books:

1. Financial Accounting (Fundamentals, Analysis and Reporting) – R. K. Arora, Wiley Publisher, First edition 2017.
2. Financial Accounting – R.L.Gupta and V.K.Gupta – Sultan Chand & Sons, New Delhi.
3. Financial Accounting – S.P.Jain and K.L.Narang – Kalyani Publishers, Ludhiana.

Reference Books:

1. Financial Accounting – Reddy and Murthy – Margham Publications, Chennai-17.
2. Advanced Accounting I – Dr.Chandra Bose PHI Learning (P) Ltd.
3. Advanced Accounting - Dr.S.Peer Mohamed Dr.S.A.N.Shezuli Ibrahim Pass Publication, Madurai.

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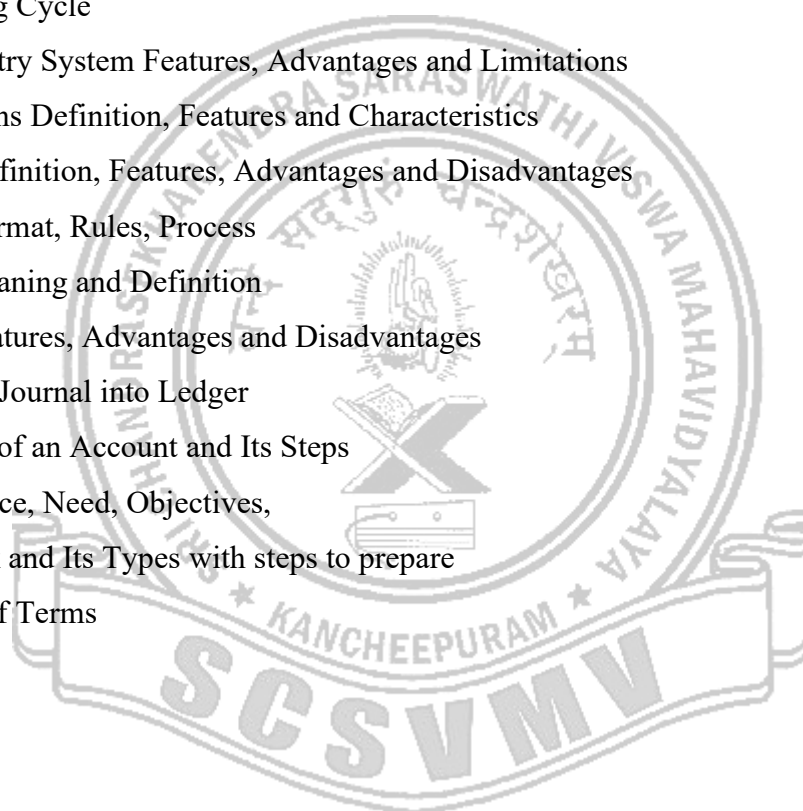
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Unit - I

Introduction to Accounting

Accounting is a systematic process of identifying, recording, classifying, summarizing, analysing, interpreting, and communicating financial information to the interested parties such as owners, investors, creditors, and management. Accounting is the "language of business" because it communicates the financial health and performance of an organization. It provides valuable insights into a business's performance, aids in compliance with laws, supports strategic planning, and enhances transparency. The main purpose of accounting is to ascertain profit or loss during a specified period, to show financial condition of the business on a particular date and to have control over the firm's property. Such accounting records are required to be maintained to measure the income of the business and communicate the information so that it may be used by managers, owners and other interested parties.

Meaning of Accounting

Accounting involves book keeping and systematic activities. Accounting is the process of identifying, recording, classifying, summarising, interpreting and communicating financial information of business to its users for judgement and decision making.

Definition of Accounting

The American Institute of Certified Public Accountants defines (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".

The American Accounting Association defines (Year 1966): "The process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of accounting".

Objectives of Accounting

i) To keep systematic records

Accounting is done to keep a systematic record of financial transactions, like purchase of goods, sale of goods, cash receipts and cash payments. Systematic record of various assets and liabilities of the business is also to be maintained.

ii) To ascertain the net effect of the business operations i.e., profit or loss of business

We know that the primary objective of business is to make profit and the businessman is very much interested in knowing the same. A proper record of income and expenses facilitates the preparation of the profit and loss account (income statement). The profit and loss account reveals the profit earned or loss incurred by the business firm during a particular period.

iii) To ascertain the financial position of the business

The businessman is not only interested in knowing the operating results, but also interested in knowing the financial position of his business i.e., where it stands. In other words, he wants to know when the business owes to others and what it owns and what happened to his capital – whether the capital increased or decreased or remained constant. A systematic record of various assets and liabilities facilitates the preparation of a statement known as ‘balance sheet’ (position statement) which answers these questions.

iv) To provide accounting information to interested parties

Apart from the owners, there are various other parties who are interested in knowing about the business firm, such as the management, the bank, the creditors, the tax authorities, etc. For this purpose, the accounting system has to furnish the required information.

Accounting Principles

The transactions of the business enterprise are recorded in the business language, which routed through accounting. The entire accounting system is governed by the practice of accountancy. The accountancy is being practiced through the universal principles which are wholly led by the concepts and conventions.

Accounting Principles = Accounting Concepts + Accounting Conventions

Accounting Concepts

The following are the most important concepts of accounting

1. Money Measurement Concept
2. Business Entity Concept
3. Going Concern Concept
4. Matching Concept
5. Accounting Period Concept
6. Duality or Double Entry Concept
7. Cost Concept

1) Money measurement concept

This is the concept tunes the system of accounting as fruitful in recording the transactions and events of the enterprise only in terms of money. The money is used as well as expressed as a denominator of the business events and transactions. The transactions which are not in the expression of monetary terms cannot be registered in the book of accounts as transactions.

2) Business Entity Concept

This concept treats the owner as totally a different entity from the business. To put in to nutshell “Owner is different and Business is different”. The capital which is brought inside the firm by the owner, at the commencement of the firm is known as capital. The amount of the capital, which was initially invested, should be returned to the owner considered as due to the owner; who was nothing but the contributory of the capital.

3) Going Concern Concept

The concept deals with the quality of long-lasting status of the business enterprise irrespective of the owners’ status, whether he is alive or not. This concept is known as concept of long-term assets. The fixed assets are bought in the intention to earn profits during the season of the business. The assets which are idle during the slack season of the business retained for future usage, in spite of that those assets are frequently sold out by the firm immediately after the utility leads to mean that those assets are not fixed

assets but tradable assets. The fixed assets are retained by the firm even after the usage is only due to the principle of long lastingness of the business enterprise. If the business disposes the assets immediately after the current usage by not considering the future utility of the assets in the firm which will not distinguish in between the long-term assets and short-term assets known as tradable in categories.

4) Matching Concept

This concept only makes the entire accounting system as meaningful to determine the volume of earnings or losses of the firm at every level of transaction; which is an outcome of matching in between the revenues and expenses.

The worth of the transaction is identified through matching of revenues which are mainly generated from the sales volume and the expenses of the firm at every level.

5) Accounting Period Concept

The life period of the business is of a long span which is classified into the operating periods which are smaller in duration. The accounting period may be either calendar year of Jan.-Dec. or fiscal year of April-Mar. The operating periods are not equivalent among the trading firms. This means that the operating period of one firm may be shorter than the other one. The ultimate aim of the concept is to nullify the deviations of the operating periods of various traders in the trading practice.

6) Duality or Double Entry Accounting Concept

It is the only concept which portrays the two sides of a single transaction. The law of entire business revolves around only on mutual agreement sharing policy among the players. How mutual agreement is taking place?

The entire principle of business is mainly conducted on mutual agreement among the parties from one occasion to another. The payment of wages is only made by the firm out of the services of labourers. What kind of mutual agreement in sharing the benefits is taking place? The services of the labourers are availed by the firm through the payment of wages. Likewise, the labourers are regularly getting wages for their services in the firm.

Payment of Wages = Labourers' service

In the angle of accounting aspects of a firm, the labourer services are availed through the payment of wages nothing but the mutual sharing of benefits. This is denominated into two different facets of accounting, viz. Debit and Credit. Every debit transaction is appropriately equated with the transaction of credit.

All the above samples of transactions are being carried out by the firm through the raising of financial resources. The resources raised are finally deployed in terms of assets. It means that the total funds raised by the firm are equated to the total investments.

7) Cost Concept

It is the concept closely relevant with the going concern concept. Under this concept, the transactions are recorded only in terms of cost rather than in market value. Fixed assets are only entered in terms of the purchase price which is an original cost of the asset at the moment of purchase. The depreciation is deducted from the original value which is the initial purchase price of the asset will highlight the book value of the asset at the end of the accounting period. The marketing value of the asset should not be taken into consideration, why? The main reason is that the market value of the asset is subject to fluctuations due to demand and supply forces. The entry of market value of the asset will require the frequent update of information to the tune of changes in the market. Will it be possible to record the changes taken place in the market then and there? This is not only impossible for regular updating of information but also leads to lot of consequences. Though the firm is ready to register the market value, which market value has to be taken into consideration? The market value can be bifurcated into two categories, viz.

Accounting Conventions

1. Convention of consistency
2. Convention of conservatism
3. Convention of disclosure
4. Convention of materiality

1) Convention of Consistency

The nature of recording the transactions should not be changed at any cause or moment. It should be maintained throughout the life period of the firm. If a firm follows the straight line method of charging the depreciation since its inception should be followed without any change. The firm should not alter the method of charging the depreciation from one method to another. The change cannot be entertained. If any change has to be incorporated, the valid reason for change should be emphasized.

2) Convention of Conservatism

The conservatism won't give any emphasis on the anticipation of the firm, instead it gives paramount importance to all possible uneventualities of the firm without considering the future profits.

The most important of the rule of guidance at the moment of valuing the stock is as follows:

Stock of the goods should be valued either market price or cost whichever is lower to anticipate the future losses due to default in the payments of the customers

This provision is created for bad and doubtful debts of the firm in order to meet the losses expected out of the defaulters.

According to this convention, the entire status of the firm should be highlighted/presented in detail without hiding anything; which has to furnish the required information to various parties involved in the process of the firm.

3) Convention of Disclosure

Convention of disclosure requires that all material and relevant facts concerning financial statements should be fully disclosed. Full disclosure means that there should be full, fair and adequate disclosure of accounting information. Adequate means sufficient set of information to be disclosed. Fair indicates an equitable treatment of users. Full refers to complete and detailed presentation of information. Thus, the convention of disclosure suggests that every financial statement should fully disclose all relevant information.

4) Convention of Materiality

The convention of materiality states that, to make financial statements meaningful, only material fact i.e., important and relevant information should be supplied to the users of accounting information. The question that arises here is what a material fact is. Information is material if its omission or misstatement could influence the economic decision of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

Book Keeping

Book-keeping is a part of accounting. It is the record keeping function of accounting and is limited up to the classifying stage. Bookkeeping is largely a mechanical process and does not involve any analysis of the financial transactions whereas, accounting includes the preparation of statements concerning assets, liabilities and the operating results of a business.

Objectives of Book Keeping

- to have permanent record of all the business transactions.
- to keep records of income and expenses in such a way that the net profit or net loss may be calculated.
- to keep records of assets and liabilities in such a way that the financial position of the business may be ascertained.
- to keep control on expenses with a view to minimise the same in order to maximise profit.
- to know the names of the customers and the amount due from them.
- to know the names of suppliers and the amount due to them.
- to have important information for legal and tax purposes.

Advantages of Book Keeping

i) Permanent and Reliable Record: Book-keeping provides permanent record for all business transactions, replacing the memory which fails to remember everything.

ii) Arithmetical Accuracy of the Accounts: With the help of book keeping trial balance can be easily prepared. This is used to check the arithmetical accuracy of accounts.

iii) Net Result of Business Operations: The result (Profit or Loss) of business can be correctly calculated.

iv) Ascertainment of Financial Position: It is not enough to know the profit or loss; the proprietor should have a full picture of his financial position in business. Once the full picture (say for a year) is known, this helps him to plan for the next year's business.

v) Ascertainment of the Progress of Business: When a proprietor prepares financial statements every year, he will be in a position to compare the statements. This will enable him to ascertain the growth of his business. Thus book keeping enables a long-range planning of business activities besides satisfying the short-term objective of calculation of annual profits or losses.

vi) Calculation of Dues: For certain transactions payments may be made later. Therefore, the businessman has to know how much he has to pay others.

vii) Control over Assets: In the course of business, the proprietor acquires various assets like building, machines, furniture, etc. He has to keep a check over them and find out their values year after year.

viii) Control over Borrowings: Many businessmen borrow from banks and other sources. These loans are repayable. Just as he must have a control over assets, he should have control over liabilities.

ix) Identifying Do's and Dont's: Book keeping enables the proprietor to make an intelligent and periodic analysis of various aspects of the business such as purchases, sales, expenditures and incomes. From such analysis, it will be possible to focus his attention on what should be done and what should not be done to enhance his profit earning capacity.

x) Fixing the Selling Price: In fixing the selling price, the businessmen have to consider many aspects of accounting information such as cost of production, cost of purchases and other expenses. Accounting information is essential in determining selling prices.

xi) Taxation: Businessmen pay sales tax, income tax, etc. The tax authorities require them to submit their accounts. For this purpose, they have to maintain a record of all their business transactions.

xii) Management Decision-making: Planning, reviewing, revising, controlling and decision-making functions of the management are well aided by book-keeping records and reports.

xiii) Legal Requirements: Claims against and for the firm in relation to outsiders can be confirmed and established by producing the records as evidence in the court.

Differences Between Book Keeping and Accounting

Basis of Differences	Book keeping	Accounting
Nature	It is concerned with identifying financial transactions; measuring them in monetary terms; recording and classifying them.	It is concerned with summarising the recorded transactions, interpreting them and communicating the result.
Objectives	It is to maintain systematic records of financial transactions	It aims at ascertaining business income and financial position by maintaining records of business transaction.
Function	It is to record business transactions. So, its scope is limited	It is recording, classifying, summarising, interpreting business transactions and communicating the result. Thus, its scope is quite wide.
Basis	Vouchers and other supporting documents are necessary as evidence to record the business transactions.	Book-keeping works as the basis for accounting information.

Level of Knowledge	It is enough to have elementary Knowledge of accounting to do bookkeeping.	For accounting, advanced and in-depth knowledge and understanding is required.
Relation	Book-keeping is the first step to accounting.	Accounting begins where bookkeeping ends

Accounting Cycle

- a) Recording of Transaction:** As soon as a transaction happens it is at first recorded in subsidiary book.
- b) Journal:** The transactions are recorded in Journal chronologically.
- c) Ledger:** All journals are posted into ledger chronologically and in a classified manner.
- d) Trial Balance:** After taking all the ledger account's closing balances, a Trial Balance is prepared at the end of the period for the preparations of financial statements.
- e) Adjustment Entries:** All the adjustments entries are to be recorded properly and adjusted accordingly before preparing financial statements.
- f) Adjusted Trial Balance:** An adjusted Trail Balance may also be prepared.
- g) Closing Entries:** All the nominal accounts are to be closed by the transferring to Trading Account and Profit and Loss Account.
- h) Financial Statements:** Financial statement can now be easily prepared which will exhibit the true financial position and operating results.

Double Entry System

It was in 1494 that Luca Pacioli the Italian mathematician, first published his comprehensive treatise on the principles of Double Entry System. The use of principles of double entry system made it possible to record not only cash but also all sorts of Mercantile transactions. It had created a profound impact on auditing too, because it enhanced the duties of an auditor to a considerable extent.

Features of Double Entry System

- i) Every transaction has two-fold aspects, i.e., one party giving the benefit and the other receiving the benefit.

ii) Every transaction is divided into two aspects, Debit and Credit. One account is to be debited and the other account is to be credited.

iii) Every debit must have its corresponding and equal credit.

Advantages of Double Entry System

i) Since personal and impersonal accounts are maintained under the double entry system, both the effects of the transactions are recorded.

ii) It ensures arithmetical accuracy of the books of accounts, for every debit, there is a corresponding and equal credit. This is ascertained by preparing a trial balance periodically or at the end of the financial year.

iii) It prevents and minimizes frauds. Moreover, frauds can be detected early.

iv) Errors can be checked and rectified easily.

v) The balances of receivables and payables are determined easily, since the personal accounts are maintained.

vi) The businessman can compare the financial position of the current year with that of the past year/s.

vii) The businessman can justify the standing of his business in comparison with the previous years purchase, sales, and stocks, incomes and expenses with that of the current year figures.

viii) Helps in decision making.

ix) The net operating results can be calculated by preparing the Trading and Profit and Loss A/c for the year ended and the financial position can be ascertained by the preparation of the Balance Sheet.

x) It becomes easy for the Government to decide the tax.

xi) It helps the Government to decide sickness of business units and extend help accordingly.

xii) The other stakeholders like suppliers, banks, etc take a proper decision regarding grant of credit or loans.

Limitations of Double Entry System

- i) The system does not disclose all the errors committed in the books accounts.
- ii) The trial balance prepared under this system does not disclose certain types of errors.
- iii) It is costly as it involves maintenance of numbers of books of accounts.

Transactions

A transaction is an exchange of goods, services, or money between two or more people or businesses. It happens when you buy or sell something.

Definition of Transactions

J.R. Batliboi defines a transaction as “A transaction is an event or condition that must be recorded in the books of accounts.”

it means any business activity that involves money and needs to be written in the accounting records.

Features of a Transactions

- **Involves Exchange** – Something is given and something is received (like goods for money).
- **Monetary Value** – It can be measured in money.
- **Two Parties** – Always involves at least two people or entities.
- **Recorded in Books** – It must be written down in accounting books.
- **Legal Agreement** – It usually has legal approval or understanding.

Characteristics of a Transactions

- **Dual Aspect** – Every transaction has two sides: debit and credit.
- **Documented Proof** – Bills, receipts, or invoices support it.
- **Affects Financial Position** – It changes the financial status of a person or business.
- **Can Be Cash or Credit** – It may happen with immediate payment (cash) or later (credit).

Journal

Journal is a book of accounts in which all day-to-day business transactions are recorded in a chronological order. Journal is also known as ‘Book of Original Record’ or ‘Book

of Primary Entry'. Recording of transactions in journal is termed as journalizing the entries.

Definition of Journal

P.N. Carter defines "The journal is a book of original entry in which transactions are recorded in the order of their occurrence." It means A journal records business events as they happen, step by step.

J.R. Batliboi defines "Journal is a book where all transactions are recorded in a chronological order and as per the rules of debit and credit." It means journal lists all transactions by date and follows accounting rules.

L.C. Croper defines "The journal is a subsidiary book in which the transactions are recorded for the first time." Means first place where business transactions are written before going into other books.

William Pickles defines "A journal is a daily record of business transactions." Gives a day-by-day log of what a business does, especially related to money.

Features of Journal

1. A journal is the **first place** where all business transactions are written down.
2. Transactions are recorded in the **order they happen**, day by day.
3. Each entry follows the **rules of debit and credit** from double-entry bookkeeping.
4. Every entry has a **short explanation (narration)** to describe the transaction.
5. Entries from the journal are later transferred to the **ledger**, which sorts information by account.
6. Every transaction affects **two accounts**: one is debited and the other is credited.
7. Journal entries are based on **proof** like bills, receipts, or invoices.
8. Each entry is written in a proper **format** with columns for date, particulars, debit, credit, and narration.

Advantages of journal

1. **Detailed Record** – Each transaction is recorded with full details, including narration.

2. **Chronological Order** – Transactions are listed in the order they happen, making tracking easy.
3. **Reduces Errors** – Using the double-entry system helps catch mistakes (debit = credit).
4. **Good for Reference** – Acts as proof and reference for future checks or audits.
5. **Helps Prepare Ledger** – Entries in the ledger come directly from the journal, making the next steps easier.
6. **Supports Accounting System** – Provides a strong base for accurate financial statements.

Disadvantages of Journal

1. **Time-Consuming** – Writing every transaction manually takes a lot of time.
2. **Not Suitable for Large Businesses** – Big companies with many transactions need faster systems.
3. **Need for Accounting Knowledge** – You must know debit and credit rules to write entries correctly.
4. **Repetition of Work** – Transactions are recorded first in the journal and again in the ledger (double work).
5. **Chance of Human Error** – Manual entry can lead to mistakes if not checked properly.

Format of Journal

Date	Particulars	(LF)	Amount (Dr)	Amount (Cr)
(1)	(2)	(3)	(4)	(5)

LF = Ledger Folio

Journalising Process

1. In the first column the date of the transaction is entered-the year is written at the top, then the month and in the narrow part of the column the particular date is entered.

2. In the second column, the names of the accounts involved are written; first the account to be debited, with the word “Dr” written towards the end of the column. In the next line, after leaving a little space, the name of the account to be credited is written preceded by the word “To” (the modern practice shows inclination towards omitting “Dr.” and “To”). Then in the next line the explanation for the entry together with necessary details is given-this is called narration.
3. In the third column the number of the page in the ledger on which the account is written up is entered. The transaction entered in a Journal is posted to the various related accounts in the ‘ledger’ (which is explained in another lesson). In ledger-folio column we enter the page-number where the account pertaining to the entry is opened and posting from the Journal is made.
4. In the fourth column the amounts to be debited to the various accounts concerned are entered.
5. In the fifth column, the amount to be credited to various accounts is entered.

Journal Rules (Rules of Debit or Credit)

1. Personal Account

An account related to a **person or a group of people**

2. Real Account

An account related to **physical things or assets**

3. Nominal Account

An account related to **expenses, losses, incomes, or gains**. It shows how much money was earned or spent.

Rules

1. Personal Account

Debit the receiver

Credit the giver

2. Real Account

Debit what comes in

Credit what goes out

3. Nominal Account

Debit all expenses and Losses

Credit all incomes and gains

Process of Journalising

Step 1. Identify the Transaction

Look at the document (like an invoice, receipt, or bill). Understand what happened in the transaction.

Step 2. Analyse the Transaction (Recognise the type of account)

Find out which account/s are affected and then decide which account is debited.

Step 3. Write the Journal entry (Apply the Rules of Debit or Credit)

which account is credited based on rules of debit and credit.

Step 4. Add narration

A narration is a short explanation written below a journal entry to describe what the transaction is about.

Need of narration

- It helps understand the reason for the entry.
- Makes the records clear and easy to follow.
- Useful during audits or checking later.

Ledger

A ledger is a book or record used in accounting to record and summarize all financial transactions of a business, organized by accountant. It is the central repository for all accounting data, providing a complete record of financial activity over time.

Definition of Ledger

Eric L. Kohler defines "A ledger is the principal book or computer file for recording and totalling economic transactions measured in terms of a monetary unit of account-by-account type, with debits and credits in separate columns and a beginning monetary balance and ending monetary balance for each account."

J.R. Batliboi defines "The Ledger is the principal book of accounts where similar transactions relating to a particular person or thing are recorded in a classified manner."

R.N. Carter defines "A ledger is a book which contains in a summarized and classified form a permanent record of all transactions."

L.C. Cropper defines "Ledger is a book that contains all accounts whether real, nominal or personal, which are first entered in the journal or in the subsidiary books."

William Pickles defines "The ledger is the ultimate destination of all entries made in the journal or in the subsidiary books and is the principal book of accounts."

Robert N. Anthony and James S. Reece defines "The ledger is a collection of accounts that show the changes made to each account as a result of past transactions and their current balances."

Ledger Format

Dr				Cr			
Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount

Features of Ledger

1. A ledger serves as the **final and permanent record** of all financial transactions after they have been recorded in the journal or subsidiary books.
2. Transactions are **classified account-wise** (e.g., Cash Account, Sales Account, Capital Account), making it easy to track the impact on individual accounts.

3. Each ledger account is maintained in a **T-account format** with **debit (Dr)** and **credit (Cr)** sides, based on the **double-entry bookkeeping system**.
4. The ledger **summarizes all financial transactions** related to each account, providing a complete history of financial activity for that account.
5. Balances extracted from the ledger accounts are used to prepare the **trial balance**, which helps in checking the **arithmetical accuracy** of accounts.
6. The ledger forms the **basis for preparing financial statements**, such as the **Income Statement (Profit & Loss)** and **Balance Sheet**.
7. Although not in the order of occurrence (like the journal), entries within each account are made in the **order in which they are posted**.
8. Each ledger account is **balanced periodically** (e.g., monthly) to know the **net balance** of that account, which can be either debit or credit.
9. A properly maintained ledger can serve as **legal evidence** in case of financial disputes or audits.

Advantages of Ledger

1. Ledger organizes all financial transactions account-wise, making it easier to track financial activity.
2. The balances from various ledger accounts are used to **prepare a trial balance**, which checks the mathematical accuracy of accounts.
3. Ledgers provide the necessary data for preparing **final accounts**, like the **Income Statement** and **Balance Sheet**.
4. Transactions are **classified by account type**, aiding in better analysis and control.
5. Individual account information can be quickly retrieved from the ledger for **decision-making or audit purposes**.
6. Balancing of accounts in the ledger helps identify **posting errors, omissions, or duplications**.
7. Properly maintained ledgers can be used as **evidence in courts or audits**.
8. Detailed records help with **internal control** by allowing checks and reconciliations.

Disadvantages of Ledger

1. Posting entries from the journal to the ledger and then balancing accounts is labor-intensive and time-consuming, especially in manual systems.
2. Ledger maintenance requires knowledge of accounting principles and accuracy, which may need trained personnel.
3. Since transactions are first recorded in the journal and then transferred to the ledger, it results in repetition of work.
4. In manual or traditional systems, the ledger does not offer real-time financial updates, which may delay decisions.
5. Errors in posting, balancing, or classifying transactions can lead to incorrect financial results.
6. While the ledger contains raw data, analytical insights (e.g., trends, ratios) require additional processing or reports.

Posting of Journal into Ledger

Step 1: Dr OR Cr

Every journal entry will have to be posted into all those accounts which have been debited and credited in the journal entry.

Step 2: Date

First of all, the date of the transaction (as given in the journal) will be entered in the date column.

Step 3: Particulars

Posting will be made on the debit side of the account which has been debited in the journal, while posting on the debit side of an account, in the particulars column we shall write the name of the account which had been credited in the journal and add the word 'To' before the name.

Posting will be made on the credit side of the account which has been credited in the journal, while posting on the credit side of an account. while posting on the credit side of an account, we shall write the name of the account which has been debited in the journal and add the word 'By' before the name.

Step 4: Folio

Write page number of journal in the 'folio' column of the ledger and page number of the ledger in the 'LF' of column of the journal.

Step 5: Amount

The amount involved in the journal entry shall be entered in amount columns of both the accounts.

Balancing of an account

Balancing is the process of equalising the two sides of an account. After posting journal to ledger has been completed, the difference between the total of debit and credit sides is ascertained. This is known as balancing of accounts. If the total of the debit side is more than that of credit side, it is said to have a debit balance. And vice versa. The difference between the two is placed on the shorter side by writing "To or By balance c/d (Carry down)" so that the two sides become equal. Thus, the total of the bigger side is written on the both total columns. In the next period, the account will start with balance as "To or By balance b/d (brought down)" this is written on the side which has a bigger total.

Steps for balancing of an account

Step 1: Total both the amount columns (debit and credit) and ascertain the difference in two totals (use a separate rough sheet for this purpose). If there is no difference between the totals of the two sides, it means there is nil balance on this account. This means, the account is closed. However, if there is some difference in the two totals, such difference is called the 'balance'. If the debit side total is more than the credit side total (as in Pankaj's Account), the difference is called debit balance. If, on the other hand, the total of the items on the credit side is greater than the total of the debit side, the difference is called credit balance.

Step 2: Put the difference between the two sides on the side showing a smaller total.

Step 3: Enter the date on which balancing is being done, in the date column. Note that balancing is not a transaction, as this does not involve any transfer between two accounts.

Step 4: If the balance is entered on the debit side, then write in particulars column 'To Balance c/d'. In case, the balance is entered on the credit side, write in particulars column 'By Balance c/d' (c/d stands for carried down).

Step 5: Now total both the amount column. There might be more entries on one side, as compared to the other. Even then, the totals must be written on the same horizontal line. Draw one line across both the amount columns, on the same horizontal line. Draw one line across both the amount columns, on the same horizontal line. Put the totals on both the sides, which will now be identical and then draw line immediately beneath the totals.

Step 6: The closing balance (which was carried down) has now to be brought down on the side which was showing the bigger total. In other words, at the beginning of the next period, the debit balance is shown on the debit side and credit balance on the credit side of the account. It is called opening balance, The balance brought down is usually given the date following the balance date. After entering the date in the date column, if the balance brought down is on the debit side, write 'To Balance b/d' in particulars column. Similarly, if the balance brought down is on the credit side, write 'By Balance b/d' (b/d stands for brought down), particulars column. Suppose an account was balanced on June 30, and the closing balance was entered on the credit side as 'By Balance c/d'. On July 1, this balance would be entered on the debit side as 'To Balance b/d' below the total.

Trial Balance

The Trial Balance is usually prepared just before the preparation of final accounts ' in order to check the arithmetical accuracy of posting into ledger.

Trial Balance is an accounting report that lists the balances of all **ledger accounts** of a business at a particular point in time. It is used to check the **arithmetical accuracy** of bookkeeping entries. It includes **debit and credit balances** from the general ledger. The total of **debit balances** should **equal** the total of **credit balances** if the books are correctly maintained. It is usually prepared at the end of an **accounting period** before preparing financial statements.

Need of Trial Balance

1. To Check Arithmetical Accuracy: It ensures that **total debits equal total credits** and Helps confirm that every debit entry has a corresponding credit entry, as required by the **double-entry system**.
2. To Detect Errors: it helps locate **mathematical or posting errors**, such as; Wrong totals, Incorrect balances and Entries posted to the wrong side (debit/credit).
3. Basis for Financial Statements: It serves as a **foundation** for preparing Trading Account, Profit & Loss Account and Balance Sheet
4. Helps in Adjustments: Adjusting entries for items like **accrued expenses, prepaid income, and depreciation** can be made easily using a trial balance.
5. Provides a summary view: Gives a **summary of all ledger accounts** in one place. Makes it easy to review financial information at a glance.
6. Facilitates Audit: Auditors use the trial balance as a starting point for examining the books of accounts.

Objectives of Preparing a Trial Balance

(i) To check arithmetical accuracy

Arithmetical accuracy in ledger posting means writing correct amount, in the correct account and on its correct side while posting transactions from various original books of accounts, such as Cash Book, Purchases Book, Sales Book, etc. It also means not only the correct balance of ledger account but also the totals of the special purpose Books.

(ii) To help in preparing Financial Statements

The ultimate objective of the accounting is to prepare financial statements i.e. Trading and Profit and Loss Account, and Balance sheet of a business enterprise at the end of an accounting year. These statements contain balances of various ledger accounts. As Trial Balance contains balances of all ledger accounts, in financial statements the balances of ledger accounts are carried from the Trial balance for proper analysis.

(iii) Helps in locating errors

If total of two columns of the trial balance agrees it is a proof of arithmetical accuracy in the ledger posting. However, if the totals of the two columns do not tally it indicates that there is some mistake in the ledger accounts. This prompts the accountant to find out the errors.

(iv) Helps in comparison

Comparison of ledger account balances of one year with the corresponding balances with the previous year helps the management taking some important decisions. This is possible by using the Trial Balances of the two years.

(v) Helps in making adjustments

While making financial statements adjustments regarding closing stock, prepaid expenses, outstanding expenses etc are to be made. Trial balance helps in identifying the items requiring adjustments in preparing the financial statements. Trial Balance is generally prepared at the end of the year. However it can be prepared at any time during the accounting year to check the accuracy of the posting.

Causes for the disagreement of a trial balance

1. Omission of posting in one account: You are aware that both the debit and credit aspects of a transaction have to be posted in the ledger accounts. If you post it to the debit of one account and forget its posting to the credit of the other concerned account, it is bound to affect the Trial Balance. For example, an amount of Rs. 200 received from Ali, correctly entered on the debit side of the cash book but is not posted to the credit side of Ali's Account. This error shall result in the lower credit and hence the Trial Balance will not tally.

2. Double posting in one account: If by mistake you post an entry two times to the debit or to the credit of an account it would result in extra debit or credit and as such cause disagreement in the Trial Balance. If, however, the whole entry is posted twice i.e., both the debit and the credit aspects are posted twice, it won't affect the Trial Balance. It is because both the debit and the credit sides will be equally affected.

3. Posting on the wrong side of an account: When an entry is posted on the wrong side of an account i.e., instead of debit side it is posted on the credit side, it would also cause disagreement in the Trial Balance. In such a situation, the difference will be for

double the amount. For example, Rs. 300 received from Khan which is correctly entered on the debit side of the Cash Book, but while posting it to Khan's Account, it is wrongly posted to the debit side instead of the credit side. This would mean that a debit of Rs. 600 (Rs. 300 in Cash Account and Rs. 300 in Khan's Account) has no corresponding credit. So, in the Trial Balance, the credit side will be lower by Rs. 600.

4. Posting wrong amount in an account: If you post an entry to the correct side of an account but commit an error in writing the amount, this would affect the Trial Balance. Suppose, in the above example you post the entry correctly on the credit side of Khan's Account but the amount is wrongly put as Rs. 200. It would cause a difference of Rs. 100. In the Trial Balance, the credit side will be lower by Rs. 100.

5. Wrong totalling of the subsidiary book: If any subsidiary book is overcast or undercast, it affects the concerned account in ledger. Suppose the correct total of Sales Journal is Rs. 5,600, but it is actually totalled as Rs. 5,300. You know that the total of Sales Journal is posted to the credit side of the Sales Account. So, the Sales Account will be short by Rs. 300, and the Trial Balance will not tally.

6. Omitting to post the total of a subsidiary book: If the total of a subsidiary book is not posted to the concerned account, it would affect the Trial Balance. Such mistake relates only to the account where posting was to be done and as such affects only one account. Take for example, the Sales Journal. If its total of Rs. 18,900 is not posted to the credit of Sales Account, the credit side on the Trial Balance will be lower by Rs. 18,900.

7. Wrong totalling or balancing of an account: When an account is wrongly totalled or wrongly balanced, this would affect the Trial Balance. Suppose the debit side of Shyam's Account is totalled as Rs. 1,300 instead of Rs. 1,100. It would lead to wrong balance in Shyam's Account. Consequently, the debit total in the Trial Balance will be higher by Rs. 200. Similarly, if the totalling is correctly done but a mistake is committed in balancing the account, it would also cause a difference in the Trial Balance.

8. Omission of an account from Trial Balance: You know that all accounts which show some balance must be included in the Trial Balance. If you forget to write the balance of any account in the Trial Balance, it will not tally. In practice, cash book balances are often omitted from Trial Balance.

9. Writing the balance of an account on the wrong side of the Trial Balance: If the balance of an account which is to be shown in the debit column of the Trial Balance is actually shown in the credit column, the Trial Balances will not tally. It will be affected by double the amount.

10. Wrong totalling of the Trial Balance: If a mistake is committed in totalling the Trial Balance amount columns of the Trial Balance itself, the Trial Balance will not tally. Thus, you learn about various errors which may cause differences in the Trial Balance. Note that these errors affect only one aspect (debit or credit). This upsets the debit-credit correspondence leading to the disagreement of the Trial Balance.

Cash Book

Cash Book is a book of account maintained for recording transactions involving receipt and payment of cash. It is also one of the books of original entry. When a cash book is maintained, cash transactions are not recorded in the Journal, and no cash or bank account is required to be maintained in the ledger as Cash Book serves the purpose of Cash Account also.

Cash book types

1. Simple Cash Book (Single Column Cash Book)
2. Discount Column Cash Book (Double or Two Column Cash Book)
3. Bank and Discount Column Cash Book (Triple or Three Column Cash Book)
4. Petty Cash Book

1. Simple Cash Book (Single Column Cash Book)

This records only cash receipts and cash payments. It has two sides, namely debit and credit. Cash receipts are recorded on the debit side it is at left hand side and cash payments are recorded on the credit side it is at right hand side. In a simple cash book, there is only one amount column each on its debit side and on the credit side.

Format of a Simple Cash Book

Dr					Cr				
Date	Particulars	VN	Folio	Amount	Date	Particulars	VN	Folio	Amount

Steps in Preparation of Simple Cash Book

Step 1: On the debit side in the particulars column, the name of the account, from which cash is received, is recorded.

Step 2: On the credit side, in the particulars column the name of account for which cash is paid, is recorded.

Step 3: In the amount column of debit side, the amount of cash received is recorded and in the amount column of credit side the amount of cash paid is recorded.

Step 4: At the end of the period, the total of the debit side of the cash book is compared with the total of the credit side and the difference if any, is entered on the credit side of the cash book under the particulars column as balance c/d.

Step 5: In case of Simple Cash Book, the total of debit side is generally more than the total of the credit side, since the payment can never exceed the available cash. The difference is written in the amount column and total of both the sides of cash book becomes equal. vi. The closing balance of the credit side if any becomes the opening balance for the next period and is written as Balance b/d on the Debit side of the Cash Book for the next period.

2. Discount Column Cash Book (Double or Two Column Cash Book)

The Discount is an incentive given on receipts for prompt payment. In order to record discount, one additional column on the both side of the cash book is added in this type of cash book. As discount is also recorded here, the cash book is termed as cash book with discount column. It used in businesses with frequent discount transactions. It helps to maintain a detailed record of cash transactions along with trade discounts related to

payments or receipts. Discount columns are not balanced, but are totalled at the end of the period.

Format of a Two Column Cash Book

Dr					Cr				
Date	Particulars	LF	Discount	Cash	Date	Particulars	LF	Discount	Cash

Trade Discount: It is the discount usually allowed by the wholesaler to the retailer computed on the list price or invoice price. e.g. the list price of a TV set could be ` 15000. The wholesaler may allow 20% discount thereof to the retailer. This means the retailer will get it for ` 12000 and is expected to sale it to final customer at the list price. Thus, the trade discount enables the retailer to make profit by selling at the list price. Trade discount is not recorded in the books of accounts. The transactions are recorded at net values only. In above example, the transaction will be recorded at ` 12000 only.

Cash Discount: This is allowed to encourage prompt payment by the debtor. This has to be recorded in the books of accounts. This is calculated after deducting the trade discount. e.g. if list price is ` 15000 on which a trade discount of 20% and cash discount of 2% apply, then first trade discount of ` 3000 (20% of ` 15000) will be deducted and the cash discount of 2% will be calculated on ` 12000 (` 15000 – ` 3000). Hence the cash discount will be ` 240 (2% of ` 12000) and net payment will be ` 11,760 (` 12,000 - ` 240)

3. Bank and Discount Column Cash Book (Three Column Cash Book)

When the number of bank transactions are large in an organization, it is necessary to have a separate book to record bank transactions. Instead of having a separate book to record Bank transactions, a Bank column is added on each side of the Cash Book. This type of cash book is known three column cash Book. All payments into Bank are recorded on the debit side and all withdrawals / payments through the Bank are recorded on the credit side of the cash book.

Format of a Tree Column Cash Book

Dr					Cr				
Date	Particulars	Discount	Cash	Bank	Date	Particulars	Discount	Cash	Bank

4. Petty Cash Book

In big business organisations, a large number of repetitive small payments such as, for conveyance, cartage, postage, telegrams, courier and other expenses are made. These organisations appoint an assistant to the Head Cashier. The appointed cashier is known as petty cashier. He makes payments of these expenses and maintains a separate cash book to record these transactions. Such a cash book is called Petty Cash Book. The petty cashier works on the imprest system. Under this system, a definite sum, say Rs. 4000/- is given to the petty cashier at the beginning of the period. This amount is called imprest money. The petty cashier meets all small payments out of this imprest amount. At the end of the period say one month he presents the account to the Head Cashier and gets reimbursed from the Head Cashier. Suppose out of Rs.4,000 he has spent Rs.3,850 by the end of the month. He will get Rs.3,850 from the head cashier. Thus, again he has the full imprest amount in the beginning of the next period. The process of reimbursement can be weekly, fortnightly or monthly depending upon the frequency of small payments. The Petty Cashier is authorised to sanction and disburse small payments. Assignment of the task of making of petty expenses to a person and the maintenance of petty cash book by him reduces the burden of the Head Cashier.

The petty cash book has a number of columns for the amount on the payment side. Each of the amount columns is allotted to items of specific payments, which are common. The last column is allotted for miscellaneous payments. At the end of the period, all amount columns are totalled. The total of the amount paid shown in column 5 is deducted from the column 1. At the opening of the month the total amount paid in the previous month is reimbursed by the Head Cashier.

Format of a Petty Cash Book

Petty Cash Book

Amount Received	Date	Particulars	Voucher No.	Amount	Analysis of Payment				
					Post age	Telep hone	Statio nery	Conve yance	Miscellane ous Expenses

Advantages of Petty Cash Book

- 1) Saving of Time and Efforts of Chief Cashier:** As petty cashier handles the work of making all petty expenses and recording them as well, a lot of time and energy of the main cashier is saved. He is to record only the total of such expenses and that too only once, at the end of each month.
- 2) Easiness in Posting:** Only the total of each head of expense is posted into the Ledger. As such, a lot of space is saved and the posting becomes very convenient.
- 3) Easiness in preparing the Cash Book:** As the number of small payments in every business is quite large and as these are recorded in the petty cash book itself, the main cash book is not overburdened and can be more easily totalled.
- 4) Control on Petty Expenses:** The main cashier keeps checking the petty cash book from time to time and a proper check is put on any unnecessary expenditure.
- 5) Lesser chances of fraud:** Petty Cashier obtains a receipt of every payment made by him and keeps a proper record of them. The receipts are duly signed by the main cashier while reimbursing the amount to the petty cashier. As such, it minimizes the chances of fraud.
- 6) Simple Method:** The maintenance of petty cash book does not require any specialised knowledge of accounting.

Disadvantages of a petty Cash Book

- 1) Simplifies Record-Keeping:** Centralizing small transactions simplifies tracking and recording minor expenses. For instance, a small business can easily track expenditures

like office supplies, snacks for staff, or minor travel expenses without cluttering the main accounting ledger.

2) Ensures Accountability: The petty cash book ensures that all petty cash expenditures are accountable with every transaction recorded and vouched for. This reduces the risk of funds being misused and provides a clear audit trail for auditors and financial managers. For example, in an SME, the petty cash book can help track expenses for quick office repairs or refreshments for client meetings.

3) Improves Cash Management: It helps monitor and control small cash outflows, preventing misuse of funds. By maintaining a petty cash book, businesses can ensure that funds are available for urgent small purchases without going through the lengthy process of approval and disbursement from the main cash reserve. This is particularly useful for businesses needing quick purchases without waiting for formal approvals.

4) Facilitates Budgeting: Detailed records of petty cash expenses aid in better budgeting and financial planning. For example, a company can analyze its petty cash book to forecast future minor expenses and allocate appropriate funds in its budget. This can help identify patterns and make more accurate financial forecasts.

5) Quick Access to Funds: Having petty cash readily available allows businesses to make quick payments for small expenses, thereby avoiding delays. This is particularly useful for urgent needs such as purchasing emergency office supplies or paying for minor repairs. For instance, a repair shop might use petty cash to buy parts needed for an urgent fix quickly.

6) Reduces Main Ledger Entries: By recording minor expenses separately, the petty cash book reduces the number of entries in the main ledger, making it easier to manage and review. This helps keep the central financial records clean and focused on larger transactions.

7) Supports Operational Efficiency: A well-maintained petty cash book can improve daily operations. Employees can address minor financial needs without disrupting the overall workflow, enhancing productivity and operational efficiency.

Glossary of Terms

Transaction: It means an event or a business activity which involves exchange of money or money's worth between parties. The event can be measured in terms of money and changes the financial position of a person e.g. purchase of goods would involve receiving material and making payment or creating an obligation to pay to the supplier at a future date. Transaction could be a cash transaction or credit transaction. When the parties settle the transaction immediately by making payment in cash or by cheque, it is called a cash transaction. In credit transaction, the payment is settled at a future date as per agreement between the parties.

Goods/Services: These are tangible article or commodity in which a business deals. These articles or commodities are either bought and sold or produced and sold. At times, what may be classified as 'goods' to one business firm may not be 'goods' to the other firm. e.g. for a machine manufacturing company, the machines are 'goods' as they are frequently made and sold. But for the buying firm, it is not 'goods' as the intention is to use it as a long term resource and not sell it. Services are intangible in nature which are rendered with or without the object of earning profits.

Profit: The excess of Revenue Income over expense is called profit. It could be calculated for each transaction or for business as a whole.

Loss: The excess of expense over income is called loss. It could be calculated for each transaction or for business as a whole.

Asset: Asset is a resource owned by the business with the purpose of using it for generating future profits. Assets can be Tangible and Intangible. Tangible Assets are the Capital assets which have some physical existence. They can, therefore, be seen, touched and felt, e.g. Plant and Machinery, Furniture and Fittings, Land and Buildings, Books, Computers, Vehicles, etc. The capital assets which have no physical existence and whose value is limited by the rights and anticipated benefits that possession confers upon the owner are known as Intangible Assets. They cannot be seen or felt although they help to generate revenue in future, e.g. Goodwill, Patents, Trade-marks, Copyrights, Brand Equity, Designs, Intellectual Property, etc.

Current Assets: An asset shall be classified as Current when it satisfies any of the following : (a) It is expected to be realised in, or is intended for sale or consumption in the Company's normal Operating Cycle, (b) It is held primarily for the purpose of being

traded , (c) It is due to be realised within 12 months after the Reporting Date, or (d) It is Cash or Cash Equivalent unless it is restricted from being exchanged or used to settle a Liability for at least 12 months after the Reporting Date.

Non-Current Assets: All other Assets shall be classified as Non-Current Assets. e.g. Machinery held for long term etc.

Liability: It is an obligation of financial nature to be settled at a future date. It represents amount of money that the business owes to the other parties. E.g. when goods are bought on credit, the firm will create an obligation to pay to the supplier the price of goods on an agreed future date or when a loan is taken from bank, an obligation to pay interest and principal amount is created. Depending upon the period of holding, these obligations could be further classified into Long Term or non-current liabilities and Short Term or current liabilities.

Current Liabilities: A liability shall be classified as Current when it satisfies any of the following : (a) It is expected to be settled in the Company's normal Operating Cycle, (b) It is held primarily for the purpose of being traded, (c) It is due to be settled within 12 months after the Reporting Date, or (d) The Company does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date (Terms of a Liability that could, at the option of the counterparty, result in its settlement by the issue of Equity Instruments do not affect its classification)

Non-Current Liabilities: All other Liabilities shall be classified as Non-Current Liabilities. E.g. Loan taken for 5 years, Debentures issued etc.

Capital: It is amount invested in the business by its owners. It may be in the form of cash, goods, or any other asset which the proprietor or partners of business invest in the business activity. From business point of view, capital of owners is a liability which is to be settled only in the event of closure or transfer of the business. Hence, it is not classified as a normal liability. For corporate bodies, capital is normally represented as share capital.

Drawings: It represents an amount of cash, goods or any other assets which the owner withdraws from business for his or her personal use. e.g. if the life insurance premium of proprietor or a partner of business is paid from the business cash, it is called drawings. Drawings will result in reduction in the owners' capital. The concept of drawing is not applicable to the corporate bodies like limited companies.

Debtor: The sum total or aggregate of the amounts which the customer owe to the business for purchasing goods on credit or services rendered or in respect of other contractual obligations, is known as Sundry Debtors or Trade Debtors, or Trade Payable, or Book-Debts or Debtors. In other words, Debtors are those persons from whom a business has to recover money on account of goods sold or service rendered on credit.

Creditor: A creditor is a person to whom the business owes money or money's worth. e.g. money payable to supplier of goods or provider of service. Creditors are generally classified as Current Liabilities.



Check Your Progress

1. Define Accounting
2. What do you mean by book keeping?
3. What is accountancy?
4. What do you mean by accounting?
5. What is accounting Process?
6. What is Journal?
7. What is Ledger?
8. What is Posting?
9. State the meaning of ledger posting.
10. What is meant by book keeping?
11. What is business transaction?
12. What is bad debt?
13. What is a Compound entry?
14. What is meant by a Cash Book?
15. What is meant by a 'Bank Column Cash Book'?
16. Draw the format of 'Bank Column Cash Book'.
17. What do you mean by Petty Cash Book?
18. State the meaning of a 'Contra Entry' with the help of an example.
19. What are Contra Entries?
20. What is 'Imprest System' of Petty Cash Book?
21. State the objectives of accounting
22. Explain the need of accounting
23. Explain the differences between book keeping and accounting.
24. State the need of book keeping.
25. Explain the advantages and disadvantages of accounting.
26. Explain how accounting is useful to employee.
27. Explain the distinction between cash and credit transactions.
28. Distinguish between trade discount and cash discount.
29. How do you deal with the amount treated as bad debt which is recovered later on?
30. Explain the types of Cash Book.

31. Who are all users of accounting information? Explain briefly in what are the ways its uses.
32. Explain the treatment of accounting concepts.
33. What are the steps to be followed in journalising the business transaction?
34. Explain the procedure for balancing a ledger account.



Unit – II

Preparation of Final Accounts of a sole trading concern

Meaning of Sole Trading Concern

Features of Sole Trading Concern

Introduction to Final Account

Types of Expenses in Accounting

Features of Direct Expenses

Trading Account

Manufacturing Account

Profit and Loss Account

Balance Sheet

Adjustments

Preparation of Final Accounts of a Non-Trading Organisation

Characteristics of Non-Trading Organisation

Receipts and payments Account

Income and Expenditure Account

Balance Sheet

2.1 Meaning of Sole Trading Concern

A sole trading concern (or sole proprietorship) is a type of business owned and managed by a single individual. It is the simplest form of business organization.

2.2 Features of sole Trading Concern

- 1. Single Ownership:** The business is owned by one individual. The owner provides the capital and controls all aspects of the business.
- 2. Unlimited Liability:** The owner's personal assets can be used to pay off business debts. There is no legal separation between the business and the owner.
- 3. Sole Risk Bearer and Profit Recipient:** The owner bears all risks and receives all profits. There is no sharing of profit or loss.
- 4. No Separate Legal Entity:** Legally, the business and the owner are the same person. The business cannot sue or be sued in its own name.
- 5. Minimal Legal Formalities:** It is easy to start and close a sole proprietorship. Requires fewer government regulations and licenses compared to other forms.
- 6. Quick Decision Making:** Since the owner makes all decisions, actions can be taken quickly and efficiently.
- 7. Direct Relationship with Customers:** The owner deals directly with customers, which helps in building strong relationships and customer loyalty.
- 8. Limited Capital:** The capital is usually limited to what the owner can afford or borrow. This restricts business expansion.
- 9. Non-transferability:** Ownership cannot be transferred easily. On the death or retirement of the owner, the business may dissolve.
- 10. Suitable for Small-Scale Businesses:** Ideal for small-scale, localized operations where personal supervision is needed.

2.3 Introduction to Final Account

Final accounts are also known as financial statements. Final accounts are a set of reports summarizing a company's financial performance and position at the end of an accounting period. One of the important purposes of accounting is to find out the profit or loss of a business for a particular accounting period and also to know its financial position on a particular date. final accounts are prepared with the help of a Trial Balance which shows all the ledger balances as at the end of an accounting period.

2.4 Types of Expenses in Accounting

Expenses are the costs incurred by a business in the process of earning revenue. They are recorded in the Profit and Loss Account and are essential for determining the net profit or loss of a business.

1) Direct Expenses

Direct expenses are the costs that are directly associated with the production or purchase of goods and services. These expenses are incurred specifically to bring the goods to a saleable or finished condition. In the case of a manufacturing business, direct expenses are related to the factory or production process, whereas in a trading business, they are related to the purchase and delivery of goods.

Direct expenses are an essential part of calculating the cost of production or purchase in a business. They ensure that the goods are available in a condition ready for sale. Understanding direct expenses is important for accurate financial reporting, cost control, and profit analysis in any business operation.

Features of Direct Expenses

- a) Incurred before the goods are ready for sale.
- b) Directly traceable to specific jobs, processes, or products.
- c) Affects the cost of goods sold (COGS).

Few Direct Expenses

Wages, Freight Inward / Carriage Inward, Import Duty, Power and Fuel etc.

2) Indirect Expenses

Indirect expenses are those costs that are not directly linked to the production or purchase of goods, but are necessary for the overall operation and management of a business. These expenses support the business activities indirectly and are not traceable to a specific product, job, or service. Indirect expenses are incurred after the goods are produced or purchased and are usually shown in the Profit and Loss Account. They help in running the business smoothly but do not contribute directly to making the product or bringing it to saleable condition.

Indirect expenses are essential for maintaining business operations and ensuring goods and services reach the customers. Though they don't contribute directly to production, they play a vital role in managing, promoting, and financing the business. Proper control and classification of indirect expenses help in accurate profit calculation, cost analysis, and financial planning.

Characteristics of indirect Expenses

- a) Not directly related to manufacturing or purchase of goods.
- b) Incurred for general operations, administration, and selling.
- c) Recorded in the Profit and Loss Account.
- d) Affect net profit or net loss, not gross profit.

Few Indirect Expenses

Office Rent, Salaries, Advertisement Expenses, Telephone and Internet Charges, Electricity Charges (Office), Depreciation, Bank Charges, Interest on Loan, Travel Expenses, Insurance Premium, etc.

Classification of Indirect Expenses

Indirect expenses are costs that are not directly linked to production or purchase but are necessary for the smooth functioning of the business. These are recorded in the Profit and Loss Account and can be classified into the following categories

1) Administrative Expenses

These are expenses related to the general management and administration of the business. Examples: Office Rent, Salaries to office staff, Stationery, Telephone and internet charges, Legal and audit fees

2) Selling and Distribution Expenses

These are expenses incurred to promote and deliver products to customers. Examples: Advertisement, Sales commission, Packing and delivery charges, Travelling expenses for sales staff, Bad debts

3) Financial Expenses

These are costs related to financing the business operations. Examples: Interest on loans, Bank charges, Discount allowed, Loan processing fees

4) Depreciation and Amortization

These are non-cash expenses that represent the gradual reduction in the value of assets. Examples: Depreciation on machinery, buildings, vehicles, Amortization of intangible assets like patents or goodwill

5) Miscellaneous Expenses

These include other general business expenses that do not fit neatly into the above categories. Examples: Entertainment expenses, Subscription fees, Donations, General repairs and maintenance

2.5 Trading Account

Trading Account is prepared to find out the Gross profit earned or Gross loss suffered by the business from business activities during an accounting year. This account is prepared in T-form. the excess of sales to cost of goods sold or excess of credit side over debit side, which is termed as Gross Profit.

Proforma of a Trading Account

Trading Account of _____ as on _____

Dr			Cr		
Particulars	Amount	Amount	Particulars	Amount	Amount
To Opening Stock		xxx	By Sales		
To Purchases:			Cash Sales	xxx	
Cash Purchases	xxx		Credit Sales	xxx	
Credit Purchases	xxx		Total Sales	xxx	
Total Purchases	xxx		Less: Sales Return	xxx	
Less: Purchases Return	xxx		Net Sales	xxx	xxx
Net Purchases	xxx	xxx	By Closing Stock		xxx
Direct Expenses:			By Gross Loss (BF)		
To Wages		xxx	Transfer to Trading Account		xxx
To Freight/ Freight Inward		xxx			
To Carriage/ Carriage Inward		xxx			
To Fuel and Power		xxx			
To Gross Profit (BF)					
Transfer to Trading Account		xxx			
		xxx			xxx

Preparation of Trading Account

1. Opening Inventory: It is also called Opening Stock. It refers to the value of the goods (raw materials, work-in-progress, or finished goods) that a business has at the beginning of an accounting period. It is the unsold stock carried over from the previous accounting period. Previous year closing stock is an opening stock of current year.

Appears in the Trading Account: Opening Inventory is shown on the debit side because it represents a cost of goods available for sale.

2. Purchases: Purchases refer to the total cost of goods bought by a business for resale during the accounting period. These goods are either sold directly or remain unsold as inventory at the end of the period. Purchases can be cash purchases and credit purchases. During the Cash Purchases cash is paid immediately for purchases of product. During Credit Purchases, payment is not made. Payments are made at a later date.

Appears in the Trading Account: Purchases are recorded on the debit side of the Trading Account, since they are part of the cost of goods sold

3. Purchases Return: Purchase Returns also called Returns Outward, it refers to goods that a business returns to its suppliers due to defects or damage, Incorrect quantity or quality and Wrong goods delivered. These are goods that were previously recorded as purchases but are now returned, so their value must be deducted from total purchases.

Appears in the Trading Account: Purchase Returns are deducted from Purchases on the debit side of the Trading Account.

4. Wages: Wages refer to payments made to workers directly involved in **production** or **handling of goods** (e.g., loading, unloading, packing, etc.).

Appears in the Trading Account: It shown on the debit side of the Trading Account. Sometimes combined as "Wages and Salaries" or "Wages (direct)".

5. Freight or Freight Inward: Freight Inward is the transportation cost incurred to bring purchased goods to the business location.

Appears in the Trading Account: Shown on the debit side of the Trading Account as it is part of the cost of goods.

6. Carriage Inward: Carriage Inward is similar to Freight Inward; it's the cost of transporting goods purchased to the business premises.

Appears in the Trading Account: Debit side of the Trading Account (part of purchase cost).

7. Import Duty: Import Duty is a tax paid on goods imported from other countries.

Appears in the Trading Account: Treated as part of direct expenses, so it is shown on the debit side of the Trading Account.

8. Sales: Sales are the total value of goods sold by the business during the accounting period. **Appears in the Trading Account:** Shown on the credit side of the Trading Account.

9. Sales Return: Sales Returns (Returns Inward) are goods returned by customers due to damage, defects, or incorrect supply.

Appears in the Trading Account: Deducted from Sales on the credit side of the Trading Account.

10. Closing Stock: Closing Stock refers to the unsold stock at the end of the accounting period or end of the current year.

Appears in the Trading Account: Shown on the credit side of the Trading Account.

2.6 Manufacturing Account

A manufacturing concern has to first prepare another account called Manufacturing Account with the help of which it works out the cost of goods produced. The cost of goods produced is then transferred to the Trading Account for ascertaining the cost of goods sold and the gross profit. A Manufacturing Account is prepared by manufacturing businesses to calculate the cost of goods manufactured (i.e., total production cost of goods made during the accounting period). It helps determine how much it cost to produce the goods that will be sold and this cost is then transferred to the Trading Account.

A manufacturing concern purchases raw materials from the market and converts them into finished goods for sale. The cost of goods produced thus includes two major costs are cost of raw materials consumed and cost of conversion.

Cost of Raw Materials Consumed: This represents the cost of raw materials used in the course of manufacture which can be worked out by adjusting the opening and closing stocks of raw materials in the purchase of raw materials.

Cost of Conversion: This includes all expenses incurred in the factory such as wages paid to labour, salaries of supervisory staff, factory rent and rates, motive power, repairs to plant and machinery, depreciation on plant and machinery, etc. All these expenses are debited to the manufacturing Account.

Proforma of a Manufacturing Account

Manufacturing Account of _____ as on _____

Dr			Cr		
Particulars	Amount	Amount	Particulars	Amount	Amount
To Raw Material Consumed			By Sale of Scrap		XXXX
Opening Stock of RM	xxx		By Closing Work-In-Progress		XXXX
(+) Purchases of RM	xxx		By Cost of Goods Produced		XXXX
(-) Closing Stock of RM	xxx		(Transferred to Trading A/c)		
(+) Carriage Inward of RM	xxx	XXXX			
To Opening Work-In-Progress		XXXX			
To Carriage Inward		XXXX			
To Freight		XXXX			
To Import Duty		XXXX			
To Dock Due		XXXX			
To Manufacturing Wages		XXXX			
To Motive Power		XXXX			
To Coal, Gas and Water		XXXX			
To Oil and Grease		XXXX			
To Factory lighting		XXXX			
To Factory Heating		XXXX			
To Factory Insurance		XXXX			
To Repairs of Factory Buildings		XXXX			
To Repairs of Plant and Machinery		XXXX			
To Depreciation of Factory Building		XXXX			
To Depreciation of plant and machinery		XXXX			
To Fuel and Power		XXXX			
		XXXX			XXXX

Scrap: The term 'scrap' is used for waste materials coming out of the manufacturing process. Cuttings of cloth in readymade garments factory and metal cutting in engineering factories are some example of scrap. Any amount realized from the sale of scrap must be adjusted in the cost of goods produced. Hence, it is credited to the Manufacturing Account.

Proforma of a Trading Account

Trading Account of _____ as on _____

Dr			Cr		
Particulars	Amount	Amount	Particulars	Amount	Amount
To Opening stock of Finished Goods		xxx	By Sale		xxx
To Cost of Goods Produced (Transferred from Manufacturing Account)		xxx	By Closing Stock of Finished Goods		xxx
To Gross Profit (BF) (Transferred to Profit and Loss Account)		xxx	By Gross Loss (BF) (Transferred to Profit and Loss Account)		xxx
		xxxx			xxxx

Work in Progress: It is quite likely that at the end of the year, there may be certain goods which are still in the process of manufacture. Such goods are called 'semi finished goods' or 'work –in-progress. There will always be some work-in progress at the beginning as well as at the end of the account year. Their cost must be adjusted while working out the cost of goods produced. Hence, their opening work-in progress is shown on its credit side.

Stock of Finished Goods: Besides the stock of raw materials and semi-finished goods, every firm will have the stock of finished goods. This is to be adjusted in the cost of goods sold and not in the cost of goods produced. Hence, it is not shown in the Manufacturing Account. As you learnt earlier, it will be shown in the Trading Account.

2.7 Profit and Loss Account

The Profit and Loss Account (P&L Account), also known as the Income Statement, is a financial statement prepared to determine the net profit or net loss of a business during a specific accounting period, usually one year. The Profit and Loss Account shows all revenues (incomes) and expenses incurred by the business. If revenues > expenses, the result is Net Profit. If expenses > revenues, the result is Net Loss. The Net Profit is transferred to the Capital Account in the balance sheet. If it is a Net Loss, it is deducted from the Capital Account. The Profit and Loss Account is a crucial financial statement that shows how well a business is performing in terms of profitability. It helps

stakeholders like owners, investors, and creditors evaluate the financial health of a business.

Proforma of a Profit and Loss Account

Profit and Loss Account of _____ as on _____

Dr			Cr		
Particulars	Amount	Amount	Particulars	Amount	Amount
To Gross Loss (Transferred from Trading Account)			By Gross Profit (Transferred from Trading Account)		
To Sales Commission			By Rent Received		
To Selling Expenses			By Miscellaneous Received		
To Distributing Expenses			By Interest Received		
To Postage			By Discount Received		
To Telegram			By Dividend Recived		
To Insurane			By Compensation Received		
To Electricity Charges			By Commission Received		
To Telephone Charges			By Profit on sale of Assets		
To General Expenses			By Bad Debt Recovered		
To Legal Charges			By Apprentice Premium		
To Audit Fee			By Net Loss (BF) (Trasferred to Balance Sheet)		
To Bank Charges					
To Interest					
To Free Sample Distribution					
To Office Expenses					
To Administrative Expenses					
To Entertainment Expenses					
To Donation					
To Charities					
To Sales Tax					
To Goods Lost by theft					
To Goods lost by fire					
To Carriage Outward					
To Pinting and Stationery					
To Rent, Rates and Taxes					
To Depreciation					

To Bad Debts					
To Other Expenses					
To Loss on sales of assets					
To Miscellaneous Expenses					
To Net Profit (BF) (Trasferred to Balance Sheet)					

Objectives of Profit and Loss Account

- 1) To Ascertain Net Profit or Net Loss:** The primary objective is to calculate whether the business has made a profit or suffered a loss during a specific accounting period. It does this by comparing revenues with expenses.
- 2) To Measure Business Performance:** It helps in evaluating how efficiently a business is performing. A consistent profit indicates strong management and good operations.
- 3) To Provide Financial Information for Decision-Making:** The P&L account provides valuable data for: Budgeting, Planning, Investment decisions, Cost control
- 4) To Assist in Tax Assessment:** The net profit figure is used to determine the taxable income of the business. This ensures compliance with government tax laws.
- 5) To Help in Comparison:** It allows comparison of Year-to-year performance of the same business. Performance with competitors or industry averages.
- 6) To Support Preparation of Final Accounts:** The net result from the Profit and Loss Account is carried forward to the Balance Sheet. It completes the final accounts along with the Trading Account and Balance Sheet.
- 7) To Maintain Transparency:** It gives a clear and structured view of all income and expenses. This promotes accountability and builds trust with stakeholders like investors, creditors, and management.

2.8 Balance Sheet

The Balance Sheet is a statement that shows the financial position of the business. It records the assets and liabilities of the business at the end of the accounting period after

the preparation of trading and profit and loss accounts. A Balance Sheet is a vital financial statement that shows the financial position of a business at a specific point in time. It presents a detailed summary of the company's assets, liabilities, and owner's equity. The purpose of the balance sheet is to give an accurate picture of what the business owns and owes, as well as the amount invested by the owner or shareholders. The balance sheet is typically prepared at the end of a financial year or accounting period. It helps stakeholders such as management, investors, lenders, and tax authorities to assess the company's financial health and make informed decisions.

Proforma of a Balance Sheet

Balance Sheet of _____ as on _____

Liabilities	Amount	Amount	Assets	Amount	Amount
Capital	XXX		<u>Current Asset:</u>		
Add: Net Profit (OR)			Cash at Bank		xxx
Less: Net Loss	xxx		Cash in hand		xxx
Add: Interest on Capital	xxx		Bills Recivable		xxx
Less: Drawings	xxx		Stock in Trade		xxx
Add: Interest on Drawings	xxx	XXX	Closing Stock		xxx
<u>Long Term Liabilities:</u>			Debtors		xxx
Loan on Mortgage		xxx	Marketable Securities		xxx
Bank Loan		xxx	Prepaid Expenses		xxx
<u>Current Liabilities:</u>			Accrued Income		xxx
Sundry Creditors		xxx	<u>Fixed Assets:</u>		
Bills Payable		xxx	Land and Building		xxx
Bank Overdraft		xxx	Building		xxx
Outstanding Expenses		xxx	Furnitures		xxx
Income Received in Advance		xxx	Vehicles		xxx
			Plant		xxx
			Goodwill		xxx
		XXXX			XXXX

Assets

In accounting, assets are the valuable resources owned or controlled by a business that are expected to provide future economic benefits. Assets are an essential part of a company's balance sheet and reflect what the business owns. These resources help the

business in carrying out its operations, generating income, and achieving growth. Assets can take many forms, such as cash, buildings, machinery, inventory, vehicles, and accounts receivable. Each of these items contributes to the functioning and profitability of the business in different ways. assets represent the economic value that a business possesses and utilizes for its growth and operations. They are crucial in evaluating the financial strength, liquidity, and investment potential of a business.

Categories of Assets

a) Current Assets

Current Assets are short-term assets that are expected to be converted into cash, sold, or consumed within one year or within the normal operating cycle of the business.

b) Non-Current Assets (Fixed Assets)

Fixed Assets are long-term assets that are used over several years in the business. They are not intended for immediate sale and are used for production or operations.

Liabilities

In accounting, liabilities are the legal or financial obligations of a business that arise from past transactions and are to be settled in the future through the payment of money, goods, or services. Liabilities are an essential part of a company's balance sheet and help in understanding the financial position of the business. Every business needs funds to operate. While part of this money comes from the owner's capital, the rest often comes from borrowed sources. These borrowed funds create liabilities. In simple terms, liabilities show the financial responsibilities of a business to outsiders, such as banks, suppliers, or others. In accounting, liabilities refer to the financial obligations or debts that a business owes to external parties such as lenders, suppliers, or service providers. These obligations arise as a result of past transactions and are expected to be settled in the future through the transfer of money, goods, or services. Liabilities are an essential part of the balance sheet and represent what the business owes. They play a key role in financing the business operations and are used alongside capital (owner's equity) to acquire assets. Liabilities are an important part of any business's financial structure. They indicate how much a business owes and must repay in the future. A well-managed balance of liabilities helps a business grow and maintain financial stability.

Categories of Liabilities

a) Current Liabilities

Current liabilities are short-term obligations that a business is expected to settle within one year or within its normal operating cycle, whichever is longer. These liabilities arise as a result of the company's day-to-day business operations. They are typically settled using current assets like cash, bank balances, or receivables.

b) Non-Current liabilities (Long Term Liabilities)

Non-current liabilities are financial obligations that are not expected to be settled within one year. These are usually long-term borrowings or obligations that support the business in funding major projects, purchasing fixed assets, or expanding operations.

c) Contingent Liabilities

Contingent liabilities are potential obligations that may or may not become actual liabilities depending on the outcome of a future event. These are not recorded in the main accounting books but are disclosed in the notes to financial statements, as they involve uncertainty. Contingent liabilities help stakeholders understand the potential financial risks that may affect the business in the future. Examples: Pending Lawsuits: The company may have to pay damages if the court judgment goes against it. Guarantees: If the company guarantees the loan of another person or company and they default, it becomes liable. Claims under Dispute: Disputed tax or insurance claims.

2.9 Adjustments

Adjustments in final accounts refer to the entries made at the end of the accounting period to match incomes and expenses to the correct accounting period. They are essential to ensure the final accounts show the true and fair financial position and performance of the business. While preparing the Trading and Profit & Loss Account and the Balance Sheet, these adjustments are recorded to include the effects of transactions that are not yet reflected in the trial balance. Adjustments in final accounts ensure that all revenues and expenses are recorded in the correct accounting period, leading to accurate financial statements. Without these adjustments, the profit or loss figure and the financial position shown in the balance sheet would be misleading.

1) Closing Stock

Closing stock refers to the value of goods or inventory that remain unsold at the end of an accounting period. It is an important component in the preparation of the final accounts, especially in the Trading Account and the Balance Sheet. Closing stock consists of raw materials, work-in-progress, and finished goods that are still in hand after sales and usage for the accounting year. The value of closing stock is determined through a physical stock-taking process and is usually valued at the cost or market price, whichever is lower, as per the conservatism principle in accounting.

Treatment

Trading A/c: Shown on the credit side as it represents goods available but not sold, helping calculate the Gross Profit.

Balance Sheet: Shown under the head Current Assets since it is a resource expected to be sold or used in the next accounting period.

2) Outstanding Expenses

Outstanding expenses refer to those expenses which have been incurred during the accounting period but have not yet been paid by the end of that period. These are also called accrued expenses. According to the accrual basis of accounting, such expenses must be recorded in the books even if payment has not yet been made, so that the financial statements reflect the true profit or loss.

Treatment

Profit & Loss A/c: Added to the related expense (e.g., salaries, rent) to reflect the total expense incurred.

Balance Sheet: Shown under Current Liabilities, as the amount is still payable.

3) Prepaid Expenses

Prepaid expenses are the expenses that are paid in advance, for goods or services that will be received or used in a future accounting period. These payments are made before the actual benefit is received, so they are considered an asset until the benefit is utilized.

Treatment

Profit & Loss A/c: Deduct from the related expense. The prepaid portion is deducted from the total expense, so that only the amount related to the current year is charged.

Balance Sheet: Show under Current Assets. The prepaid amount is shown as an asset under Current Assets, since it represents a future benefit.

4) Accrued Income

Accrued income refers to the income that has been earned by a business during an accounting period but has not yet been received by the end of that period. It is also known as outstanding income. According to the accrual basis of accounting, income should be recorded in the books when it is earned, not when the cash is actually received. accrued income is income that a business has earned but not yet received. It is treated as a current asset and is important for accurately measuring profit in the financial statements.

Treatment

Profit & Loss A/c: Add to the related income. The accrued income is added to the related income account to show the total income earned during the period.

Balance Sheet: Show under Current Assets. The accrued income is shown as an asset under the Current Assets section, as it represents an amount receivable in the future.

5) Income Received in Advance

Income received in advance refers to the amount of money that a business has received before providing goods or services, or before the income is actually earned. It is also known as unearned income or advance income. According to the accrual basis of accounting, income should be recorded only when it is earned, not when it is received. Therefore, any income received in advance is not considered current year income and should not be included in the Profit & Loss Account for the current period. income received in advance is treated as a liability until it is earned, ensuring correct income reporting and compliance with accounting principles.

Treatment

Profit & Loss A/c: Deduct from the related income. The advance income is deducted from the total income received during the year to calculate the actual income earned.

Balance Sheet: Show under Current Liabilities. The amount received in advance is shown as a liability under Current Liabilities, because the business is yet to provide the service or fulfill the obligation.

6) Depreciation

Depreciation is the gradual and systematic reduction in the value of a fixed asset over its useful life due to wear and tear, usage, time, obsolescence, or natural decay. It represents the decrease in the value of tangible assets such as machinery, buildings, furniture, and vehicles as they are used in the business operations. In accounting, depreciation is treated as an expense and is charged to the Profit and Loss Account. This helps in accurately determining the net profit and the true value of assets in the Balance Sheet.

Treatment

Profit & Loss A/c: It is expenses and show as an expense. It is debited to the Profit and Loss Account to reduce net profit.

Balance Sheet: Deduct from the value of the concerned asset. Depreciation is deducted from the value of the concerned fixed asset to arrive at its book value.

7) Bad Debts

Bad debts refer to the portion of accounts receivable (debtors) that are no longer recoverable from customers due to reasons like bankruptcy, dishonesty, or inability to pay. When a business sells goods on credit, it expects the customer to pay the amount in the future. However, if it becomes certain that a customer will not pay, that amount is treated as a bad debt and is written off as a loss. Bad debts are considered a business expense because they reduce the expected income from sales. According to the prudence (conservatism) principle of accounting, expected losses such as bad debts should be recorded as soon as they are identified, even if the actual recovery process continues. Bad debts are irrecoverable amounts from customers and are treated as an expense. In final accounts, they are debited to the Profit & Loss Account and deducted from debtors in the Balance Sheet. This ensures accurate reporting of both profit and receivables.

Treatment

Profit & Loss A/c: Show as an expense.

Balance Sheet: Deduct from Debtors (if not already adjusted). Deduct bad debts from Sundry Debtors under Current Assets

8) Provision for Bad and Doubtful Debts

Provision for Bad and Doubtful Debts is an estimated amount set aside by a business to cover potential future losses from its debtors (accounts receivable) who may not be able to pay their dues. While some debts are already confirmed as bad (bad debts), others are still uncertain but may become bad in the future. To follow the prudence (conservatism) principle, businesses create a provision to cover these possible losses. This provision is not for known bad debts but for anticipated losses, based on past experience, customer credibility, and the age of debts. It ensures that the assets (debtors) are not shown at an overestimated value in the balance sheet and that net profit is not overstated.

Treatment

Profit & Loss A/c: Show as an expense.

Balance Sheet: Deduct from Debtors. The provision is deducted from sundry debtors under current assets

9) Interest on Capital

Interest on Capital refers to the amount of money that a business allows to its owner or partners as a reward for investing capital into the business. It is treated as a business expense, especially in the case of partnership firms, where each partner contributes a certain amount of capital. The interest is paid on this capital to compensate the owner or partners for using their money in the business instead of investing it elsewhere. This interest is usually allowed at an agreed rate as per the partnership deed or business agreement. When the owner invests capital in the business, the business may allow interest on capital to the owner as a reward for using personal funds in the business. Though the owner and the business are legally the same, for accounting purposes, interest on capital is treated as a business expense.

This is done to assess the true profitability of the business and to make fair comparisons with other investment opportunities.

Interest on capital is a way of compensating the owner or partners for the use of their funds in the business. It is not a charge against profit, but an appropriation of profit, and helps in fair distribution of earnings among partners.

Treatment

Debit to Profit & Loss A/c. Interest on capital is debited as a business expense

Add to Capital in Balance Sheet. Interest is added to the capital account, since it increases the amount due to the owner

10) Interest on Drawings

Interest on Drawings refers to the amount charged by a business to its owner or partners when they withdraw money or goods for personal use from the business during the accounting year. This interest is charged as a compensation to the business for the use of its funds for non-business (personal) purposes. When an owner or partner takes money out of the business for personal use, the business loses the opportunity to use those funds for income-generating activities. Hence, interest is charged on such drawings, usually at a fixed rate agreed upon in the partnership deed or as per firm policy.

Treatment

Credit to Profit & Loss A/c. Interest on drawings is credited as it is income to the business

Deduct from Capital. Interest on drawings is added to drawings and deducted from capital (as it reduces owner's investment)

11) Goods in Transit

Goods in transit refer to goods that have been purchased or sold but are still being transported and have not yet reached the buyer or seller by the end of the accounting year. In the context of purchases, if the business has bought goods and the ownership has already transferred, even though the goods haven't physically arrived, they are still considered part of closing stock. Similarly, if the business has sold goods but ownership

hasn't yet passed to the customer, the goods are still considered part of the seller's inventory.

Treatment

Credit to Trading A/c. Include in closing stock

Show as a Current Asset under “Goods in Transit”

Preparation of Final Accounts of a Non-Trading Organisations.

A Non-Trading Organisation (NTO), also known as a Non-Profit Organisation (NPO), is an entity that exists not to earn profit, but to serve the community or promote social, cultural, educational, or charitable activities. Unlike trading concerns that aim to maximize profits, non-trading organisations work toward fulfilling a specific mission or objective that benefits society at large. These organisations are a) Charitable Trusts, b) Clubs (sports, social or recreational), c) Hospitals, d) Educational Institutions, e) Religious institutions, f) NGOs (Non-Governmental Organisations).

Characteristics of Non-Trading Organisations

- a) Service-Oriented:** Their primary goal is to provide services rather than to earn profits.
- b) No Profit Motive:** Any surplus generated is used for furthering the objectives, not for distribution among members.
- c) Members and Subscriptions:** They usually receive recurring income in the form of membership fees or subscriptions.
- d) Managed by Trustees or Committees:** These organisations are governed by a group of individuals called trustees or a managing committee.
- e) Donations and Grants:** A major portion of their funds comes from donations, grants, or aid.
- f) Accounting:** Their accounts are maintained to show proper utilization of funds, rather than profitability.

Financial Statement of Non-Trading Organisation

1) Receipts and Payments Account

A summary of cash and bank transactions during the accounting period. It includes both capital and revenue items, whether related to current year or not.

2) Income and Expenditure Account

Equivalent to the Profit & Loss Account for Non-Trading Organisations. Prepared on accrual basis, recording only revenue items related to the current year.

3) Balance Sheet

Shows the financial position of the organisation. Includes capital fund, assets, liabilities, and adjustments for outstanding/prepaid items.

Importance of Accounting for Non-Trading Organisations

1) Ensures Proper Utilization of Funds: Non-trading organisations often receive donations, grants, and subscriptions. Accounting helps ensure that these funds are used appropriately for the purpose they were intended.

2) Maintains Financial Transparency: Accurate financial records build trust among stakeholders like donors, members, and the public. Transparency encourages more donations and government grants.

3) Assists in Decision Making: Financial reports like Income and Expenditure Account and Balance Sheet help management assess financial health. Informed decisions can be made regarding expansion, new programs, or cost control.

4) Legal and Regulatory Compliance: Many Non-Trading Organisations are required to submit financial statements to the government, tax authorities, or registration bodies. Proper accounting ensures compliance with statutory requirements.

5) Evaluation of Performance: Though profit is not the aim, accounting helps assess whether the organisation is meeting its objectives efficiently. Comparison of current and past financial data helps in performance evaluation.

6) Preparation of Budgets and Plans: With proper accounting, the organisation can plan budgets realistically for upcoming periods. Helps allocate resources where they are needed most.

7) Detection and Prevention of Fraud: Maintaining systematic accounting records reduces chances of misuse or fraud. Internal audits and reconciliations help detect irregularities early.

8) Basis for Fundraising and Grants: Donors and funding agencies often ask for audited accounts before providing aid. A well-maintained accounting system improves credibility and fundraising potential.

Final Accounts of Non-Trading Organisations

Non-Trading Organisations (NTOs) also known as Non-Profit Organisations (NPOs) are institutions that do not aim to earn profits but provide services to society. Examples include clubs, educational institutions, charitable hospitals, religious trusts, etc. Instead of Trading and Profit & Loss Accounts, NTOs prepare a different set of final accounts to show the results of operations and the financial position. Non-trading organisations prepare three main financial statements.

1. Receipts and Payments Account, 2. Income and Expenditure Account and 3. Balance Sheet

1. Receipts and Payments Account

It is a summary of all cash and bank transactions during the accounting period. Includes both revenue and capital items, whether related to current year, previous, or future. It is similar to a Cash Book but prepared at the end of the year. Includes capital + revenue, past + current + future cash flows.

Features of Receipts and Payments Account

1) Summary of Cash Transactions: It records all cash and bank receipts and payments during the accounting year, just like a cash book.

3) Real Account nature: Based on the principle of real account, “Debit what comes in, credit what goes out.”

2) Follows Cash basis of accounting: Only transactions that involve actual cash or bank movement are recorded. No accruals or adjustments are included (like outstanding expenses or incomes).

4) Includes both capital and revenue items: Records all types of receipts and payments, whether capital (e.g., assets) or revenue (e.g., salaries, subscriptions).

5) No Distinction of Period: Receipts and payments may belong to previous, current, or future years—there is no adjustment for timing.

6) Does not show surplus or deficit: It does not show the financial performance (i.e., surplus or deficit). That is shown in the Income and Expenditure Account.

7) Opening and Closing Balance: Begins with opening cash/bank balance and ends with closing balance, which is carried forward to the next year.

8) Simple format: It is simple in structure, with Receipts on the left and Payments on the right, making it easy to understand and prepare.

9) Used as base for final accounts: It serves as a basis for preparing the Income & Expenditure Account and Balance Sheet of a non-trading organisation.

10) Unaudited Information Source: Usually prepared before adjustments and may need further scrutiny during final account preparation.

Proforma of a Receipts and Payments Account

Receipts and Payments Account of _____ as on _____

Receipts	Amount	Amount	Payments	Amount	Amount
To Opening Balance			By Salaries		xxx
Cash	xx		By Rent and Taxes		xxx
Bank	xx	xxx	By Printing		xxx
To Subscriptions		xxx	By Electricity Charges		xxx
To Donations		xxx	By Sports Equipment Purchased		xxx
To Entrance Fee		xxx	By Furniture Purchased		xxx
To Sale of old news paper		xxx	By Honorarium		xxx
To Interest Received		xxx	By Postage		xxx
To Government Grants		xxx	By Closing Balance		
To Miscellaneous Income		xxx	Cash	xx	
			Bank	xx	xxx
		XXX			XXX

Steps to prepare Receipts and Payments Account

Step 1: Collect Cash Book or Cash Transaction Records

Gather all cash and bank transactions (receipts and payments) from the accounting period.

Step 2: Classify Transactions

Separate all cash receipts and payments. Revenue items (e.g., subscriptions, rent) and Capital items (e.g., donations for building, asset purchase)

Step 3: Prepare the Format

a) Title the Account

Write the heading as “Receipts and Payments Account for the Year Ended with date and year”

b) Divide the Page into Two Sides

Left side (Debit side): All Receipts (cash inflows) and Right side (Credit side): All Payments (cash outflows)

Step 4: Start with opening balance

Cash in hand or Bank balance at the beginning of the year is written on the Receipts side. (usually first item)

Step 5: Record All Cash and Bank Receipts

List all incoming cash/bank transactions on the Receipts side with proper headings.

Step 6: Record All Cash and Bank Payments

List all cash/bank payments on the Payments side with clear classification.

Step 7: Compute the Closing Balance

Total both sides and compute the closing balance, The difference is the closing cash/bank balance, written on the Payments side as “By Balance c/d”. which is carried forward to the next year.

2. Income and Expenditure Account

Income and expenditure account is similar to a Profit and Loss Account used in business. It is prepared to find out whether the organisation has a surplus (extra income) or deficit (extra expenses) during the year. All incomes like Subscriptions, donations, interest) are shown on the right side (credit side). All expenses like salaries, rent, electricity) are shown on the left side (debit side). It includes only the items related to the current year, even if they are not paid or received in cash. This means it is prepared on the accrual basis of accounting. The result of this account may surplus or deficit is added to or subtracted from the Capital Fund in the Balance Sheet. In short, the Income and Expenditure Account shows whether the organisation has earned more than it spent or spent more than it earned during a financial year.

Features of Income and Expenditure account

1) Prepared by Non-Trading Organisation

It is prepared by clubs, schools, hospitals, charitable trusts, and other non-profit organisations.

2) Similar to Profit and Loss Account

It is similar in format and purpose to a Profit and Loss Account, but it is used to find out surplus (excess of income) or deficit (excess of expenses).

3) Prepared on Accrual Basis

It includes all incomes earned and expenses incurred during the accounting year, whether received/paid or not.

4) Includes only revenue items

It includes only revenue incomes and expenses. Capital items like the purchase of assets or building funds are not shown here.

5) Relates to Current year only

It records only those items which belong to the current accounting year.

6) Helps in finding surplus and deficit

The difference between total income and total expenditure shows whether the organisation has a surplus or deficit.

7) No opening and closing balances

Income and expenditure do not show opening or closing cash balances.

8) Non-Cash items Included

Non-cash expenses like depreciation are included.

9) Affects Capital Fund

Surplus or deficit shown in this account is added to or deducted from the Capital Fund in the Balance Sheet.

Proforma of an Income and Expenditure Account

Income and Expenditure Account of _____ as on _____

Expenditure	Amount	Amount	Income	Amount	Amount
To salaries		xxx	By Subscriptions		xxx
To rent and taxes		xxx	By Donation (General)		xxx
To Electricity charges		xxx	By Entrance Fee		xxx
To printing and stationery		xxx	By Interest on		
To Repairs and			Investments		xxx
Maintanance		xxx	By miscellaneous Income		xxx
To Sports or Cultural					
Expenses		xxx	By Deficit (BF)		XXX
			(Excess of Expenditure		
To Depreciation of Assets		xxx	over income)		
To Audit Fees		xxx			
To Loss on sale of assets		xxx			
To Surplus (BF)		XXX			
(Excess of Income over					
Expenditures)					
		XXXX			XXXX

Note:

- This account is prepared on accrual basis.
- Only revenue items (not capital items) are included.
- The surplus or deficit is transferred to the Capital Fund in the Balance Sheet.

Steps to Prepare Income and Expenditure Account

Step 1: Identify Revenue Items

From the Receipts and Payments Account, select only revenue items (not capital items). Include only those items that relate to the current accounting period.

Step 2: Pick Only Revenue Items

Select only revenue receipts (like subscriptions, interest, donations for general purposes). Select only revenue payments (like salaries, rent, printing). Ignore capital receipts/payments (e.g., purchase of furniture, building fund donations).

Step 3: Exclude Capital Items

Do not include items like purchase/sale of fixed assets, loans, and donations for specific purposes (e.g., building fund).

Step 4: Adjust for Accruals

a) Add outstanding incomes (incomes earned but not yet received). b) Deduct income received in advance. c) Add outstanding expenses (expenses incurred but not yet paid). d) Deduct prepaid expenses.

Step 5: Add Non-Cash items (Adjustments)

Include depreciation, bad debts, loss/gain on sale of asset, etc.

Step 6: Classify into Income and Expenditure

Incomes go on the credit side (right side) and Expenses go on the debit side (left side).

Step 7: Balance the Account

The difference between the two sides is either Surplus or Deficit

If income > expenditure, the result is Surplus. Surplus (Excess of Income over Expenditure) – Add to the capital fund in the balance sheet liability side.

If expenditure > income, the result is Deficit. Deficit (Excess of Expenditure over Income) – deducted from the capital fund in the balance sheet liability side.

3. Balance Sheet

A Balance Sheet is a financial statement that shows the financial position of a non-trading organisation (such as clubs, schools, hospitals, and charitable institutions) at the end of an accounting year. It is prepared after the Income and Expenditure Account, and it shows what the organisation owns (assets) and owes (liabilities) on a specific date. In non-trading organisations, the Balance Sheet is slightly different from that of business organisations because it does not contain capital and profit. Instead, it shows a Capital Fund (or General Fund), which represents the accumulated surplus of the organisation. Any surplus or deficit from the Income and Expenditure Account is added to or subtracted from this fund.

This statement helps in understanding the overall financial strength of the organisation, its solvency, and how its resources are being managed. It also ensures transparency and accountability, especially when the organisation receives funds from donors, government bodies, or members.

Proforma of a Balance Sheet of Non-Trading Organisation

Balance Sheet of _____ as on _____

Liabilities	Amount	Amount	Assets	Amount	Amount
Capital Fund (Opening Balance)	xxx		Fixed Assets:		
Add: Surplus	xx		Furniture	xxx	
OR			Less: Depreciation	xx	
Less: Deficit	xx		Net Furniture Value	xxx	xxx
(From Income and Expenditure account)			Equipments		xxx
Adjusted Capital Fund	XXX	xxx	Investments		xxx
Out Standing Expenses		xxx	Current Assets:		
Subscription Received in Advance		xxx	Subscription due (Accrued Income)		xxx
Deposits		xxx	Prepaid Expenses		xxx
Creditors		xxx	Stock on Stationery		xxx
Other Liabilities		xxx	Cash in Hand		xxx
			Cash at Bank		xxx
		XXX			XXX

Note: The Capital Fund acts like the capital account and changes each year based on surplus or deficit. All figures must include necessary adjustments (like outstanding, prepaid, etc.).

Adjustments

- 1) **Outstanding Expenses:** Add to particular expenses and shown as Liabilities in balance sheet.
- 2) **Prepaid Expenses:** Deduct from particular expenses and Shown as Asset in the balance sheet
- 3) **Subscription outstanding:** Add to subscription in income and expenditure account and shown as asset in the balance sheet (Accrued Income)
- 4) **Subscription Received in Advance:** Deduct from subscription in income and expenditure account and shown as liability in the balance sheet.
- 5) **Depreciation of Asset:** Add to expenses in income and expenditure account and Deduct from the particular asset in the balance sheet assets side.
- 6) **Accrued income:** Add to income in income and expenditure account and Shown in the asset side of the balance sheet.

Features of Balance Sheet of Non-Trading Organisation

1. Prepared After Income and Expenditure Account

It is prepared after calculating surplus or deficit in the Income and Expenditure Account.

2. Includes Assets and Liabilities

The Balance Sheet shows Assets (what the organisation owns) right side of the balance sheet and Capital Fund & Liabilities (What it owes and accumulated funds) left side of the balance sheet.

3. Capital Fund Instead of Capital

Instead of a “Capital Account” like in businesses, non-trading organisations have a Capital Fund or General Fund, which increases with surplus and decreases with deficit. which changes every year based on surplus or deficit.

4) No Profit or Loss

As non-trading organisations are not profit-motivated, the Balance Sheet does not show profit or loss, but shows surplus or deficit added to or deducted from the Capital Fund. The surplus (if receipt is more than the expenditure) or deficit (if expenditure is more than the) from the Income and Expenditure Account is added to or subtracted from the Capital Fund.

5) Includes Both Fixed and Current Assets

Fixed Assets: Furniture, Building, Equipment and **Current Assets:** Cash, Bank Balance, Subscriptions Due and subscriptions receivable are shown.

6) Includes Adjusted Figures

All figures in the balance sheet are shown after adjustments, such as a) Outstanding Expenses, b) Prepaid Expenses, c) Accrued Income, d) Income Received in Advance to give a correct financial picture.

7) Follows Accounting Principles

It follows standard accounting principles like matching concept, accrual basis, and going concern.

8) Based on Accrual Principle

The balance sheet follows the accrual basis of accounting, meaning it includes all expenses and incomes related to the current year, whether paid or not.

9) Useful for Stakeholders

It helps members, trustees, and donors know how well the organisation is managing its funds and resources.

Steps to Prepare Balance Sheet of Non-Trading Organisation

Step 1: Write the title and use the format with two sides

Write the title like “Balance sheet of xxx club as on 31st March 2025”. This tells the financial position of the organisation on a specific date.

The balance sheet is prepared in two sides. Left side of the balance sheet is liabilities and right side of the balance sheet is the assets

Step 2: Gather Information

Collect data from: a) Receipts and Payments Account b) Income and Expenditure Account and c) Adjustments (like outstanding expenses, depreciation, etc.)

Step 3: Start with capital fund

Take the opening Capital Fund from last year's balance sheet. Add Surplus (from Income & Expenditure Account) to Capital Fund. If deficit, deduct deficit from capital fund.

Step 4: Record all Liabilities

List all liabilities in Liabilities side of the balance sheet

Step 5: Record all Assets

List all assets in assets side of the balance sheet

Step 6: Apply all Adjustment

Add Outstanding expenses to liabilities side

Add Subscription in advance to liabilities side

Add outstanding income to asset side

Add prepaid expenses to asset side

Deduct depreciation from particular asset to asset side

Step 7: balance Both side

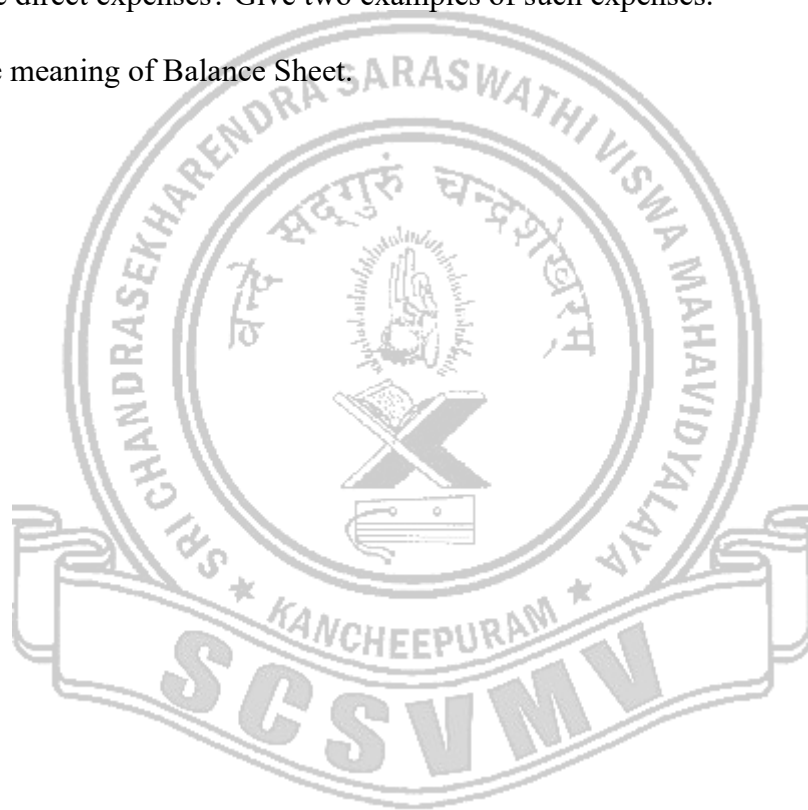
Total up both side as capital fund + liabilities = assets (if not equal, recheck entries and adjustments)

Glossary of Term

- i) Wages paid to factory workers or laborers involved in production.
- ii) Freight Inward / Carriage Inward – cost of bringing raw materials or goods to the factory or shop.
- iii) Import Duty paid on raw materials or goods purchased from abroad.
- iv) Power and Fuel used in the manufacturing process.
- v) Office Rent: Cost paid for using office space for administrative purposes.
- vi) Salaries: Payments made to office and administrative staff.
- vii) Advertisement Expenses: Costs for promoting goods or services to boost sales.
- viii) Telephone and Internet Charges: Communication expenses for business operations.
- ix) Electricity Charges (Office): Power costs for running office equipment and lighting.
- x) Depreciation: Reduction in the value of fixed assets over time.
- xi) Bank Charges: Fees deducted by the bank for financial services.
- xii) Interest on Loan: Cost of borrowing funds from financial institutions.
- xiii) Travel Expenses: Costs incurred for business-related travel.
- xiv) Insurance Premium: Payment made to cover business assets or risks.
- xv) Receipts and Payments Accounts: The Receipts and Payments Account is a summary of cash and bank transactions (both revenue and capital in nature) made by a non-trading organisation during an accounting period.

Check Your Progress

1. How is cost of goods sold calculated?
2. How is Gross Profit calculated?
3. What is Trading Account?
4. What is meant by Profit and Loss Account?
5. When does Profit and Loss Account show Net Profit?
6. What are direct expenses? Give two examples of such expenses.
7. State the meaning of Balance Sheet.



Unit – III

Rectification of Errors

Rectification of errors refers to the process of correcting mistakes made in the books of accounts. These errors may arise during recording, posting, or totaling of transactions. Timely rectification ensures that the final accounts show a true and fair view of the financial position.

Types of Errors

1. Errors of Omission

In accounting, omission refers to the failure to record a financial transaction either partially or completely in the books of accounts. It is one of the common types of accounting errors that can lead to inaccurate financial statements if not identified and corrected. This omissions are two types namely complete Omission and Partial Omission.

Types of Omission

a) Complete Omission

A business transaction is totally left out from the books of accounts. It is not recorded at all, neither in the journal nor in the ledger. No effect on the trial balance.

Steps to Rectify a Complete Omission

Step 1: Identify the Omitted Transaction - Determine what transaction was omitted, the amount, date, and parties involved.

Step 2: Analyze the Correct Entry - Figure out the correct journal entry that should have been passed.

Step 3: Pass the Correct Journal Entry - Now record the correct entry in the journal as if it was being done originally.

Note:

- i) This entry is similar to the original entry because the transaction was completely missed.
- ii) No correction or adjustment is needed—just pass the normal journal entry.

b) Partial Omission

A business transaction is recorded in the journal but not posted to the ledger. It may cause a mismatch in the trial balance.

Steps to Rectify a Partial Omission

Step 1: Identify the Error - Find out which part of the transaction is missing (e.g., not posted to the ledger or posted only to one account).

Step 2: Determine the Correct Posting - Identify which account is affected and what the correct entry should have been.

Step 3: Post the Missing Part - Pass a journal entry to complete the missing part of the transaction.

Note:

- i) Suspense Account is used only when the trial balance disagrees due to one-sided error.
- ii) If error is found before final accounts, rectify it in the journal.
- iii) If error is found after final accounts, rectify it in the next year's books.

2. Errors of Commission

Errors of Commission occur when a transaction is recorded, but incorrectly, due to a mistake in posting the wrong amount, posting to the wrong side of the correct account, entering in to the wrong account of the same class and calculating mistakes (errors in totalling or balancing)

Error Type	Example	Explanation
Case 1: Wrong amount posted	a) excess post: Rs. 4,500 received from Mohan is posted as Rs. 5,400	Amount is wrongly excess posted
	b) Under Post: Rs. 950 paid to supplier was posted as Rs. 590 to supplier's account	Amount is wrongly under posted

Case 2: Posted to wrong side	Rent Paid Rs. 2,000 posted credit instead of debit	Side error
Case 3: Posted to wrong account	Cash received from Ram posted to the account of Shyam	Same class, wrong person
Case 4: Casting error	Total of purchases book is overcast by Rs. 1,000	Calculation error

Case 1: steps to rectify the wrong amount posted

a) **excess post:** Rs. 4,500 received from Mohan is posted as Rs. 5,400

Suspense a/c	Dr	900	
To Mohan a/c			900
(Being correction of excess posting to Mohan's account)			

b) **Under Post:** Rs. 950 paid to supplier was posted as Rs. 590 to supplier's account

Supplier a/c	Dr	360	
To Suspense a/c			360
(Being correction of under posting in Supplier's account)			

Note for case 1:

- i) If both debit and credit are affected with wrong amounts, reverse the wrong entry and then pass the correct entry.
- ii) If error is one-sided, use Suspense A/c.
- iii) The difference (not the full amount) is corrected.

Case 2: Steps to rectify the posted to wrong side

a) Rent Paid Rs. 2,000 posted credit instead of debit

Rent a/c	Dr	4,000	
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a) Overcasting - Sales book overcast by ₹1,000 (Sales Account was credited ₹1,000 extra)

Sales a/c	Dr	1,000	
To Suspense a/c			1,000
(Being rectification of overcasting of sales book by Rs. 1,000)			

b) Under casting - Purchase book undercast by ₹500 (Purchases Account was debited ₹500 less)

Purchases a/c	Dr	500	
To Suspense a/c			500
(Being rectification of undercasting of purchase book by Rs. 500)			

Note for case 4:

- i) If the error affects only one side of the account, use Suspense A/c.
- ii) If found before the trial balance is prepared, you may adjust the original entry directly.
- iii) If found after the trial balance, pass a journal entry as shown.

Over all Note:

- i) Errors of commission are usually clerical/mathematical.
- ii) May or may not affect the trial balance.
- iii) Often corrected by adjusting Suspense A/c or reversing wrong postings.

Bank Reconciliation Statement

A Bank Reconciliation Statement (BRS) is a statement prepared to reconcile the difference between the bank balance as per the Cash Book (company's books) and the bank balance as per the Pass Book (bank statement).

Objective of Preparing Bank Reconciliation Statement

- 1) To find the causes of differences between the Cash Book and Pass Book balances.

- 2) To ensure that no errors or omissions have been made.
- 3) To update the cash book with missing entries.
- 4) To detect any fraud, mistake, or delay in cheque clearance.

Reasons for Differences Between Cash Book and Pass Book

Here are some reasons for difference between cash book and pass book

S. No.	Reasons	Effects
01	Cheques issued but not yet presented	Less in cash book, more in pass book
02	Cheques deposited but not yet credited	More in cash book, less in pass book
03	Bank charges not recorded in cash book	Less in pass book
04	Interest credited by bank not recorded in cash book	More in pass book
05	Direct deposit into bank by customer	More in pass book
06	Standing instructions by bank (e.g., EMI, Rent)	Less in pass book
07	Dishonour of cheques not recorded in cash book	Less in pass book
08	Errors in cash book or pass book	Depends on the nature of error

Glossary of Terms

Due Date: The date from which interest is calculated.

Product: Amount $\times$ Number of days from due date to closing date.

Debit Product: Interest to be charged.

Credit Product: Interest to be allowed.

Net Interest: Difference between total debit and credit interest.

Error: A mistake in recording, posting, or classifying accounting data.

Rectification: The process of identifying and correcting accounting errors to ensure accurate books of accounts.

Compensating Errors: Two or more errors that offset each other, making the trial balance still agree.

Suspense Account: A temporary account used when the trial balance does not agree, to locate and rectify one-sided errors.

One-Sided Error: An error that affects only one account, causing trial balance disagreement.

Two-Sided Error: An error that affects two accounts equally; does not affect the trial balance.

Rectification Entry: A special journal entry passed to correct an earlier mistake in the books.

Cash Book (Bank Column): A record maintained by the business that shows all receipts and payments through the bank.

Pass Book / Bank Statement: A record maintained by the bank showing all transactions in the customer's bank account.

Reconciliation: The process of matching and explaining the differences between the balances in the cash book and pass book.

Outstanding Cheques: Cheques issued by the firm but not yet presented for payment by the recipient.

Deposits in Transit / Cheques Deposited but Not Credited: Cheques received and recorded in the cash book but not yet credited by the bank.

Dishonour of Cheque: A cheque deposited or issued that is not honoured by the bank due to reasons like insufficient funds.

Errors in Cash Book: Mistakes made by the business while recording transactions in the bank column of the cash book.

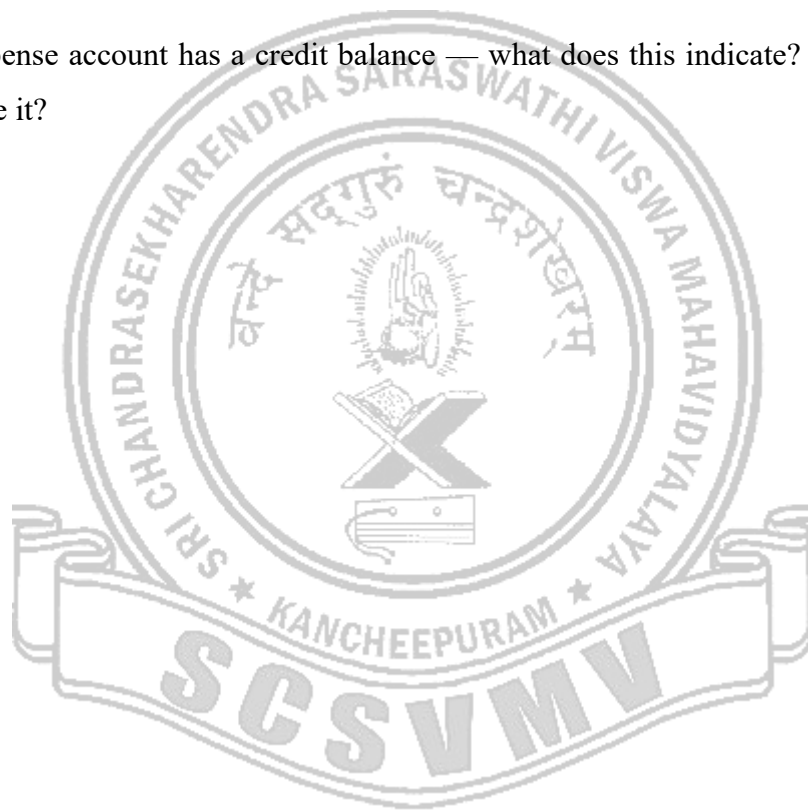
Errors in Pass Book: Mistakes made by the bank in recording transactions in the customer's account.



Check Your Progress

- 1) What is an accounting error?
- 2) Mention any two types of errors.
- 3) Define an error of omission.
- 4) What is an error of principle?
- 5) Explain the classification of errors in accounting.
- 6) Differentiate between Error of commission and error of omission
- 7) Differentiate between Error of principle and compensating error
- 8) What are compensating errors? Give examples.
- 9) Write a short note on errors not affecting the trial balance.
- 10) What is rectification of errors?
- 11) What type of errors affect the trial balance?
- 12) Explain the steps in rectifying one-sided and two-sided errors.
- 13) How are errors rectified before and after preparing the trial balance?
- 14) State the differences between rectification through journal entries and rectification through suspense account.
- 15) Write the rules for rectifying errors detected after preparing final accounts.
- 16) What is a suspense account?
- 17) State one reason for creating a suspense account.
- 18) Explain the need and importance of suspense account in accounting.
- 19) How is a suspense account used to rectify errors affecting only one side of the trial balance?
- 20) Write a note on the treatment of suspense account at the end of the accounting year.
- 21) What is a Bank Reconciliation Statement?
- 22) State any two causes of differences between cash book and pass book balances.
- 23) What is an overdraft as per pass book?

- 24) What is the need for preparing a bank reconciliation statement?
- 25) What are the common reasons for differences between the bank balance as per cash book and pass book?
- 26) Distinguish between cash book and pass book balances.
- 27) Explain the procedure for preparing a bank reconciliation statement.
- 28) How do errors affect the accuracy of financial statements?
- 29) Can a trial balance agree even when errors exist? Justify with reasons.
- 30) Discuss the role of BRS in internal control of a business.
- 31) A suspense account has a credit balance — what does this indicate? How would you resolve it?



Unit – IV

Depreciation

Depreciation refers to the gradual decrease in the value of fixed tangible assets due to wear and tear, usage, passage of time, or obsolescence. It is an accounting method used to allocate the cost of an asset over its useful life.

Objectives of Providing Depreciation

- 1) To allocate the cost of the asset over its useful life
- 2) To reflect the true value of assets in the balance sheet
- 3) To determine the real profit or loss
- 4) To provide funds for replacement of assets
- 5) To comply with accounting standards and principles

Causes of Depreciation

- 1) Wear and Tear - Loss in value due to constant use of the asset.
- 2) Passage of Time - Even unused assets depreciate with time.
- 3) Obsolescence - Becoming outdated due to new technology.
- 4) Accidents - Unexpected events may reduce asset value.
- 5) Depletion - For natural resources — reduction in quantity (e.g., mines, oil wells)

Methods of Depreciation

- 1) Straight Line Method (SLM)
- 2) Written Down Value Method (WDV)
- 3) Insurance Policy Method
- 4) Sinking Fund Method
- 5) Annuity Method

1) Straight Line Method (SLM)

The Straight-Line Method (SLM) is the simplest and most commonly used method. In this method, a fixed and equal amount of depreciation is charged each year over the useful life of the asset.

Formula

Cost of Asset – Residual (Scrap) Value

Annual Depreciation = -----
Useful Life of Assets

Cost of Asset = Purchase price + Installation Charges + Other capital cost.

Residual Value = Estimated value at the end of useful life.

Useful Life = Number of years the asset is expected to be used.

Features of Straight-Line Method (SLM)

1) Fixed Annual Depreciation

A constant and equal amount of depreciation is charged each year. This makes accounting predictable and consistent.

2) Simple and Easy to Apply

The method involves a basic formula and is easy to understand and implement.

3) Asset Value Reduces Uniformly

The book value of the asset decreases evenly over its useful life.

4) Full Depreciation Over Useful Life

The total cost of the asset (minus residual value) is written off completely over its useful life.

5) Suitable for Uniformly Used Assets

Best suited for assets whose usage and wear-and-tear are consistent over time, such as:

Buildings, Furniture, Office equipment

6) Residual Value Considered

The asset's estimated scrap or residual value is subtracted while calculating depreciation.

7) Useful Life Is Estimated in Advance

The method requires estimation of the asset's useful life, which may vary depending on asset type and usage.

8) Book Value Never Becomes Zero (If Residual Value Exists)

At the end of the useful life, the book value equals the residual value, not zero.

9) Helps in Planning

Since depreciation is fixed, it helps in budgeting and forecasting financial statements easily.

Example Problem:

Cost of Asset = ₹ 22,50,000

Residual Value = ₹ 50,000

Useful Life = 5 years

$$\text{Annual Depreciation} = \frac{\text{₹ 22,50,000} - \text{₹ 50,000}}{5 \text{ Years}} = \text{₹ 4,40,000}$$

Depreciation Schedule:

Year	Depreciation (₹)	Book Value at Year End (₹)
1	₹ 4,40,000	₹ 18,10,000 (22,50,000 – 4,40,000)
2	₹ 4,40,000	₹ 13,70,000 (18,10,000 – 4,40,000)
3	₹ 4,40,000	₹ 9,30,000 (13,70,000 – 4,40,000)
4	₹ 4,40,000	₹ 4,90,000 (9,30,000 – 4,40,000)
5	₹ 4,40,000	₹ 50,000 (4,90,000 – 4,40,000)

Advantages of Straight-Line Method

1) Simple and Easy to Use

The method is easy to understand and apply, requiring only basic calculations. Suitable for small businesses and students.

2) Equal Depreciation Every Year

Depreciation is charged uniformly each year, making accounting consistent and predictable.

3) Facilitates Easy Budgeting

Since the depreciation expense is fixed annually, it helps in accurate forecasting and budgeting of expenses.

4) Assets Fully Depreciated Over Useful Life

The total cost (minus residual value) is completely written off over the asset's useful life.

5) Suitable for Assets with Consistent Usage

Ideal for assets that wear out evenly over time, such as: Buildings, Furniture and Office equipment

6) Helps in Profit Comparison

Due to equal depreciation, profit comparisons across years are easier and more meaningful.

7) Accepted by Accounting Standards

Widely recognized under various accounting frameworks (like AS, IFRS), making it legally compliant.

8) Easy to Determine Asset Value

Since depreciation is linear, it is easy to calculate the current book value of the asset at any time.

Disadvantages of Straight-Line Method

1) Ignores Actual Usage of Asset

Depreciation is charged equally every year, regardless of how much the asset is actually used. Not suitable for assets whose usage varies significantly from year to year.

2) Does Not Account for Increasing Repairs

As an asset ages, maintenance and repair costs usually increase, but SLM keeps depreciation constant. This leads to uneven total expenses (Depreciation + Repairs) over the asset's life.

3) No Adjustment for Technological Obsolescence

It does not consider the rapid obsolescence of some assets due to technological advancements.

4) Book Value May Not Reflect Market Value

The asset's book value (cost – accumulated depreciation) may not reflect its true market value, especially in early or late years.

5) Not Suitable for All Asset Types

It is not ideal for assets that lose more value in the initial years (like vehicles or machinery).

6) Residual Value and Useful Life Are Estimates

If the residual value or useful life is wrongly estimated, it can lead to inaccurate depreciation and misleading financials.

7) No Incentive for Tax Planning

Many tax laws (like in India) prefer accelerated depreciation methods (e.g., WDV), which allow higher depreciation in early years for tax savings. SLM doesn't offer this benefit.

Written Down Value Method (WDV) OR Diminishing Balance Method

The Written Down Value (WDV) Method, also known as the Diminishing Balance Method or Reducing Balance Method, is one of the most widely used methods for calculating depreciation on fixed assets. Under this method, depreciation is charged at a fixed percentage on the book value (also called written down value) of the asset at the beginning of each accounting year. Unlike the Straight Line Method, where the same

amount of depreciation is charged every year, the WDV method results in decreasing depreciation charges over time.

The WDV method assumes that assets lose more value in the earlier years of their useful life and lesser value in the later years. This reflects the natural wear and tear or obsolescence pattern of most assets, such as machinery and vehicles, which tend to be more productive or efficient in the initial years.

Each year, the depreciation is calculated on the reduced balance (cost of asset minus accumulated depreciation). As a result, the value of the asset never reaches zero, though it becomes very small over a long period.

This method is commonly used for income tax purposes in many countries, including India, due to its alignment with the actual usage pattern of assets. It also provides the advantage of matching higher depreciation expense with higher revenue generation in the early years of asset usage.

Features of Written Down Value (WDV) Method

- 1) Fixed Rate of Depreciation:** Depreciation is charged at a constant percentage rate each year on the asset's book value.
- 2) Declining Depreciation Amount:** The amount of depreciation decreases every year since it is calculated on the reduced (written down) value of the asset.
- 3) Book Value Basis:** Depreciation is computed on the asset's opening balance (i.e., original cost minus accumulated depreciation).
- 4) Never Reaches Zero:** The value of the asset never becomes zero; it reduces gradually but never fully depreciates to nil.
- 5) More Depreciation in Initial Years:** Higher depreciation is charged in the early years of the asset's life, which reflects higher productivity or utility during those years.
- 6) Suitable for Tax Purposes:** It is commonly accepted for income tax purposes in many countries, including India, as it matches income with expenses more accurately in early years.
- 7) Reflects Actual Asset Usage:** Ideal for assets that lose their value more quickly in the initial years due to heavy use, wear and tear, or obsolescence.

8) Reduces Profits Initially: Since depreciation is higher in the early years, it reduces taxable profits more in those years.

9) Used for Long-Term Assets: Best suited for long-term tangible assets like machinery, vehicles, and equipment.

10) Not Suitable When Asset Usage is Uniform: This method is less appropriate for assets that provide equal benefits over their useful life, such as buildings or office furniture.

Objectives of Written Down Value (WDV) Method

1) To Reflect True Asset Value: The WDV method aims to show a realistic and gradually declining book value of the asset over time, in line with its usage and wear.

2) To Match Cost with Revenue: It helps match higher depreciation expenses with higher revenues in the earlier years when the asset is more productive, ensuring better income-expenditure matching.

3) To Provide Tax Benefits in Early Years: By charging higher depreciation initially, it reduces taxable income in the early years, offering tax-saving benefits when business costs are typically higher.

4) To Represent Actual Asset Utility: It assumes that assets lose more value in early years due to higher usage and technological obsolescence, reflecting actual economic value reduction.

5) To Maintain Prudence in Accounting: The method supports conservative accounting practices by ensuring that asset values are not overstated in financial statements.

6) To Simplify Computation: Using a fixed percentage each year makes the depreciation calculation consistent and straightforward, especially for long-term assets.

7) To Support Long-Term Financial Planning: Gradual reduction in asset value helps businesses plan for future asset replacement and capital budgeting more effectively.

8) To Comply with Legal and Tax Regulations: The WDV method is often mandated or preferred under various income tax laws and accounting standards, ensuring legal compliance.

Formula for Calculating Depreciation under Written Down Value (WDV) Method

a) Indirect Method

Depreciation = Book value of the asset at beginning of the year X $\frac{\text{Rate of Depreciation}}{100}$

Book value at the end of the year under WDV method = Book value of the asset at beginning of the year – Depreciation for the year.

b) Direct Method

WDV after n years = Original Cost of Asset X $[1 - \{r/100\}]^n$

Original cost of the asset = Initial cost of asset

r = Rate of depreciation (%)

n = Number of Years

Advantages of Written Down Value method

- 1) Higher Depreciation in Early Years:** Matches the actual usage and wear-and-tear of the asset, which is usually higher in the beginning.
- 2) Tax Benefits:** Reduces taxable income in the early years due to higher depreciation, leading to lower tax liability.
- 3) Realistic Asset Valuation:** Provides a more accurate picture of the asset's declining value over time.
- 4) Useful for Technologically Sensitive Assets:** Suitable for assets that become obsolete quickly, such as machinery, computers, and vehicles.
- 5) Conservative Accounting Practice:** Ensures that assets are not overstated in financial statements, promoting prudence.
- 6) Easy to Apply:** Uses a fixed percentage, making annual depreciation calculations simple and consistent.

Disadvantages of Written Down Value method

- 1) **Value Never Becomes Zero:** The asset's value never fully depreciates to zero, which may not reflect its actual disposal value.
- 2) **Uneven Profit Impact:** Leads to lower profits in earlier years and higher profits in later years, which may distort performance comparison.
- 3) **Not Suitable for Uniformly Used Assets:** Inappropriate for assets like buildings or office furniture that provide equal utility over time.
- 4) **Difficult to Estimate Correct Rate:** Selecting the right depreciation rate is critical and can be challenging; a wrong rate may misstate asset value.
- 5) **May Affect Investment Decisions:** Lower profits in early years may make financial performance look weak, affecting investor perception.
- 6) **Complex in Case of Asset Additions:** Calculating depreciation for assets added during the year can become complicated.

Insurance Policy Method

This name emphasizes the use of an insurance policy to fund the replacement of the asset rather than investing in securities as done in the sinking fund method. While it is similar in purpose to the Sinking Fund Method, it is not exactly the same. So, it is not directly called the Sinking Fund Method, but they are closely related in concept.

The Insurance Policy Method is a special method of providing for depreciation where a business takes an insurance policy to replace the fixed asset at the end of its useful life. This method ensures that the business will have sufficient funds to replace the asset when it becomes obsolete or unusable. This method is particularly used when a business wants to ensure that funds are available to replace an asset without investing in external securities, as done in the sinking fund method. Under this method, the business takes an insurance policy from an insurance company equal to the cost of replacing the asset. The policy is set to mature at the end of the asset's useful life. The business pays a fixed annual premium to the insurance company throughout the life of the asset. This annual premium is treated as a depreciation charge in the books of accounts. At the end of the asset's useful life, the insurance policy matures, and the business receives a lump sum amount from the insurance company. This amount is then used to purchase a new asset, effectively replacing the old one without affecting the working capital of the business.

This method ensures financial discipline and guarantees that sufficient funds are available for replacement. It is especially beneficial for organizations that want a secure, low-risk approach to asset replacement planning.

Features of Insurance Policy Method

- 1) Annual Premium Payments: A fixed annual premium is paid to an insurance company instead of investing in a depreciation fund or securities.
- 2) Use of Insurance Policy: An insurance policy is taken out that matures at the end of the asset's useful life to provide funds for its replacement.
- 3) No Actual Depreciation Charged: The premium paid is treated as depreciation expense in the books, even though no direct depreciation is calculated on the asset.
- 4) Guaranteed Fund Availability: At the end of the asset's life, the maturity value of the policy is received, ensuring funds are available for replacement.
- 5) No Interest Earned: Unlike the Sinking Fund Method, no interest or investment income is earned during the asset's life.
- 6) Simple and Secure Method: It is a straightforward and low-risk method since the insurance company guarantees the maturity amount.
- 7) Ideal for Fixed Replacement Planning: Suitable for businesses that want to ensure fixed contributions each year and guaranteed availability of funds for asset renewal.
- 8) No Investment Management Required: The business does not need to manage any investments, as the responsibility is transferred to the insurance company.
- 9) Separate Account Maintained: A "Depreciation Insurance Policy Account" is maintained to record the annual premium payments.
- 10) Used in Long-Term Asset Replacement: Generally used for high-cost or long-term assets where planned replacement is critical.

Advantages of Insurance Policy Method

- 1) Guaranteed Fund Availability: Ensures that a fixed sum will be available at the end of the asset's life for its replacement through the maturity of the insurance policy.
- 2) Financial Discipline: Fixed annual premium payments promote disciplined financial planning and systematic provision for asset replacement.

- 3) Simple and Easy to Apply: The method is straightforward, requiring only annual premium payments without complex investment decisions or calculations.
- 4) Low Risk: No exposure to market fluctuations, as the insurance company guarantees the maturity amount.
- 5) Suitable for Long-Term Planning: deal for businesses that want a safe and predictable method to accumulate funds for future asset replacement.
- 6) Reduces Pressure on Working Capital: The replacement of the asset does not strain business cash flows as the fund is already available.

Disadvantages of Insurance Policy Method

- 1) No Return on Investment: Unlike the Sinking Fund Method, no interest or dividend income is earned on the premiums paid.
- 2) Higher Cost: Insurance premiums may be higher than the amount needed to be invested in other methods to achieve the same result.
- 3) Dependency on Insurance Company: The method relies entirely on the insurance company's performance and timely settlement.
- 4) No Depreciation in Asset Value Reflected: Since no direct depreciation is charged on the asset, the actual reduction in asset value is not shown year by year.
- 5) Less Flexible: Once the policy is taken, it cannot be easily altered or adjusted based on changing business needs or asset usage.

Sinking Fund Method

The Sinking Fund Method of Depreciation, also known as the Depreciation Fund Method, is a systematic approach to providing depreciation while also ensuring the availability of funds for the replacement of an asset at the end of its useful life. This method is especially useful when businesses deal with expensive and long-term assets like machinery, equipment, or buildings.

Under this method, a fixed amount of depreciation is charged annually to the Profit and Loss Account. However, unlike other methods, the same amount is invested in interest-

earning securities outside the business. These investments are made regularly, and the interest earned is also reinvested. Over time, the accumulated value of the investments, along with the interest, grows to equal the cost of replacing the asset.

The key idea behind the sinking fund method is to not only account for the decrease in asset value but also to prepare financially for its replacement. By the time the asset becomes obsolete or unusable, the business has a ready fund to purchase a new one without affecting its working capital or borrowing.

This method is widely regarded as financially prudent and disciplined, as it creates a separate fund specifically for asset replacement. It is particularly helpful in capital-intensive industries or public sector undertakings, where asset replacement planning is crucial.

While the method provides a secure way of funding asset renewal, it also involves administrative effort, such as investment management and accounting for interest income.

The Sinking Fund Method serves a dual purpose: it helps recognize the gradual loss in asset value and simultaneously builds up a reserve fund, ensuring the business remains financially prepared for future asset investments.

Features of Sinking Fund Method

- 1) Fixed Annual Depreciation Charge:** A fixed amount is debited to the Profit & Loss Account every year as depreciation.
- 2) Creation of a Separate Fund:** A Sinking Fund or Depreciation Fund is created to accumulate money for the replacement of the asset.
- 3) Investment of Funds:** The amount charged as depreciation is invested in interest-bearing securities (such as government bonds) outside the business.
- 4) Interest Earned is Reinvested:** Any interest earned on the investments is reinvested into the sinking fund to grow the reserve over time.
- 5) Asset Replacement is Planned:** At the end of the asset's useful life, the fund (principal + interest) is used to purchase a new asset.

6) No Direct Reduction in Asset Account: The asset's original cost remains in the books; depreciation is shown via the Sinking Fund Account, not by reducing the asset's book value directly.

7) Scientific and Disciplined Approach: Encourages systematic and disciplined financial planning for asset replacement.

8) Secure and Predictable: As funds are invested regularly and conservatively, it provides financial security for future replacement.

9) Separate Accounts Maintained: Requires maintaining multiple accounts like Sinking Fund Account and Sinking Fund Investment Account.

10) Long-Term Perspective: Suitable for businesses with long-term, high-cost fixed assets, especially in public utilities or large industries.

Advantages of the Sinking Fund Method

a) Ensures Asset Replacement: A fund is systematically built up to replace the asset at the end of its useful life without financial strain.

b) Disciplined Financial Planning: Encourages regular savings and promotes financial discipline within the business.

c) Interest Income Earned: Investments generate interest, which is reinvested and adds to the replacement fund, reducing the effective cost of depreciation.

d) Maintains Capital Structure: Since the replacement is funded from accumulated investments, there is no need to raise external finance when replacing the asset.

e) Reduces Sudden Cash Outflows: Avoids large, one-time expenses for asset replacement by spreading the cost over several years.

f) Systematic and Scientific Method: This method combines depreciation with investment, making it both an accounting and financial planning tool.

Disadvantages of the Sinking Fund Method

a) Complex Accounting: Requires maintaining multiple accounts and recording transactions related to investments, interest, and reinvestment.

b) Funds Locked in Investments: The funds set aside for depreciation are not available for business use, which may affect liquidity.

c) Market Risk: Investments are subject to market conditions; if investments do not perform well, the fund may fall short of the expected amount.

d) Not Suitable for Low-Cost Assets: This method may be unnecessarily complex for assets with a short life or low cost.

e) Depreciation Does Not Affect Asset Account Directly: The asset account remains at original cost, which may not reflect the actual book value in financial statements.

Difference between Insurance Policy and Sinking Fund Methods of Depreciation

Both methods aim to accumulate resources for asset replacement, but they differ significantly in execution and risk profile. Insurance Policy Method is best for businesses that want safety and simplicity. Sinking Fund Method is suited for those seeking returns on investment and are capable of managing funds.

S. No.	Basis	Insurance Policy Method	Sinking Fund Method
01	Meaning	Depreciation is provided by paying a fixed annual premium to an insurance company, which pays a lump sum at maturity.	Depreciation is provided by setting aside a fixed amount annually and investing it in interest-earning securities.
02	Type of Investment	Insurance policy is taken instead of investing in securities.	Amount is invested in external securities (e.g., government bonds).
03	Earnings on Investment	No interest is earned; maturity value is fixed.	Interest is earned annually and reinvested in the fund.

04	Risk	No market risk as amount is guaranteed by the insurance company.	Subject to investment risk; return may vary based on market conditions.
05	Management of Funds	Simple – no need to manage investments, just pay premiums.	Requires management of investments and accounting for interest.
06	Amount Received at End	Lump sum received from the insurance company on maturity.	Accumulated value of principal and interest from investments is received.
07	Asset Account	Asset account is not reduced; only premium is treated as depreciation.	Asset account is not directly reduced; depreciation fund is created separately.
08	Complexity	Simple and easy to operate.	More complex due to investment and interest tracking.
09	Suitable For	Firms wanting guaranteed and fixed provision for replacement.	Firms comfortable with investment and interested in earning returns.
10	Flexibility	Less flexible once the policy is taken.	More flexible as investments can be adjusted.

Annuity Method

The Annuity Method of Depreciation is a scientific and systematic method that considers both the depreciation on the asset and the interest lost on the capital invested in purchasing the asset. This method is based on the principle of the time value of

money, assuming that if the capital used to acquire the asset had been invested elsewhere, it would have earned interest.

Under this method, a fixed amount—known as the annuity amount—is charged to the Profit and Loss Account every year during the asset's useful life. This charge includes both depreciation and interest. The interest component is calculated on the book value of the asset at the beginning of each year, and the remaining balance of the annuity charge is treated as depreciation. As a result, the interest portion decreases, and the depreciation portion increases each year.

The annuity amount is calculated using annuity tables based on the cost of the asset, the expected useful life, and the rate of interest. This ensures that the total charge to the Profit and Loss Account remains uniform each year, even though the composition of interest and depreciation changes.

This method is particularly suitable for assets with high initial investment and long useful life, such as leases, buildings, or railway wagons. It is commonly used in financial institutions and government departments, where accurate cost matching and capital accounting are critical.

the Annuity Method of Depreciation not only allocates the cost of an asset over its useful life but also accounts for the opportunity cost of capital. Though more complex than other methods, it provides a more realistic and fair measure of asset consumption and cost allocation.

the Annuity Method is best suited for financially sophisticated users and high-value assets, but it may not be practical for simpler or smaller businesses.

Features of Annuity Method

- 1) Considers Time Value of Money:** This method takes into account the interest that could have been earned if the money used to purchase the asset was invested elsewhere.
- 2) Fixed Annual Charge:** A uniform annual amount is charged to the Profit & Loss Account, which includes both depreciation and interest.
- 3) Changing Components:** In each annual charge, the interest portion decreases, and the depreciation portion increases over the years.
- 4) Interest is Treated as Cost:** Interest is calculated on the book value of the asset at the beginning of each year and treated as an expense.

5) Gradual Reduction of Asset Value: The asset's book value is reduced each year by the depreciation portion of the annuity amount.

6) Based on Annuity Tables: The annual charge is calculated using annuity factors derived from annuity tables based on interest rate and asset life.

7) Scientific and Accurate Method: It offers a more realistic approach to depreciation by combining capital cost recovery and interest.

8) Suitable for High-Value Long-Term Assets: Ideal for costly and long-life assets like leases, buildings, or infrastructure, where capital cost and interest impact are significant.

9) Uniform Profit Impact: Though depreciation and interest components vary, the total annual expense remains the same, offering stable expense recognition.

10) Complex Calculations: Compared to other methods, it requires more complex calculations and understanding of financial concepts like annuities and interest.

Advantages of Annuity Method

1) Considers Time Value of Money: Recognizes interest lost on capital invested, giving a more realistic measure of the asset's cost.

2) Uniform Annual Charge: A fixed annual charge (depreciation + interest) is applied to the Profit and Loss Account, ensuring consistency in expense reporting.

3) Scientific and Accurate: Combines both depreciation and interest, making it a more accurate and logical method of cost allocation.

4) Systematic Reduction of Asset Value: The asset's value is reduced each year in a structured way, helping in precise book-keeping.

5) Suitable for Long-Term Assets: Ideal for expensive and long-life assets like leases, infrastructure, or public utilities.

6) Improves Financial Planning: Predictable annual charges make it easier to plan and manage operating expenses.

Disadvantages of Annuity Method

1) Complex to Calculate: Requires the use of annuity tables or financial calculators, making it difficult for small businesses or manual accounting systems.

2) Interest Assumptions May Be Unrealistic: The assumed interest rate may not reflect actual investment opportunities or economic conditions.

3) Not Widely Accepted in Practice: Less commonly used compared to simpler methods like Straight Line or Written Down Value, especially in small or medium enterprises.

4) May Mislead if Misapplied: If the interest rate or useful life is incorrectly estimated, the annual charges may be inaccurate.

5) Asset Use Not Always Reflected: The method emphasizes financial logic over physical usage, which may not match the actual wear and tear of the asset.



Glossary of Terms

Depreciation: A decrease in the value of fixed assets due to usage, wear and tear, passage of time, or obsolescence.

Wear and Tear: Physical deterioration due to constant use.

Obsolescence: Reduction in value due to becoming outdated or irrelevant due to technological or market changes.

Depletion: Reduction in the value of natural resources (e.g., mines, oil wells).

Amortization: Gradual reduction of intangible assets or loan amounts over time.

Premium: Regular amount paid for the insurance policy.

Maturity Value: Final amount received on the policy's maturity.

Sinking Fund: Reserve created for future replacement of assets.

Sinking Fund Table: A table used to find the annual amount to be invested based on interest and years.

Insurance: A contract that provides compensation for specified losses in return for a premium.

Claim: The amount requested by the insured from the insurance company for a loss.

Indemnity Period: Period during which the business is affected and loss of profit is calculated.

Standing Charges: Fixed costs (like rent, salary) that are recoverable under insurance.

Annuity: A fixed annual amount including both depreciation and interest.

Check Your Progress

- 1) What is depreciation?
- 2) Mention any two causes of depreciation.
- 3) Define useful life of an asset.
- 4) What is scrap or residual value?
- 5) Explain the meaning and objectives of providing depreciation.
- 6) State and explain the main causes of depreciation.
- 7) Write a short note on the importance of charging depreciation in accounting.
- 8) Distinguish between Depreciation, Depletion, and Amortization.
- 9) Explain the Straight Line Method of depreciation with features.
- 10) Explain the Written Down Value Method with advantages and disadvantages.
- 11) What is the Insurance Policy Method? How is it used to provide for depreciation?
- 12) What is a Sinking Fund Method? How does it differ from the Insurance Policy Method?
- 13) Explain the Annuity Method of depreciation with its features.
- 14) Differentiate between Straight Line Method and Written Down Value Method.
- 15) Compare and contrast Sinking Fund Method vs Insurance Policy Method.
- 16) Write the advantages and disadvantages of any two methods of depreciation.
- 17) What is the Average Clause in insurance?
- 18) Define Loss of Stock Policy.
- 19) What is Indemnity Period?
- 20) What are Standing Charges in a Loss of Profit claim?
- 21) Explain how loss of stock is calculated in case of fire.
- 22) What is the role of a Memorandum Trading Account in insurance claim for loss of stock?
- 23) Explain the steps involved in calculating a claim under Loss of Profit policy.

- 24) Describe the meaning and application of the Average Clause with a suitable example.
- 25) Why is depreciation not a source of income, even though it is a non-cash expense?
- 26) How does charging depreciation affect the financial statements?
- 27) What are the practical difficulties in applying Sinking Fund Method in small firms?
- 28) Explain with example how under-insurance affects the claim amount under the average clause.



Unit – V

Single Entry

The Single-Entry System is a simple and incomplete method of accounting, primarily used by small businesses and individuals who do not have the resources or expertise to maintain a full double-entry accounting system. Unlike the double-entry system, which records both debit and credit aspects of every transaction, the single-entry system records only one aspect, usually the cash or personal accounts. This system does not follow a standard format and lacks a comprehensive framework, making it more of a record-keeping method than a formal accounting system.

In the single-entry system, only partial information is available—such as cash receipts, payments, and details of personal accounts (debtors and creditors). It does not maintain real and nominal accounts like machinery, furniture, rent, salary, etc. Therefore, it becomes difficult to prepare a complete trial balance or accurately determine the financial position of the business.

Despite its limitations, the single-entry system is often used by sole proprietors, small traders, and professionals who conduct simple transactions. It is cost-effective, easy to maintain, and requires less bookkeeping knowledge. However, it provides limited information, and errors or fraud may go undetected due to lack of internal checks and balances.

One major drawback of this system is that it does not allow the preparation of a detailed Profit and Loss Account or Balance Sheet without estimation. As a result, it is unsuitable for larger businesses or those requiring formal financial reporting for tax or audit purposes.

the single-entry system is a basic accounting method useful for small businesses with limited transactions. However, as a business grows and its financial dealings become more complex, transitioning to a double-entry system becomes essential for accuracy, transparency, and better financial control.

Features of Single Entry System

1) Incomplete Accounting System: The single-entry system does not record all aspects of transactions. Usually, only cash and personal accounts (debtors and creditors) are maintained, while real and nominal accounts are ignored.

- 2) No Double Entry Principle: This system does not follow the double entry principle. Only one aspect of the transaction is recorded, not both debit and credit sides.
- 3) Lack of Uniformity: There is no standard or uniform method followed in the single-entry system. Each business may maintain records in its own way.
- 4) Maintains Only Select Accounts: Generally, only cash book and personal accounts (like those of customers and suppliers) are maintained. Other essential accounts such as purchases, sales, expenses, and assets are often missing.
- 5) Simple and Economical: It is easy to understand and inexpensive to maintain. Small businesses and sole proprietors often prefer this method due to limited transactions and low costs.
- 6) Unsuitable for Large Businesses: The single entry system is not ideal for large-scale businesses, as it lacks proper control, accuracy, and detailed information required for decision-making.
- 7) Difficult to Detect Errors and Frauds: Since only partial records are kept, there is a high risk of undetected errors or fraud. Internal checks are weak or non-existent.
- 8) Profit or Loss Determined Indirectly: Accurate trading and profit & loss accounts cannot be prepared. Profit is generally calculated by comparing the opening and closing capital (Statement of Affairs method).
- 9) No Trial Balance: Due to incomplete records and absence of double entry, a trial balance cannot be prepared to verify the arithmetical accuracy of books.
- 10) Not Accepted by Tax Authorities: Because of its incompleteness and lack of reliability, this system is generally not accepted by auditors or tax authorities for official reporting.

Advantages of Single Entry System

- 1) Simple and Easy to Use: It requires basic accounting knowledge and is easy to operate, especially suitable for small businesses or sole proprietors.
- 2) Low Cost: Maintaining a single entry system is cost-effective since it does not require professional accountants or advanced software.
- 3) Time-Saving: As it involves recording fewer details, it consumes less time compared to the double-entry system.

4) Flexible in Nature: The system offers flexibility, as businesses can record only what they feel is necessary based on their needs.

5) Helps Track Cash and Personal Accounts: It keeps track of important information like cash transactions and personal accounts (debtors and creditors), which are vital for small businesses.

Disadvantages of Single Entry System

1) Incomplete Records: It does not maintain complete information about all financial transactions, especially real and nominal accounts.

2) No Double Entry Check: Errors or frauds may go undetected due to the absence of a double-check mechanism present in the double-entry system.

3) No Accurate Financial Position: It is difficult to prepare reliable final accounts like the Profit and Loss Account or Balance Sheet, leading to an unclear view of financial performance.

4) No Trial Balance: Without a trial balance, the arithmetical accuracy of accounts cannot be verified.

5) Not Suitable for Large Businesses: The system cannot handle complex and large volumes of transactions and is inappropriate for businesses with varied operations.

6) Not Accepted by Authorities: Tax and regulatory authorities generally do not accept records maintained under this system due to its lack of accuracy and completeness.

Difference between Single Entry System and Double Entry System

The Single Entry System is simple and cost-effective but lacks completeness and accuracy. The Double Entry System, though more complex, is comprehensive, reliable, and essential for larger or legally regulated businesses.

S. No.	Basis	Single Entry System	Double Entry System
01	Meaning	A simple method where only one aspect of each transaction is recorded.	A scientific method where both debit and credit aspects are recorded.

02	Nature	Incomplete and unstructured.	Complete and systematic.
03	Accounts Maintained	Only personal and cash accounts are maintained.	All types of accounts (personal, real, nominal) are maintained.
04	Principle Followed	Does not follow the double entry principle.	Follows the double entry principle – every debit has a corresponding credit.
05	Accuracy	Less accurate; difficult to detect errors.	More accurate; trial balance helps verify correctness.
06	Detection of Errors & Frauds	Difficult due to lack of checks and balances.	Easier to detect and prevent due to complete records.
07	Trial Balance	Cannot be prepared.	Can be prepared to check arithmetic accuracy.
08	Financial Statements	Profit and financial position are estimated.	Profit & Loss Account and Balance Sheet can be prepared accurately.
09	Suitability	Suitable for small businesses and sole proprietors.	Suitable for all types of businesses, especially large ones.
10	Legal Acceptance	Not accepted by tax authorities or auditors.	Legally recognized and accepted.
11	Cost of Maintenance	Less expensive and easy to maintain.	More expensive and requires skilled personnel.

Methods of Single-Entry System

1) Statement of Affaire Method

2) Conversion Method

1) Statement of Affaire Method

The Statement of Affairs Method is a technique used to determine the profit or loss of a business when it maintains incomplete records, typically under the Single Entry System. Since detailed accounts are not maintained, the business cannot prepare a standard Profit and Loss Account. Instead, it estimates profit or loss by comparing the opening and closing capital through a statement called the Statement of Affairs.

Meaning

A Statement of Affairs is similar to a Balance Sheet, but it is prepared from incomplete records. It lists the estimated assets and liabilities of the business to determine the capital (net worth) at a particular date.

Steps to Calculate Profit/Loss Using Statement of Affairs Method

- 1) Prepare Opening Statement of Affairs: Determine the capital at the beginning of the year (Opening Capital) by subtracting liabilities from assets.
- 2) Prepare Closing Statement of Affairs: Determine the capital at the end of the year (Closing Capital).
- 3) Adjust for Drawings and Additional Capital:
Add drawings (if any) to the closing capital.
Deduct additional capital introduced during the year.
- 4) Calculate Profit or Loss:

Objectives of Statement of Affairs Method

1. To Determine Profit or Loss

The main objective is to calculate the net profit or loss of the business for a specific accounting period by comparing the opening and closing capital after adjusting for drawings and additional capital.

2. To Estimate the Financial Position

It helps to estimate the financial position of the business by preparing a Statement of Affairs, which shows the approximate value of assets and liabilities.

3. To Ascertain Opening and Closing Capital

The method aims to find out the opening capital (at the beginning of the period) and closing capital (at the end), which are essential for profit or loss calculation.

4. To Provide a Simple Reporting Tool for Small Businesses

This method serves as a basic and cost-effective reporting system for small traders or sole proprietors who cannot maintain full double-entry records.

5. To Enable Continuation of Business Records

It provides a practical way to maintain financial data and continue basic accounting activities even with limited information and resources.

6. To Support Decision-Making at a Basic Level

Although not precise, the method gives a general idea of the business's performance, helping the owner make simple business decisions.

7. To Serve as a Basis for Transition to Double Entry System

It can be used as a starting point for converting to a formal double entry system later, by giving approximate values of capital and other figures.

Features of Statement of Affairs Method

The Statement of Affairs Method is commonly used under the Single Entry System to estimate profit or loss when complete records are not maintained. Below are its key features:

1. Based on Incomplete Records

This method is used when businesses do not maintain full double-entry accounts. It relies on partial or estimated data available from existing records.

2. Uses Statement of Affairs

A Statement of Affairs, which resembles a balance sheet, is prepared at the beginning and end of the accounting period to determine the capital.

3. Capital Comparison Approach

Profit or loss is calculated by comparing the opening capital and closing capital (adjusted for drawings and additional capital introduced).

4. Non-standardized Format

There is no fixed format for preparing the Statement of Affairs. It is flexible and based on available information.

5. Estimates Used for Values

Many asset and liability values are estimated, not based on actual ledgers, which reduces the accuracy of the final results.

6. No Proper Books of Accounts

Businesses using this method do not maintain real, nominal, or detailed ledger accounts, so proper accounting records are absent.

7. Cannot Prepare Trial Balance

Due to incomplete data and lack of double entry, a trial balance cannot be prepared to check arithmetic accuracy.

8. Simple and Cost-effective

This method is easy to use and does not require advanced accounting knowledge or professional accountants—ideal for small traders.

9. Not Accepted by Authorities

Since it lacks reliability and completeness, this method is not accepted by auditors, tax authorities, or financial institutions.

10. Suitable for Small Businesses

Best suited for small-scale enterprises or sole proprietors who handle limited transactions and do not require formal financial reporting.

Advantages of Statement of Affairs Method

1) Simple and Easy to Use: The method is straightforward and does not require technical accounting knowledge, making it suitable for small business owners.

2) Cost-Effective: Since it does not require the maintenance of complete books or hiring professional accountants, it saves time and money.

3) Useful for Small Businesses: Best suited for sole proprietors or small traders with limited transactions who don't need detailed financial reports.

4) Requires Minimal Records: Can be prepared even with basic data such as cash records, personal accounts, and estimates of assets and liabilities.

5) Time-Saving: The process of preparing the Statement of Affairs and calculating profit is quicker compared to full-fledged accounting systems.

Disadvantages of Statement of Affairs Method

1) Lacks Accuracy and Reliability: As it is based on incomplete records and estimated figures, the results may not be accurate or dependable.

2) No Double Entry System: Absence of double entry makes it difficult to detect errors and prevents internal checks.

3) Not Accepted by Auditors or Tax Authorities: This method does not meet statutory or regulatory standards, making it unsuitable for audit or official reporting.

4) Difficult to Detect Frauds and Misstatements: Limited data and lack of cross-verification increase the risk of undetected fraud or manipulation.

5) Cannot Provide Detailed Financial Information: Since it focuses only on capital comparison, it does not show detailed performance, expenses, or profitability analysis.

6) No Trial Balance or Final Accounts: It is not possible to prepare a trial balance, proper Profit & Loss Account, or Balance Sheet under this method.

2) Conversion Method

The Conversion Method is used to convert the incomplete records maintained under the Single Entry System into a complete Double Entry System. This method helps in preparing accurate financial statements such as the Trading Account, Profit & Loss Account, and Balance Sheet by reconstructing missing accounts based on available information.

Meaning:

When a business initially maintains incomplete records (e.g., only cash book and personal accounts), and later decides to prepare full financial statements, the available data must be converted into double entry form. This process is known as the Conversion Method.

Objectives of the Conversion Method

- a) To transform single entry data into complete double entry.
- b) To prepare a Trial Balance and identify errors.
- c) To prepare accurate final accounts (Profit & Loss Account and Balance Sheet).
- d) To determine true profit or loss of the business.

Features of Conversion Method

The Conversion Method is used to convert incomplete records (Single Entry System) into a complete Double Entry System for accurate financial reporting. Here are the key features of this method

1. Converts Incomplete to Complete Records

It transforms the data from the single entry system (incomplete and unstructured) into a complete double entry format, enabling proper accounting.

2. Facilitates Accurate Final Accounts

By reconstructing necessary ledger accounts, this method allows the preparation of accurate Trading Account, Profit & Loss Account, and Balance Sheet.

3. Involves Reconstruction of Missing Accounts

Accounts like Total Debtors Account, Total Creditors Account, Bills Receivable/Payable, Cash Book, etc., are prepared using available and estimated data.

4. Helps in Determining True Profit or Loss

Unlike the Statement of Affairs method, the Conversion Method helps in finding the actual net profit or loss through standard accounting procedures.

5. Useful for Transition to Double Entry System

This method is often used when a business wants to switch from single entry to double entry, ensuring better control and accuracy.

6. Requires Opening and Closing Balances

Opening and closing capital, assets, and liabilities are essential to start the conversion process and complete financial statements.

7. Enables Preparation of Trial Balance

Once accounts are reconstructed, a Trial Balance can be prepared to check the arithmetical accuracy of the books.

8. Suitable for Growing Businesses

It is ideal for businesses that have outgrown single entry and need a more reliable and formal accounting system.

9. Requires Accounting Knowledge

Since it involves detailed account preparation and adjustments, it requires basic to moderate accounting skills.

10. Enhances Financial Control and Transparency

With complete records, businesses can achieve better financial control, detect errors or frauds, and present transparent financial data to stakeholders.

Steps in the Conversion Method

- 1) Ascertain Opening Capital:** Prepare an Opening Statement of Affairs to find the opening capital.
- 2) Reconstruct Ledger Accounts:** Prepare missing accounts such as Total Debtors Account, Total Creditors Account, Bills Receivable/Payable Account, and Cash/Bank Account using available information.
- 3) Determine Closing Capital:** Prepare a Closing Statement of Affairs or complete Balance Sheet after reconstruction.
- 4) Prepare Trial Balance:** Extract balances from reconstructed accounts and check the arithmetical accuracy.
- 5) Prepare Final Accounts:** Use adjusted figures to prepare the Trading Account, Profit & Loss Account, and Balance Sheet.

Advantages of Conversion Method

- 1) Accurate Determination of Profit or Loss:** It allows the preparation of a proper Profit & Loss Account, helping in the accurate calculation of net profit or loss.
- 2) Enables Complete Financial Statements:** Facilitates the preparation of full financial statements like Trading Account, Profit & Loss Account, and Balance Sheet.

- 3) Improves Reliability of Records:** Converted accounts follow the double entry system, making the records more reliable, verifiable, and acceptable to auditors and tax authorities.
- 4) Facilitates Internal Control:** The double entry format helps in detecting errors and frauds, improving the control and accuracy of the accounts.
- 5) Supports Better Decision-Making:** Complete financial data supports more informed and effective business decisions by management.
- 6) Useful for Legal and Tax Compliance:** Helps the business meet legal requirements and file accurate returns for income tax, GST, etc.
- 7) Acts as a Step Toward Financial Discipline:** Encourages businesses to adopt systematic accounting practices as they grow.

Disadvantages of Conversion Method

- 1) Requires Accounting Expertise:** Conversion involves reconstructing multiple accounts and adjustments, which may be difficult without proper knowledge.
- 2) Time-Consuming Process:** The process of converting single entry to double entry can be lengthy and complex, especially if records are disorganized.
- 3) Depends on Availability of Data:** If the original records are too incomplete, conversion may result in assumptions or estimates, reducing accuracy.
- 4) May Involve Additional Costs:** Businesses might need to hire accountants or purchase software, increasing administrative expenses.
- 5) Not Feasible for Very Poor Records:** If records are extremely limited or unreliable, accurate conversion may not be possible.
- 6) Challenging for Small Business Owners:** Small traders with limited education or resources may find this method too complex or unnecessary for their needs.

Glossary of Terms

Single Entry System: An incomplete system of accounting where only one aspect of the transaction (usually personal accounts and cash book) is recorded. It does not follow the double-entry principles.

Double Entry System: A scientific accounting method where every transaction affects at least two accounts—one debit and one credit—with equal amounts.

Personal Accounts: Accounts related to individuals, firms, or institutions (e.g., debtors, creditors).

Real Accounts: Accounts related to assets and properties (e.g., cash, building)—mostly missing in single entry.

Nominal Accounts: Accounts related to expenses, losses, incomes, and gains—not usually maintained in single entry.

Incomplete Records: A term used to describe single entry because not all transactions are recorded systematically.

Statement of Affairs: A statement similar to a balance sheet prepared using estimated and available figures to find the capital.

Opening Capital: Capital at the beginning of the period, found from the opening Statement of Affairs.

Closing Capital: Capital at the end of the year, calculated from the closing Statement of Affairs.

Drawings: Amount withdrawn by the proprietor for personal use.

Additional Capital: Any new capital introduced during the year.

Conversion Method: A method where incomplete records are converted into a complete set of double-entry books to prepare a proper Trading, Profit & Loss Account and Balance Sheet.

Trading Account: Shows gross profit by comparing sales and cost of goods sold.

Profit & Loss Account: Calculates net profit by adjusting indirect expenses and incomes.

Balance Sheet: Statement showing financial position at the end of the period.

Adjustment Entries: Entries made to bring missing information (e.g., depreciation, outstanding expenses, prepaid items) into the records.

Check Your Progress

- 1) What is meant by a single entry system?
- 2) Mention two features of the single entry system.
- 3) Write any two defects of the single entry system.
- 4) Who usually follows the single entry system?
- 5) Explain the features of the single entry system.
- 6) What are the limitations/defects of the single entry system?
- 7) State the difference between single entry and double entry system (any five points).
- 8) Why is the single entry system called an incomplete or defective system?
- 9) What is a Statement of Affairs?
- 10) How is profit or loss calculated under the Statement of Affairs method?
- 11) What are the steps involved in calculating profit under the Statement of Affairs Method?
- 12) Write a short note on opening and closing capital.
- 13) Distinguish between Statement of Affairs and Balance Sheet.
- 14) What is meant by the conversion method in single entry?
- 15) Name any two accounts prepared under the conversion method.
- 16) Explain the need for converting single entry into double entry system.
- 17) What are the steps involved in converting single entry records into double entry?
- 18) Write a note on the preparation of Trading, Profit & Loss Account and Balance Sheet from single entry.
- 19) Why is the single entry system not suitable for large organizations?
- 20) Can financial statements prepared from single entry be reliable? Why or why not?
- 21) Compare the effectiveness of the Statement of Affairs method and Conversion method for profit determination.

22) Discuss the practical difficulties involved in maintaining books under single entry.

