

CHRISTIAN EMINENT COLLEGE, INDORE

(Academy of Management, Professional Education and
Research)

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E-Content

On

“Financial Accounting”

Prepared By: Dr. Indira Dixit

Department of Commerce & Management

UNIT-I

Meaning and scope of accounting, nature of financial accounting principles, basis of accounting; accounting process – from recording of business transaction to preparation of trial balance

Q1: Define accounting.

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

In 1966, the American Accounting Association (AAA) defined accounting as ‘the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of information’.

Q2: Enumerate main objectives of accounting. Ans: Objectives of Accounting

1. Maintenance of Records of Business Transactions
2. Calculation of Profit and Loss
3. Depiction of Financial Position
4. Providing Accounting Information to its Users

Q3: Define trial balance

Ans: A trial balance is a statement showing the balances, or total of debits and credits, of all the accounts in the ledger with a view to verify the arithmetical accuracy of posting into the ledger accounts. Trial balance is an important statement in the accounting process. Which shows final position of all accounts and helps in preparing the final statements? The task of preparing the statements is simplified because the accountant can take the account balances from the trial balance instead of looking them up in the ledger. It is normally prepared at the end of an accounting year. However, an organization may prepare a trial balance at the end of any chosen period, which may be monthly, quarterly, half yearly or annually depending upon its requirements.

Long types Questions:

Q6: Define accounting and state its objectives. Describe the role of accounting in the modern world.

Ans: **Meaning of Accounting** In 1941, The American Institute of Certified Public Accountants (AICPA) had defined accounting as the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of financial character, and interpreting the results thereof.

With greater economic development resulting in changing role of accounting, its scope, became broader. In 1966, the American Accounting Association (AAA) defined accounting as ‘the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of information’.

In 1970, the Accounting Principles Board of AICPA also emphasized that the function of accounting is to provide quantitative information, primarily financial in nature, about economic entities, that is intended to be useful in making economic decisions.

Accounting can therefore be defined as the process of identifying, measuring, recording and communicating the required information relating to the economic events of an organization to the interested users of such information. In order to appreciate the exact nature of accounting, we must understand the following relevant aspects of the definition:

- a. Economic Events
- b. Identification, Measurement, Recording and Communication
- c. Organization

d. Interested Users of Information

1. **Economic Event:** A business organization involves economic events. An economic event is known as a happening of consequence to a business organization which consists of transactions and which are measurable in monetary terms. For example, purchase of machinery, installing and keeping it ready for manufacturing is an event which comprises number of financial transactions such as buying a machine, transportation of machine, site preparation for installation of a machine, expenditure incurred on its installation and trial runs. Thus, accounting identifies bunch of transactions relating to an economic event. If an event involves transactions between an outsider and an organization, these are known as *external events*. The following are the examples of such transactions:

- a. Sale of Reebok shoes to the customers.
- b. Rendering services to the customers by Videocon Limited.
- c. Purchase of materials from suppliers.
- d. Payment of monthly rent to the landlord.

An internal event is an economic event that occurs entirely between the internal wings of an enterprise, e.g., supply of raw material or components by the stores department to the manufacturing department, payment of wages to the employees, etc.

2. **Identification, Measurement, Recording and Communication: Identification:** It means determining what transactions to record, i.e., to identify events which are to be recorded. It involves observing activities and selecting those events that are of considered financial character and relate to the organization. The business transactions and other economic events therefore are evaluated for deciding whether it has to be recorded in books of account. For example, the value of human resources, changes in managerial policies or appointment of personnel are important but none of these are recorded in books of account.
3. **Measurement:** It means quantification (including estimates) of business transactions into financial terms by using monetary unit, viz. rupees and paisa as a measuring unit. If an event cannot be quantified in monetary terms, it is not considered for recording in financial accounts. That is why important items like the appointment of a new managing director, signing of contracts or changes in personnel are not shown in the books of accounts.
4. **Recording:** Once the economic events are identified and measured in financial terms, these are recorded in books of account in monetary terms and in a chronological order. Recording is done in a manner that the necessary financial information is summarized as per well-established practice and is made available as and when required.
5. **Communication:** The economic events are identified, measured and recorded in order that the pertinent information is generated and communicated in a certain form to management and other internal and external users. The information is regularly communicated through accounting reports. These reports provide information that are useful to a variety of users who have an interest in assessing the financial performance and the position of an enterprise, planning and controlling business activities and making necessary decisions from time to time. The accounting information system should be designed in such a way that the right information is communicated to the right person at the right time. Reports can be daily, weekly, monthly, or quarterly, depending upon the needs of the users. An important element in the communication process is the accountant's ability and efficiency in presenting the relevant information.
6. **Organization:** Organization refers to a business enterprise, whether for profit or not-for profit motive. Depending upon the size of activities and level of business operation, it can be a sole-proprietor concern, partnership firm, cooperative society, company, and local authority, Municipal Corporation or any other association of persons.
7. **Interested Users of Information:** Accounting is a means by which necessary financial information about business enterprise is communicated and is also called the language of business. Many users need financial information in order to make important decisions. These users can be divided into two broad categories: *internal users and external users*. Internal users include: Chief Executive, Financial Officer, Vice President, Business Unit Managers, Plant Managers, Store Managers, Line Supervisors, etc. External users include: present and potential Investors (shareholders), Creditors (Banks and other Financial Institutions, Debenture holders and other Lenders), Tax Authorities, Regulatory Agencies (Department of Company Affairs, Registrar of Companies, Securities Exchange Board of India, Labour Unions, Trade Associations, Stock Exchange and Customers, etc. Since the primary function of accounting is to provide useful information for decision-making, it is a means to an end, with the end being the decision that is helped by the availability of accounting information.

Objectives of Accounting

As an information system, the basic objective of accounting is to provide useful information to the interested group of users, both external and internal. The necessary information, particularly in case of

external users, is provided in the form of financial statements, viz., profit and loss account and balance sheet. Besides these, the management is provided with additional information from time to time from the accounting records of business. Thus, the primary objectives of accounting include the following:

- **Maintenance of Records of Business Transactions:** Accounting is used for the maintenance of a systematic record of all financial transactions in book of accounts. Even the most brilliant executive or manager cannot accurately remember the numerous amount of varied transactions such as purchases, sales, receipts, payments, etc. that takes place in business every day. Hence, proper and complete records of all business transactions are kept regularly. Moreover, the recorded information enables verifiability and acts as evidence.
- **Calculation of Profit and Loss:** The owners of business are keen to have an idea about the net results of their business operations periodically, i.e. whether the business has earned profits or incurred losses. Thus, another objective of accounting is to ascertain the profit earned or loss sustained by a business during an accounting period which can be easily worked out with help of record of incomes and expenses relating to the business by preparing a profit or loss account for the period. Profit represents excess of revenue (income), over expenses. If the total revenue of a given period is Rs 6,00,000 and total expenses are Rs. 5,40,000 the profit will be equal to Rs. 60,000 (Rs. 6,00,000 – Rs. 5,40,000). If however, the total expenses exceed the total revenue, the difference reflects the loss.
- **Depiction of Financial Position:** Accounting also aims at ascertaining the financial position of the business concern in the form of its assets and liabilities at the end of every accounting period. A proper record of resources owned by business organization (Assets) and claims against such resources (Liabilities) facilitates the preparation of a statement known as balance sheet position statement.
- **Providing Accounting Information to its Users:** The accounting information generated by the accounting process is communicated in the form of reports, statements, graphs and charts to the users who need it in different decision situations. As already stated, there are two main user groups, viz. *internal users*, mainly management, who needs timely information on cost of sales, profitability, etc. for planning, controlling and decision-making and *external users* who have limited authority, ability and resources to obtain the necessary information and have to rely on financial statements (Balance Sheet, Profit and Loss account)

Role of Accounting

- For centuries, the role of accounting has been changing with the changes in economic development and increasing societal demands. It describes and analyses a mass of data of an enterprise through measurement, classification and summarization, and reduces those data into reports and statements, which show the financial condition and results of operations of that enterprise.
- Hence, it is regarded as a language of business. It also performs the service activity by providing quantitative financial information that helps the users in various ways. Accounting as an information system collects and communicates economic information about an enterprise to a wide variety of interested parties.
- However, accounting information relates to the past transactions and is quantitative and financial in nature, it does not provide qualitative and nonfinancial information. These limitations of accounting must be kept in view while making use of the accounting information.

Q7: 'The accounting concepts and accounting standards are generally referred to as the essence of financial accounting'. Comment?

Ans: Generally Accepted Accounting Principles (GAAP): Generally Accepted Accounting principles refer to the rules or guidelines adopted for recording and reporting of business transactions in order to bring uniformity in the preparation and presentation of financial statements. These principles are also referred to as concepts and conventions. From the practicality view point, the various terms such as principles, postulates, conventions modifying principles, assumptions, etc. have been used interchangeably and are referred to as basic accounting concepts, in the present book.

Basic Accounting Concepts: The basic accounting concepts are referred to as the fundamental ideas or basic assumptions underlying the theory and practice of financial accounting and are broad working rules of accounting activities.

- **Business Entity:** This concept assumes that business has distinct and separate entity from its owners. Thus, for the purpose of accounting, business and its owners are to be treated as two separate entities. Every business requires to be accounted for separately by the proprietor. Personal and business-related dealings should not be mixed.
- **Money Measurement:** The concept of money measurement states that only those transactions and happenings in an organization, which can be expressed in terms of money are to be recorded in the book of accounts. Also, the records of the transactions are to be kept not in the physical units but in the monetary units.
- **Going Concern:** The concept of going concern assumes that a business firm would continue to carry out its operations indefinitely (for a fairly long period of time) and would not be liquidated in the near future. The business will continue operating and will not close but will realize assets and discharge liabilities in the normal course of operations Principles derived from tradition, such as the concept of matching. In any report of financial statements (audit, compilation, review, etc.), the preparer/auditor must indicate to the reader whether or not the information contained within the statements complies with GAAP.
- **Accounting Period :** Accounting period refers to the span of time at the end of which the financial statements of an enterprise are prepared to know whether it has earned profits or incurred losses during that period and what exactly is the position of its assets and liabilities, at the end of that period.
- **Cost Concept:** The cost concept requires that all assets are recorded in the book of accounts at their cost price, which includes cost of acquisition, transportation, installation and making the asset ready for the use. To illustrate, on June 2005, an old plant was purchased for Rs. 50 lakh by Shiva Enterprise, which is into the business of manufacturing detergent powder. An amount of Rs. 10,000 was spent on transporting the plant to the factory site. In addition, Rs. 15,000 was spent on repairs for bringing the plant into running position and Rs. 25,000 on its installation. The total amount at which the plant will be recorded in the books of account would be the sum of all these, i.e. Rs. 50,50,000.
- **Dual Aspect:** This concept states that every transaction has a dual or two fold effect on various accounts and should therefore be recorded at two places. The duality principle is commonly expressed in terms of fundamental accounting equation, which is : **Assets = Liabilities + Capital**
- **Revenue Recognition:** Revenue is the gross in-flow of cash arising from the sale of goods and services by an enterprise and use by others of the enterprise resources yielding interest royalties and dividedness. The concept of revenue recognition requires that the revenue for a business transaction should be considered realized when a legal right to receive it arises.
- **Matching:** The concept of matching emphasizes that expenses incurred in an accounting period should be matched with revenues during that period. It follows from this that the revenue and expenses incurred to earn these revenue must belong to the same accounting period.
- **Full Disclosure:** This concept requires that all material and relevant facts concerning financial performance of an enterprise must be fully and completely disclosed in the financial statements and their accompanying footnotes.
- **Consistency:** these concepts state that accounting policies and practices followed by enterprises should be uniform and consistent one the period of time so that results are compostable. Comparability results when the same accounting principles are consistently being applied by different enterprises for the period under comparison, or the same firm for a number of periods.
- **Conservatism:** This concept requires that business transactions should be recorded in such a manner that profits are not overstated. All anticipated losses should be accounted for but all unrealized gains should be ignored.
- **Materiality:** This concept states that accounting should focus on material facts. If the item is likely to influence the decision of a reasonably prudent investor or creditor, it should be regarded as material, and shown in the financial statements
- **Objectivity:** According to this concept, accounting transactions should be recorded in the manner so that it is free from the bias of accountants and others.

UNIT-II

Depreciation accounting; preparation of final accounts (non-corporate entities) along with major adjustments

Short type questions

Q1: Define depreciation.

Ans: Depreciation may be described as a permanent, continuing and gradual shrinkage in the book value of fixed assets. It is based on the cost of assets consumed in a business and not on its market value.

Accounting Standard-6 issued by The Institute of Chartered Accountants of India (ICAI) defines depreciation as “a measure of the wearing out, consumption or other loss of value of depreciable asset arising from use, effluxion of time or obsolescence through technology and market-change.

Depreciation is allocated so as to charge fair proportion of depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortization of assets whose useful life is pre-determined”.

Q2: Define Financial Statements.

Ans: The basic objectives of preparing financial statements are:

- To present a true and fair view of the financial performance of the business
- To present a true and fair view of the financial position of the business; and

For this purpose, the firm usually prepares the following financial statements:

1. Trading and Profit and Loss Account
2. Balance Sheet

Trading and Profit and Loss account, also known as Income statement, shows the financial performance in the form of profit earned or loss sustained by the business. Balance Sheet shows financial position in the form of assets, liabilities and capital. These are prepared on the basis of trial balance and additional information, if any.

Q3: Define Straight Line Method?

Ans: It is also called fixed installment method because the amount of depreciation remains constant from year to year over the useful life of the asset. According to this method, a fixed and an equal amount is charged as depreciation in every accounting period during the lifetime of an asset. The amount annually charged as depreciation is such that it reduces the original cost of the asset to its scrap value, at the end of its useful life. This method is also known as fixed percentage on original cost method because same percentage of the original cost (infact depreciable cost) is written off as depreciation from year to year.

The depreciation amount to be provided under this method is computed by using the following formula:

$$\text{Depreciation} = \frac{\text{Cost of asset} - \text{Estimated net residual value}}{\text{Estimated useful life of the asset}}$$

Q4: Define written down method?

Ans: Under this method, depreciation is charged on the book value of the asset. Since book value keeps on reducing by the annual charge of depreciation, it is also known as reducing balance method. This method involves the application of a pre-determined proportion/percentage of the book value of the asset at the beginning of every accounting period, so as to calculate the amount of depreciation. The amount of depreciation reduces year after year. For example, the original cost of the asset is Rs. 2,00,000 and depreciation is charged @ 10% p.a. at written down value, then the amount of depreciation will be computed as follows:

- (i) Depreciation (1 year) = Rs. 20,00,000 * 10/100 = Rs. 20,000

Q5: Difference between Straight line method vs written down method.

Ans:

Basis of Difference	Straight Line Method	Written Down Value Method
1. Basis of charging depreciation	Original cost	Book Value (i.e. original cost less depreciation charged till date)
2. Annual depreciation charge	Fixed (Constant) year	Declines year after year
3. Total charge against profit and loss account in respect of depreciation and repairs	Almost equal every year.	Unequal year after year. It increases in later years.
4. Recognition by income tax law	Not recognized	Recognized

Q6: Elaborate Sinking fund

Ans: A sinking fund is a fund established by a government agency or business for the purpose of reducing debt by repaying or purchasing outstanding loans and securities

Long Types Questions

Q1: Explain the concept of depreciation. What is the need for charging depreciation and what are the causes of depreciation?

Or

Discuss in detail the straight line method and written down value method of depreciation. Distinguish between the two and also give situations where they are useful.

Ans: Depreciation may be described as a permanent, continuing and gradual shrinkage in the book value of fixed assets. It is based on the cost of assets consumed in a business and not on its market value.

According to Institute of Cost and Management Accounting, London (ICMA) terminology “ The depreciation is the diminution in intrinsic value of the asset due to use and/or lapse of time.”

Accounting Standard-6 issued by The Institute of Chartered Accountants of India (ICAI) defines depreciation as “a measure of the wearing out, consumption or other loss of value of depreciable asset arising from use, effluxion of time or obsolescence through technology and market-change.

Depreciation is allocated so as to charge fair proportion of depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortization of assets whose useful life is pre-determined”.

Need for Depreciation

The need for providing depreciation in accounting records arises from conceptual, legal, and practical business consideration. These considerations provide depreciation a particular significance as a business expense.

1. **Matching of Costs and Revenue:** The rationale of the acquisition of fixed assets in business operations is that these are used in the earning of revenue. Every asset is bound to undergo some wear and tear, and hence lose value, once it is put to use in business. Therefore, depreciation is as much the cost as any other expense incurred in the normal course of business like salary, carriage, postage and stationary, etc. It is a charge against the revenue of the corresponding period and must be deducted before arriving at net profit according to ‘Generally Accepted Accounting Principles’.
2. **Consideration of Tax:** Depreciation is a deductible cost for tax purposes. However, tax rules for the calculation of depreciation amount need not necessarily be similar to current business practices,
3. **True and Fair Financial Position:** If depreciation on assets is not provided for, then the assets will be overvalued and the balance sheet will not depict the correct financial position of the business. Also, this is not permitted either by established accounting practices or by specific provisions of law.
4. **Compliance with Law:** Apart from tax regulations, there are certain specific legislations that indirectly compel some business organizations like corporate enterprises to provide depreciation on fixed assets.

Factors Affecting the Amount of Depreciation

The determination of depreciation depends on three parameters, viz. cost, estimated useful life and probable salvage value.

- **Cost of Asset:** Cost (also known as original cost or historical cost) of an asset includes invoice price and other costs, which are necessary to put the asset in use or working condition. Besides the purchase price, it includes freight and transportation cost, transit insurance, installation cost, registration cost, commissions paid on purchase of asset add items such as software, etc. In case of purchase of a second hand asset it includes initial repair cost to put the asset in workable condition. According to Accounting Standand-6 of ICAI, cost of a fixed asset is “the total cost spent in connection with its acquisition, installation and commissioning as well as for addition or improvement of the depreciable asset”.

For example, a photocopy machine is purchased for Rs. 50,000 and Rs. 5,000 is spent on its transportation and

installation. In this case the original cost of the machine is Rs. 55,000 (i.e. Rs. 50,000 + Rs.5,000) which will be written off as depreciation over the useful life of the machine.

- **Estimated Net Residual Value:** Net Residual value (also known as scrap value or salvage value for accounting purpose) is the estimated net realizable value (or sale value) of the asset at the end of its useful life. The net residual value is calculated after deducting the expenses necessary for the disposal of the asset.

For example, a machine is purchased for Rs. 50,000 and is expected to have a useful life of 10 years. At the end of 10th year it is expected to have a sale value of Rs. 6,000 but expenses related to its disposal are estimated at Rs. 1,000. Then its net residual value shall be Rs. 5,000 (i.e. Rs. 6,000 – Rs. 1,000).

- **Depreciable Cost:** Depreciable cost of an asset is equal to its cost (as calculated in point 7.5.1 above) less net residual value (as calculated in point 7.5.2.) Hence, in the above example, the depreciable cost of machine is Rs. 45,000 (i.e., Rs. 50,000 – Rs. 5,000.) It is the depreciable cost, which is distributed and charged as depreciation expense over the estimated useful life of the asset. In the above example, Rs. 45,000 shall be charged as depreciation over a period of 10 years. It is important to mention here that total amount of depreciation charged over the useful life of the asset must be equal to the depreciable cost. If total amount of depreciation charged is less than the depreciable cost then the capital expenditure is under recovered. It violates the principle of proper matching of revenue and expense.
- **Estimated Useful Life:** Useful life of an asset is the estimated economic or commercial life of the asset. Physical life is not important for this purpose because an asset may still exist physically but may not be capable of commercially viable production. For example, a machine is purchased and it is estimated that it can be used in production process for 5 years. After 5 years the machine may still be in good physical condition but can't be used for production profitably, i.e., if it is still used the cost of production may be very high. Therefore, the useful life of the machine is considered as 5 years irrespective of its physical life. Estimation of useful life of an asset is difficult as it depends upon several factors such as usage level of asset, maintenance of the asset, technological changes, market changes, etc. As per Accounting Standard – 6 useful life of an asset is normally the “period over which it is expected to be used by the enterprise”. Normally, useful life is shorter than the physical life. The useful life of an asset is expressed in number of years but it can also be expressed in other units, e.g., number of units of output (as in case of mines) or number of working hours. Useful life depends upon the following factors:
 - Pre-determined by legal or contractual limits, e.g. in case of leasehold asset, the useful life is the period of lease.
 - The number of shifts for which asset is to be used.
 - Repair and maintenance policy of the business organization.
 - Technological obsolescence.
 - Innovation/improvement in production method.

Or

Q2: Discuss in detail the straight line method and written down value method of depreciation. Distinguish between the two and also give situations where they are useful.

Ans: The depreciation amounts to be charged for during an accounting year depend up on depreciable amount and the method of allocation. For this, two methods are mandated by law and enforced by professional accounting practice in India. These methods are straight line method and written down value method. Besides these two main methods there are other methods such as – annuity method, depreciation fund method, insurance policy method, sum of years digit method, double declining method, etc. which may be used for determining the amount of depreciation. The selection of an appropriate method depends upon the following:

Type of the asset;

- Nature of the use of such asset;
- Circumstances prevailing in the business;

As per Accounting Standard-6, the selected depreciation method should be applied consistently from period to period. Change in depreciation method may be allowed only under specific circumstances.

Straight Line Method: This is the earliest and one of the widely used methods of providing depreciation. This method is based on the assumption of equal usage of the asset over its entire useful life. It is called straight line for a reason that if the amount of depreciation and corresponding time period is plotted on a graph, it will result in a straight line. It is also called fixed installment method because the amount of

depreciation remains constant from year to year over the useful life of the asset. According to this method, a fixed and an equal amount is charged as depreciation in every accounting period during the lifetime of an asset. The amount annually charged as depreciation is such that it reduces the original cost of the asset to its scrap value, at the end of its useful life. This method is also known as fixed percentage on original cost method because same percentage of the original cost (infact depreciable cost) is written off as depreciation from year to year.

The depreciation amount to be provided under this method is computed by using the following formula:

Depreciation	=	$\frac{\text{Cost of asset} - \text{Estimated net residential value}}{\text{Estimated useful life of the asset}}$
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Advantages of Straight Line Method: Straight Line method has certain advantages which are stated below:

- It is very simple, easy to understand and apply. Simplicity makes it a popular method in practice;
- Asset can be depreciated up to the net scrap value or zero value. Therefore, this method makes it possible to distribute full depreciable cost over useful life of the asset;
- Every year, same amount is charged as depreciation in profit and loss account. This makes comparison of profits for different years easy;
- This method is suitable for those assets whose useful life can be estimated accurately and where the use of the asset is consistent from year to year such as leasehold buildings.

Limitations of Straight Line Method

Although straight line method is simple and easy to apply it suffers from certain limitations which are given below.

- This method is based on the faulty assumption of same utility of the asset in different accounting years;
- With the passage of time, work efficiency of the asset decreases and repair and maintenance expense increases. Hence, under this method total amount charged against profit on account of depreciation and repair taken together will not be uniform throughout the life of the asset, rather it will keep on increasing from year to year.

Written Down Value Method: Under this method, depreciation is charged on the book value of the asset. Since book value keeps on reducing by the annual charge of depreciation, it is also known as reducing balance method. This method involves the application of a pre-determined proportion/percentage of the book value of the asset at the beginning of every accounting period, so as to calculate the amount of depreciation. The amount of depreciation reduces year after year. For example, the original cost of the asset is Rs. 2,00,000 and depreciation is charged @ 10% p.a. at written down value, then the amount of depreciation will be computed as follows:

(i) Depreciation (1 year) = Rs. 20,00,000 * 10/100 = Rs. 20,000

Advantages of Written Down Value Method: Written down value method has the following advantages:

- This method is based on a more realistic assumption that the benefits from asset go on diminishing with the passage of time. Hence, it calls for proper allocation of cost because higher depreciation is charged in earlier years when asset's utility is more as compared to later years when it becomes less useful;
- It results into almost equal burden on profit or loss account of depreciation and repair expenses taken together every year; Income Tax Act accept this method for tax purposes;
- As a large portion of cost is written-off in earlier years, loss due to obsolescence gets reduced;
- This method is suitable for fixed assets, which lasts for long and which require increased repair and maintenance expenses with passage of time. It can also be used where obsolescence rate is high.

Limitations of Written Down Value Method

Although this method is based upon a more realistic assumption it suffers from the following limitations.

- As depreciation is calculated at fixed percentage of written down value, depreciable cost of the asset cannot be fully written-off. The value of the asset can never be zero;
- It is difficult to ascertain a suitable rate of depreciation.

Straight line method is suitable for assets in which repair charges are less, the possibility of obsolescence is less and scrap value depends upon the time period involved. Such as freehold land and buildings, patents, trademarks, etc. Written down value method is suitable for assets, which are affected by technological changes and require more repair expenses with passage of time such as plant and machinery, vehicles, etc.

Basis of Difference	Straight Line Method	Written Down Value Method
1. Basis of charging depreciation	Original cost	Book Value (i.e. original cost less depreciation charged till date)

2. Annual depreciation charge	Fixed (Constant) year	Declines year after year
3. Total charge against profit and loss account in respect of depreciation and repairs	Almost equal every year.	Unequal year after year. It increases in later years.
4. Recognition by income tax law	Not recognized	Recognized

Q3: What are financial statements? What information do they provide?

Ans: The basic objectives of preparing financial statements are:

- (a) To present a true and fair view of the financial performance of the business;
- (b) To present a true and fair view of the financial position of the business; and

For this purpose, the firm usually prepares the following financial statements:

1. Trading and Profit and Loss Account
2. Balance Sheet

Trading and Profit and Loss account, also known as Income statement, shows the financial performance in the form of profit earned or loss sustained by the business. Balance Sheet shows financial position in the form of assets, liabilities and capital. These are prepared on the basis of trial balance and additional information, if any.

Trading and Profit and Loss Account: Trading and Profit and Loss account is prepared to determine the profit earned or loss sustained by the business enterprise during the accounting period. It is basically a summary of revenues and expenses of the business and calculates the net figure termed as profit or loss. Profit is revenue *less* expenses. If expenses are more than revenues, the figure is termed as *loss*. Trading and Profit and Loss account summarizes the performance for an accounting period. It is achieved by transferring the balances of revenues and expenses to the trading and profit and loss account from the trial balance. Trading and Profit and Loss account is also an account with *Debit and Credit* sides. It can be observed that debit balances (representing expenses) and losses are transferred to the debit side of the Trading and a Profit and Loss account and credit balance (representing revenues/gains) are transferred to its credit side.

Relevant Items in Trading and Profit and Loss Account

The different items appearing in the trading and profit and loss account are explained hereunder:

Items on the debit side

(i) *Opening stock* : It is the stock of goods in hand at the beginning of the accounting year. This is the stock of goods which has been carried forward from the previous year and remains unchanged during the year and appears in the trial balance. In the trading account it appears on the debit side because it forms the part of cost of goods sold for the current accounting year.

(ii) *Purchases less returns* : Goods, which have been bought for resale appears as purchases on the debit side of the trading account. They include both cash as well as credit purchases. Goods which are returned to suppliers are termed as purchases return. It is shown by way of deduction from purchases and the computed amount is known as *Net purchases*.

(iii) *Wages* : Wages refer to remuneration paid to workers who are directly engaged in factory for loading, unloading and production of goods and are debited to trading account.

(iv) *Carriage inwards/Freight inwards*: These expenses are the items of transport expenses, which are incurred on bringing materials/goods purchased to the place of business. These items are paid in respect of purchases made during the year and are debited to the trading account.

(v) *Fuel/Water/Power/Gas* : These items are used in the production process and hence are part of expenses.

(vi) *Packaging material and Packing charges* : Cost of packaging material used in the product are direct expenses as it refers to small containers which form part of goods sold. However, the packing refers to the big containers that are used for transporting the goods and is regarded as an indirect expense debited to profit and loss account.

(vii) *Salaries* : These include salaries paid to the administration, godown and warehouse staff for the services rendered by them for running the business. If salaries are paid in kind by providing certain facilities (called perks) to the employees such as rent free accommodation, meals, uniform, medical facilities should also be regarded as salaries and debited to the profit and loss account.

(viii) *Rent paid* : These include office and godown rent, municipal rates and taxes, factory rent, rates and taxes. The amount of rent paid is shown on the debit side of the profit and loss account.

(ix) *Interest paid* : Interest paid on loans, bank overdraft, renewal of bills of exchange, etc. is an expense and is debited to profit and loss account.

(x) *Commission paid*: Commission paid or payable on business transactions undertaken through the agents is an item of expense and is debited to profit and loss account.

(xi) *Repairs* : Repairs and small renewals/ replacements relating to plant and machinery, furniture, fixtures, fittings, etc. for keeping them in working condition are included under this head. Such expenditure is debited to profit and loss account.

(xii) *Miscellaneous expenses* : Though expenses are classified and booked under different heads, but certain expenses being of small amount clubbed together and are called miscellaneous expenses. In normal usage these expenses are called *Sundry expenses* or *Trade expenses*.

Items on the credit side

(i) *Sales less returns* : Sales account in trial balance shows gross total sales(cash as well as credit) made during the year. It is shown on the credit side of the trading account. Goods returned by customers are called return inwards and are shown as deduction from total sales and the computed amount is known as net sales.

(ii) *Other incomes* : Besides salaries and other gains and incomes are also recorded in the profit and loss account. Examples of such incomes are rent received, dividend received, interest received, discount received, commission received, etc.

Preparing Balance Sheet

All the account of assets, liabilities and capital are shown in the balance sheet. Accounts of capital and liabilities are shown on the left hand side, known as *Liabilities*. Assets and other debit balances are shown on the right hand side, known as *Assets*. There is no prescribed form of Balance sheet, for a proprietary and partnership firms. However, *Schedule VI Part I of the Companies Act 1956* prescribes the format and the order in which the assets and liabilities of a company should be shown.

Q4: What adjusting entries would you record for the following?

Ans: These are adjusted at the time of preparing financial statements. The purpose of making various adjustments is to ensure that the final accounts reveal the true profit or loss and the true financial position of the business. The items which usually need adjustments are:

1. Closing stock
2. Outstanding/expenses
3. Prepaid/Unexpired expenses
4. Accrued income
5. Income received in advance
6. Depreciation
7. Bad debts
8. Provision for doubtful debts
9. Provision for discount on debtors
10. Manager's commission
11. Interest on capital

- **Closing Stock**

Closing stock represents the cost of unsold goods lying in the stores at the end of the accounting period. The adjustment with regard to the closing stock is done by

- (i) by crediting it to the trading and profit and loss account, and
- (ii) By showing it on the asset side of the balance sheet. The adjustment entry to be recorded in this regard is :

Closing stock A/c	Dr.
To Trading A/c	

The closing stock of the year becomes the opening stock of the next year and is reflected in the trial balance of the next year.

- **Outstanding Expenses**

It is quite common for a business enterprise to have some unpaid expenses in the normal course of business operations at the end of an accounting year. Such items usually are wages, salaries, interest on loan, etc. When expenses of an accounting period remain unpaid at the end of an accounting period, they are termed as *outstanding expenses*. As they relate to the earning of revenue during the current accounting year, it is logical that they should be duly charged against revenue for computation of the correct amount of profit or loss. The entry to bring such expenses into account is:

Concerned expense A/c	Dr.
To Outstanding expense A/c	

The above entry opens a new account called *Outstanding Expenses* which is shown on the liabilities side of the balance sheet. The amount of outstanding expenses is added to the total of expenses under a particular head for the purpose of preparing trading and profit and loss account.

- **Prepaid Expenses**

There are several items of expense which are paid in advance in the normal course of business operations. At the end of the accounting year, it is found that the benefits of such expenses have not yet been fully received; a portion of its benefit would be received in the next accounting year. This portion of expense is carried forward to the next year and is termed as *prepaid expenses*. The necessary adjustment in respect of prepaid expenses is made by recording the following entry:

Prepaid expense A/c	Dr.
To concerned expense A/c	

The effect of the above adjustment entry is that the amount of prepaid part is deducted from the total of the particular expense, and the new account of prepaid expense is shown on the liabilities side of the balance sheet.

- **Accrued Income**

UNIT-III

Rectification of errors; accounts of non-profit organization, joint venture accounts

UNIT-IV

Hire purchase, lease and installment purchase system accounting; consignment accounts

Short Types Questions:

Q1: Define Hire-Purchase:

Ans: Hire purchase is a type of installment credit under which the hire purchaser, called the hirer, agrees to take the goods on hire at a stated rental, which is inclusive of the repayment of principal as well as interest, with an option to purchase. Under this transaction, the hire purchaser acquires the property (goods) immediately on signing the hire purchase agreement but the ownership or title of the same is transferred only when the last installment is paid. The hire purchase system is regulated by the Hire Purchase Act 1972. This Act defines a hire purchase as “an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement and includes an agreement under which:

- 1) The owner delivers possession of goods thereof to a person on condition that such person pays the agreed amount in periodic installments.
- 2) The property in the goods is to pass to such person on the payment of the last of such installments’, and
- 3) Such person has a right to terminate the agreement at any time before the property so passes”.

Q2: DIFFERENCE BETWEEN LEASE FINANCING AND HIRE PURCHASE

Ans:

BASIS	LEASE FINANCING	HIRE PURCHASE
Meaning	A lease transaction is a commercial arrangement, whereby an equipment owner or manufacturer conveys to the equipment user the right to use the equipment in return for a rental.	Hire purchase is a type of installment credit under which the hire purchaser agrees to take the goods on hire at a stated rental, which is inclusive of the repayment of principal as well as interest, with an option to purchase.
Option to user	No option is provided to the lessee (user) to purchase the goods.	Option is provided to the hirer (user).
Nature of expenditure	Lease rentals paid by the lessee are entirely revenue expenditure of the lessee.	Only interest element included in the HP installments’ is revenue expenditure by nature.
Components	Lease rentals comprise of 2 elements (1) finance charge and (2) capital recovery.	HP installments’ comprise of 3 elements (1) normal trading profit (2) finance charge and (3) recovery of cost of goods/assets.

Q3: Define Lease Financing:

Ans: A lease transaction is a commercial arrangement whereby an equipment owner or Manufacturer conveys to the equipment user the right to use the equipment in return for a rental. In other words, lease is a contract between the owner of an asset (the lessor) and its user (the lessee) for the right to use the asset during a specified period in return for a mutually agreed periodic payment (the lease rentals). The important feature of a lease contract is separation of the ownership of the asset from its usage.

Q4: What are the types of lease Agreements?

Ans: Lease agreements are basically of two types. They are

(a) Financial lease and

(b) Operating lease.

The other variations in lease agreements are

(c) Sale and lease back

(d) Leveraged leasing and

(e) Direct leasing.

Q5: Define Direct Leasing?

Ans: Under direct leasing, a firm acquires the right to use an asset from the manufacturer directly. The ownership of the asset leased out remains with the manufacturer itself. The major types of direct lessor include manufacturers, finance companies, independent lease companies, special purpose leasing companies etc

Q6: Define Consignment

Ans: Consignment is a means of facilitating sale but is not actually a sale. Consignment is different from sales. A consignment is returnable if goods are not sold but in case of sale, the goods are not returnable except for special reasons, such as on account of damage or if below standard goods are supplied. When goods are sold to a person the property in them passes to that person, but when goods are consigned to a person the legal ownership of the goods remains with the consignor. Hence when goods are sold the relationship between two parties is that of a creditor and debtor but when the goods are consigned relationship between the consignor and consignee is that of 'principal' and 'an agent'.

Q7: Who is Consignee?

Ans: Consignee is a person to whom goods are sent and who sells the goods. He is entitled to get reimbursement of all the expenses incurred by him. He receives commission for his services.

Q8: Del-Credere Commission

Ans: Ordinarily the consignee is not responsible to the consignor for the payment of money by the purchasers but sometime he undertakes to guarantee payment due for all the goods he sells on credit and cash whether his customers pay him or not. In consideration of his warranting the solvency of the buyers, he is paid an extra commission called a Del Credere Commission. The consignee will pay the consignor whether he himself receives payment from debtors or not. The commission is payable on total proceeds.

Long Types Questions:

Q1: Define 'Consignment'. What is the difference between a consignment and a sale of goods?

Ans: Consignment is a means of facilitating sale but is not actually a sale. Consignment is different from sales. A consignment is returnable if goods are not sold but in case of sale, the goods are not returnable except for special reasons, such as on account of damage or if below standard goods are supplied. When goods are sold to a person the property in them passes to that person, but when goods are consigned to a person the legal ownership of the goods remains with the consignor. Hence when goods are sold the relationship between two parties is that of a creditor and debtor but when the goods are consigned relationship between the consignor and consignee is that of 'principal' and 'an agent'.

ACCOUNTING TREATMENT OF CONSIGNMENT TRANSACTIONS

(A) Books of the Consignor: The consignor opens three accounts in his ledger.

(1) Consignment Account: It is prepared to ascertain profit or loss on each consignment e.g. Consignment to Bombay Accounts. It is not a personal account but a special Trading and Profit and Loss account or a nominal account.

(2) Consignee's Account: It is prepared to show the balance due to or from consignee at a particular date. It is a personal account; and

(3) Goods sent on Consignment Account: It is prepared to show the amount of goods sent to the consignee. This is real account. The balance is credited to Purchase or Trading Account.

The following points summarize clearly, the difference between a consignment and a sale.

Basis	Consignment	Sale
Property in goods i.e. Ownership	Ownership remains with the consignor	Ownership passed to the buyer
Relation	Consignee is the agent of the	Buyer is debtor of seller until the

	consignor	account is settled.
Risk and damage	Consignee holds the goods at the risk of the consignor therefore subsequent damage to the goods is the loss of the consignor	Any subsequent damage to the goods is the loss of the buyer
Return of goods	Goods may be returned if not sold	Goods are not returnable except for special reasons e.g. wrong kind or defective goods etc.
Expenses after delivery	Recoverable from the consignor	To be borne by the buyer
Forwarding letter	Proforma invoice	Invoice

Q2: Explain the term Leasing. State the various types of lease agreements. What are the advantages of Leasing?

Ans: A lease transaction is a commercial arrangement whereby an equipment owner or Manufacturer conveys to the equipment user the right to use the equipment in return for a rental. In other words, lease is a contract between the owner of an asset (the lessor) and its user (the lessee) for the right to use the asset during a specified period in return for a mutually agreed periodic payment (the lease rentals). The important feature of a lease contract is separation of the ownership of the asset from its usage.

TYPES OF LEASE AGREEMENTS

Lease agreements are basically of two types.

They are

- (a) Financial lease and
- (b) Operating lease.

The other variations in lease agreements are

- (c) Sale and lease back
- (d) Leveraged leasing and
- (e) Direct leasing.

1. FINANCIAL LEASE: Long-term, non-cancellable lease contracts are known as financial leases. The essential point of financial lease agreement is that it contains a condition whereby the lessor agrees to transfer the title for the asset at the end of the lease period at a nominal cost. At lease it must give an option to the lessee to purchase the asset he has used at the expiry of the lease. Under this lease the lessor recovers 90% of the fair value of the asset as lease rentals and the lease period is 75% of the economic life of the asset. The lease agreement is irrevocable. Practically all the risks incidental to the asset ownership and all the benefits arising there from are transferred to the lessee who bears the cost of maintenance, insurance and repairs. Only title deeds remain with the lessor. Financial lease is also known as 'capital lease'. In India, financial leases are very popular with high-cost and high technology equipment.

2. OPERATING LEASE: An operating lease stands in contrast to the financial lease in almost all aspects. This lease agreement gives to the lessee only a limited right to use the asset. The lessor is responsible for the upkeep and maintenance of the asset. The lessee is not given any uplift to purchase the asset at the end of the lease period. Normally the lease is for a short period and even otherwise is revocable at a short notice. Mines, Computers hardware, trucks and automobiles are found suitable for operating lease because the rate of obsolescence is very high in this kind of assets.

3. SALE AND LEASE BACK: It is a sub-part of finance lease. Under this, the owner of an asset sells the asset to a party (the buyer), who in turn leases back the same asset to the owner in consideration of lease rentals. However, under this arrangement, the assets are not physically exchanged but it all happens in records only. This is nothing but a paper transaction. Sale and lease back transaction is suitable for those assets, which are not subjected depreciation but appreciation, say land. The advantage of this method is that the lessee can satisfy himself completely regarding the quality of the asset and after possession of the asset convert the sale into a lease arrangement. The sale and lease back transaction can be expressed with the help of the following figure.

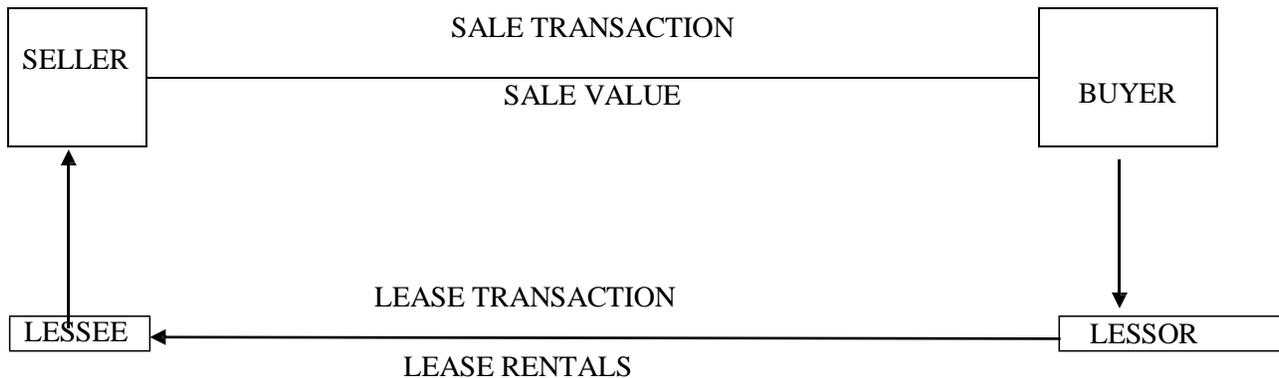


Figure 15.2: Structure of a Sale and Leaseback Deal

Under this transaction, the seller assumes the role of a lessee and the buyer assumes the role of a lessor. The seller gets the agreed selling price and the buyer gets the lease rentals. It is possible to structure the sale at agreed value (below or above the fair

4. LEVERAGED LEASING: Under leveraged leasing arrangement, a third party is involved beside lessor and lessee. The lessor borrows a part of the purchase cost (say 80%) of the asset from the third party i.e., lender and the asset so purchased is held as security against the loan. The lender is paid off from the lease rentals directly by the lessee and the surplus after meeting the claims of the lender goes to the lessor. The lessor, the owner of the asset is entitled to depreciation allowance associated with the asset.

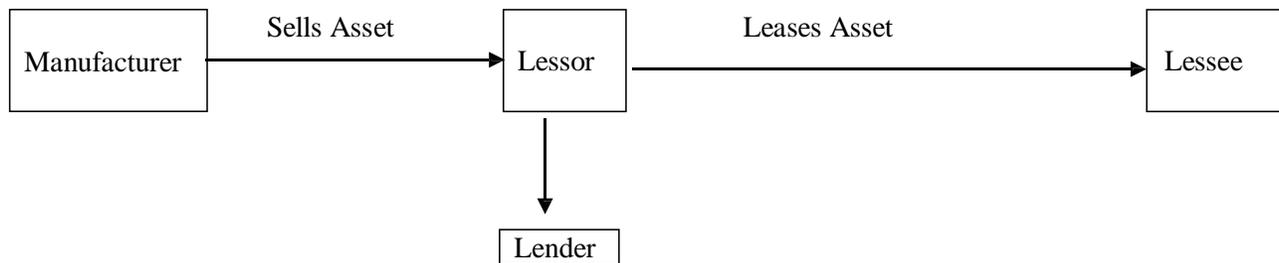


Figure 15. 3: Leveraged Lease

5. DIRECT LEASING: Under direct leasing, a firm acquires the right to use an asset from the manufacturer directly. The ownership of the asset leased out remains with the manufacturer itself. The major types of direct lessor include manufacturers, finance companies, independent lease companies, special purpose leasing companies etc

ADVANTAGES OF LEASING

There are several extolled advantages of acquiring capital assets on lease:

(1) **SAVING OF CAPITAL:** Leasing covers the full cost of the equipment used in the business by providing 100% finance. The lessee is not to provide or pay any margin money as there is no down payment. In this way the saving in capital or financial resources can be used for other productive purposes e.g. purchase of inventories.

(2) **FLEXIBILITY AND CONVENIENCE:** The lease agreement can be tailor- made in respect of lease period and lease rentals according to the convenience and requirements of all lessees.

(3) **PLANNING CASH FLOWS:** Leasing enables the lessee to plan its cash flows properly. The rentals

can be paid out of the cash coming into the business from the use of the same assets.

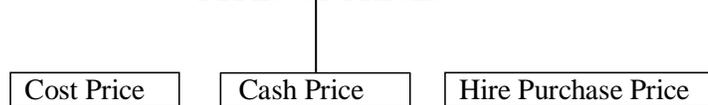
(4) **IMPROVEMENT IN LIQUADITY:** Leasing enables the lessee to improve their liquidity position by adopting the sale and lease back technique.

Q3: What is the hire purchase financing? How does it differ from the lease financing?

Ans: Hire purchase is a type of installment credit under which the hire purchaser, called the hirer, agrees to take the goods on hire at a stated rental, which is inclusive of the repayment of principal as well as interest, with an option to purchase. Under this transaction, the hire purchaser acquires the property (goods) immediately on signing the hire purchase agreement but the ownership or title of the same is transferred only when the last installment is paid. The hire purchase system is regulated by the Hire Purchase Act 1972. This Act defines a hire purchase as “an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement and includes an agreement under which:

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- 3) Such person has a right to terminate the agreement at any time before the property so passes”.

TYPES OF PRICES



DIFFERENCE BETWEEN LEASE FINANCING AND HIRE PURCHASE

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