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Readings in Accounting

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قســـــــم المحاســبة

Theoretical vocabulary of Readings in Accounting

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Dr. Majeed

CHAPTER 1
Accounting Principles and Concepts

Meaning and Scope of Accounting

Accounting is the language of business. The main objectives of Accounting is to safeguard the interests of the business, its proprietors and others connected with the business transactions. This is done by providing suitable information to the owners, creditors, shareholders, Government, financial institutions and other related agencies.

Definition of Accounting

The American Accounting Association defines accounting as "the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by the users of the information."

According to AICPA (American Institute of Certified Public Accountants) it is defined 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 a financial character and interpreting the result thereof."

Steps of Accounting

The following are the important steps to be adopted in the accounting process:

(1) ***Recording:*** Recording all the transactions in subsidiary books for purpose of future record or reference. It is referred to as "Journal."

(2) ***Classifying:*** All recorded transactions in subsidiary books are classified and posted to the main book of accounts. It is known as "Ledger."

(3) ***Summarizing:*** All recorded transactions in main books will be summarized for the preparation of Trail Balance, Profit and Loss Account and Balance Sheet.

(4) ***Interpreting:*** Interpreting refers to the explanation of the meaning and significance of the result of finanal accounts and balance sheet so that parties concerned with business can determine the future earnings, ability to pay interest, liquidity and profitability of a sound dividend policy.

Functions of Accounting

From the definition and analysis of the above the main functions of accounting can be summarized as:

(1) Keeping systematic record of business transactions.

(2) Protecting properties of the business.

(3) Communicating the results to various parties interested in or connected with the business.

(4) Meeting legal requirements.

Objectives of Accounting

(1) Providing suitable information with an aim of safeguarding the interest of the business and its proprietors and others connected with it.

(2) To emphasis on the ascertainment and exhibition of profits earned or losses incurred in the business.

(3) To ascertain the financial position of the business as a whole.

(4) To ensure accounts are prepared according to some accepted accounting concepts and conventions.

(5) To comply with the requirements of the Companies Act, Income Tax Act, etc.

Definition of Bookkeeping

Bookkeeping may be defined as "the art of recording the business transactions in the books of accounts in a systematic manner." A person who is responsible for and who maintains and keeps a record of the business transactions is known as Bookkeeper. His work is primarily clerical in nature.

On the other hand, Accounting is primarily concerned with the recording, classifying, summarizing, interpreting the financial data and communicating the information disclosed by the accounting records to those persons interested in the accounting information relating to the business.

Limitations of Accounting

(1) Accounting provides only limited information because it reveals the profitability of the concern as a whole.

(2) Accounting considers only those transactions which can be measured in terms of money or quantitatively expressed. Qualitative information is not taken into account.

(3) Accounting provides limited information to the management.

(4) Accounting is only historical in nature. It provides only a post mortem record of business transactions.

Branches of Accounting

The main function of accounting is to provide the required informations for different parties who are interested in the welfare of that enterprise concerned. In order to serve the needs of management and outsiders various new branches of accounting have been developed. The following are the main branches of accounting:

(1) Financial Accounting.

(2) Cost Accounting.

(3) Management Accounting.

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(1) ***Financial Accounting:*** Financial Accounting is prepared to determine profitability and financial position of a concern for a specific period of time.

(2) ***Cost Accounting:*** Cost Accounting is the formal accounting system setup for recording costs. It is a systematic procedure for determining the unit cost of output produced or service rendered.

(3) ***Management Accounting:*** Management Accounting is concerned with presentation of accounting information to the management for effective decision making and control.

Accounting Principles

Various accounting systems and techniques are designed to meet the needs of the management. The information should be recorded and presented in such a way that management is able to arrive at right conclusions. The ultimate aim of the management is to increase profitability and losses. In order to achieve the objectives of the concern as a whole, it is essential to prepare the accounting statements in accordance with the generally accepted principles and procedures.

The term principles refers to the rule of action or conduct to be applied in accounting. Accounting principles may be defined as "those rules of conduct or procedure which are adopted by the accountants universally, while recording the accounting transactions."

The accounting principles can be classified into two categories:

I. Accounting Concepts.

II. Accounting Conventions.

I. Accounting Concepts

Accounting concepts mean and include necessary assumptions or postulates or ideas which are used to accounting practice and preparation of financial statements. The following are the important accounting concepts:

(1) Entity Concept;

(2) Dual Aspect Concept;

(3) Accounting Period Concept;

(4) Going Concern Concept;

(5) Cost Concept;

(6) Money Measurement Concept;

(7) Matching Concept;

(8) Realization Concept;

(9) Accrual Concept;

(10) Rupee Value Concept.

II. Accounting Conventions

Accounting Convention implies that those customs, methods and practices to be followed as a guideline for preparation of accounting statements. The accounting conventions can be classified as follows:

(1) Convention of Disclosure.

(2) Convention of Conservatism.

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(3) Convention of Consistency.

(4) Convention of Materiality.

The following table summarizes classifications of Accounting Principles:

Accounting Principles

Accounting Concept	*Accounting Conventions*
(1) Entity Concept	(1) Convention of Disclosure
(2) Dual Aspect Concept	(2) Convention of Conservatism
(3) Accounting Period Concept	(3) Convention of Consistency
(4) Going Concern Concept	(4) Convention of Materiality
(5) Cost Concept	
(6) Money Measurement Concept	
(7) Matching Concept	
(8) Realization Concept	
(9) Accrual Concept	
(10) Rupee Value Concept	

The classification of accounting concepts and conventions can be explained in the following pages.

I. Accounting Concepts

(1) Entity Concept: Separate entity concept implies that business unit or a company is a body corporate and having a separate legal entity distinct from its proprietors. The proprietors or members are not liable for the acts of the company. But in the case of the partnership business or sole trader business no separate legal entity from its proprietors. Here proprietors or members are liable for the acts of the firm. As per the separate entity concept of accounting it applies to all forms of business to determine the scope of what is to be recorded or what is to be excluded from the business books. For example, if the proprietor of the business invests Rs.50,000 in his business, it is deemed that the proprietor has given that much amount to the business as loan which will be shown as a liability for the business. On withdrawal of any amount it will be debited in cash account and credited in proprietor's capital account. In conclusion, this separate entity concept applies much larger in body corporate sectors than sole traders and partnership firms.

(2) Dual Aspect Concept: According to this concept, every business transaction involves two aspects, namely, for every receiving of benefit and, there is a corresponding giving of benefit. The dual aspect concept is the basis of the double entry book keeping. Accordingly for every debit there is an equal and corresponding credit. The accounting equation of the dual aspect concept is:

Capital + Liabilities = Assets

(or)

Assets = Equities (Capital)

The term Capital refers to funds provide by the proprietor of the business concern. On the other hand, the term liability denotes the funds provided by the creditors and debenture holders against the assets of the business. The term assets represents the resources owned by the business. For example, Mr.Thomas Starts business with cash of Rs.1,00,000 and building of Rs.5,00,000, then this fact is recorded at two places ; Assets Accounts and Capital Account. In other words, the business acquires assets of Rs.6,00,000 which is equal to the proprietor's capital in the form of cash of Rs.1,00,000 and building worth of Rs.5,00,000. The above relationship can be shown in the form of accounting equation:

Capital + Liabilities = Assets

Rs.1,00,000 + Rs.5,00,000 = Rs.6,00,000

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(3) Accounting Period Concept: According to this concept, income or loss of a business can be analysed and determined on the basis of suitable accounting period instead of wait for a long period, i.e., until it is liquidated. Being a business in continuous affairs for an indefinite period of time, the proprietors, the shareholders and outsiders want to know the financial position of the concern, periodically. Thus, the accounting period is normally adopted for one year. At the end of the each accounting period an income statement and balance sheet are prepared. This concept is simply intended for a periodical ascertainment and reporting the true and fair financial position of the concern as a whole.

(4) Going Concern Concept: It is otherwise known as Continue of Activity Concept. This concept assumes that business concern will continue for a long period to exit. In other words, under this assumption, the enterprise is normally viewed as a going concern and it is not likely to be liquidated in the near future. This assumption implies that while valuing the assets of the business on the basis of productivity and not on the basis of their realizable value or the present market value, at cost less depreciation till date for the purpose of balance sheet. It is useful in valuation of assets and liabilities, depreciation of fixed assets and treatment of prepaid expenses.

(5) Cost Concept: This concept is based on "Going Concern Concept." Cost Concept implies that assets acquired are recorded in the accounting books at the cost or price paid to acquire it. And this cost is the basis for subsequent accounting for the asset. For accounting purpose the market value of assets are not taken into account either for valuation or charging depreciation of such assets. Cost Concept has the advantage of bringing objectivity in the preparation and presentation of financial statements. In the absence of cost concept, figures shown in accounting records would be subjective and questionable. But due to inflationary tendencies, the preparation of financial statements on the basis of cost concept has become irrelevant for judging the true financial position of the business.

(6) Money Measurement Concept: According to this concept, accounting transactions are measured, expressed and recorded in terms of money. This concept excludes those transactions or events which cannot be expressed in terms of money. For example, factors such as the skill of the supervisor, product policies, planning, employer-employee relationship cannot be recorded in accounts in spite of their importance to the business. This makes the financial statements incomplete.

(7) Matching Concept: Matching Concept is closely related to accounting period concept. The chief aim of the business concern is to ascertain the profit periodically. To measure the profit for a particular period it is essential to match accurately the costs associated with the revenue. Thus, matching of costs and revenues related to a particular period is called as Matching Concept.

(8) Realization Concept: Realization Concept is otherwise known as Revenue Recognition Concept. According to this concept, revenue is the gross inflow of cash, receivables or other considerations arising in the course of an enterprise from the sale of goods or rendering of services from the holding of assets. If no sale takes place, no revenue is considered. However, there are certain exceptions to this concept. Examples, Hire Purchase / Sale, Contract Accounts etc.

(9) Accrual Concept: Accrual Concept is closely related to Matching Concept. According to this concept, revenue recognition depends on its realization and not accrual receipt. Likewise cost are recognized when they are incurred and not when paid. The accrual concept ensures that the profit or loss shown is on the basis of full fact relating to all expenses and incomes.

(10) Rupee Value Concept: This concept assumes that the value of rupee is constant. In fact, due to inflationary pressures, the value of rupee will be declining. Under this situations financial statements are prepared on the basis of historical costs not considering the declining value of rupee. Similarly depreciation is also charged on the basis of cost price. Thus, this concept results in underestimation of depreciation and overestimation of assets in the balance sheet and hence will not reflect the true position of the business.

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II. Accounting Conventions

(1) **Convention of Disclosure:** The disclosure of all material information is one of the important accounting conventions. According to this conventions all accounting statements should be honestly prepared and all facts and figures must be disclosed therein. The disclosure of financial informations are required for different parties who are interested in the welfare of that enterprise. The Companies Act lays down the forms of Profit and Loss Account and Balance Sheet. Thus convention of disclosure is required to be kept as per the requirement of the Companies Act and Income Tax Act.

(2) **Convention of Conservatism:** This convention is closely related to the policy of playing safe. This principle is often described as "anticipate no profit, and provide for all possible losses." Thus, this convention emphasise that uncertainties and risks inherent in business transactions should be given proper consideration. For example, under this convention inventory is valued at cost price or market price whichever is lower. Similarly, bad and doubtful debts is made in the books before ascertaining the profit.

(3) **Convention of Consistency:** The Convention of Consistency implies that accounting policies, procedures and methods should remain unchanged for preparation of financial statements from one period to another. Under this convention alternative improved accounting policies are also equally acceptable. In order to measure the operational efficiency of a concern, this convention allows a meaningful comparison in the performance of different period.

(4) **Convention of Materiality:** According to Kohler's Dictionary of Accountants Materiality may be defined as "the characteristic attaching to a statement fact, or item whereby its disclosure or method of giving it expression would be likely to influence the judgment of a reasonable person." According to this convention consideration is given to all material events, insignificant details are ignored while preparing the profit and loss account and balance sheet. The evaluation and decision of material or immaterial depends upon the circumstances and lies at the discretion of the Accountant.

QUESTIONS

1. Define Accounting.
2. Explain nature and scope of accounting.
3. What are the important functions of accounting?
4. What are the objectives of accounting?
5. Define bookkeeping.
6. Briefly explain the basic accounting concept and conventions.
7. What are the important classification of accounting concepts? Explain them briefly.
8. Write short notes on :
   (a) Convention of Disclosure.
   (b) Convention of Conservatism.
   (c) Convention of Consistency.
9. What do you understand by Dual Aspect Concept?
10. Explain Going Concern Concept.
11. Write short notes on:
    (a) Cost Concept.
    (b) Money Measurement Concept.
    (c) Accounting Period Concept.
12. What are the limitations of Accounting?

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Fill in the missing words in the sentences below. Choose from the box. You will need to use each word more than once.

account	accounts	accountant	accounting	accountancy

- Can you check that the figures have been entered correctly in the bank _account_ ?
- He's at university studying ________ .
- The management of the company have not yet decided on their ________ policies.
- A bookkeeper writes details of financial transactions in the ________ .
- Most people in the profession read ________ magazines and journals in order to stay informed.
- She's been working as an ________ with this firm for several years now.
- The directors of the company approve the ________ at the end of the ________ year.
- The chief ________ has completed the draft ________ for this year.
- Each branch maintains its own full ________ system.
- They have opened an ________ for the consignment to Bombay.
- ________ is really not an exact science.
- A business manager needs some ________ knowledge in order to understand what he reads in the company ________.

Q3: Jenks Company performs the following accounting tasks during the year.

1. ______Analyzing and interpreting information.
2. ______Classifying economic events.
3. ______Explaining uses, meaning, and limitations of data.
4. ______Keeping a systematic chronological diary of events.
5. ______Measuring events in dollars and cents.
6. ______Preparing accounting reports.
7. ______Reporting information in a standard format.
8. ______Selecting economic activities relevant to the company.
9. ______Summarizing economic events.

Instructions:

- Categorize the accounting tasks performed by Jenks as relating to either the identification (I), recording (R), or communication (C) aspects of accounting.

Reference

Anthony R.N. and J.S. Reece, *Accounting Principles*, Richard D. Irwin Inc.

A Objective-type Questions

I. State whether the following statements are True or False

1. Accounting information is useful only to the management.
2. Accounting is the language of business.
3. Accounting involves communication.
4. Financial statements are the channel of accounting communication.
5. If the transaction cannot be translated in monetary terms, it is not considered as part of the accounting information system.
6. Information needs of accounting are not required for owners of small business enterprises.
7. Most of the needs of the accounting information are met from unpublished internal reports by the management.
8. Under cash basis of accounting, credit transactions are not at all recorded in the books of account.
9. Under accrual basis of accounting, revenue is recognised only when cash is actually received.
10. Under cash basis of accounting, no adjustments are made for outstanding expenses and accrued income.

Answers

1. False
2. True
3. True
4. True
5. True
6. False
7. True
8. True
9. False
10. True

II. Fill in the blanks with suitable words

1. The information generated by final reports of an enterprise is generally known as ________________ information.
2. The two broad categories of users of the financial accounting information are ________________ and ________________.
3. Ability of the firm to meet its long term obligations is referred to as ________________.
4. Ability of the firm to meet its short term obligations is referred to as ________________.
5. The major internal user of the accounting information is ________________ of an enterprise.
6. Consistency ________________ the switching of accounting methods from year to year.
7. Under cash basis of accounting ________________ transactions are not recorded.
8. Under accrual basis of accounting, revenues are recognised when they are ________________.
9. Under hybrid basis of accounting, revenues are recognised on ________________ basis while expenses are recorded on ________________ basis.
10. Under accrual basis of accounting, outstanding expenses and unaccrued income will affect the Profit and Loss Account showing a ________________ profit.

Answers

1. Financial Accounting
2. External and Internal
3. Solvency
4. Liquidity
5. The Management
6. Does not permit
7. Credit
8. Earned
9. Cash basis and accrual basis
10. Lower

B Short Answer-type Questions

1. Define accounting.
2. What is an accounting information system?
3. What are the broad purposes of an accounting system?
4. What are the important financial characteristics which are of common interest to users of information?
5. What are the categories of users of financial accounting information? Give two examples to each category of users.
6. What are the branches of accounting?
7. What is meant by hybrid basis of accounting?
8. Explain the cash basis of accounting.
9. What is accrual basis of accounting? Mention two advantages of accrual basis of accounting.
10. Distinguish between the accrual basis of accounting and the cash basis of accounting.

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10. As per entity concept, income is the property of the business and not that of the owners.
11. Money, the unit of measurement, has always a constant value.
12. The going concern concept facilitates the classification of assets and liabilities into short term and long term.
13. The accounting period concept necessitates the preparation of income statement on accrual basis.
14. As per the cost concept, assets are always values at historical cost.
15. Unexpired costs are not recorded in the balance sheet.
16. Realisation of revenue occurs at the time of exchange of goods or services.
17. Under accrual basis of accounting, revenue is recognised when the cash is received.
18. The accrual concept can also be described as the matching concept.
19. As per prudence convention, the accountants should anticipate profit and should not make provision for loss
20. As per materiality convention, the accountants should disclose all information in the financial statements, irrespective of the nature of materiality.

Answers

1. True	2. False	3. True
4. False	5. True	6. False
7. False	8. True	9. False
10. True	11. False	12. True
13. True	14. True	15. False
16. True	17. False	18. True
19. False	20. False	

II. Fill in the blanks with suitable words

1. In double entry accounting, all business transactions are marked as having __________ aspect.
2. Accounting principles are only __________ based on usage, and experience over a period of years.
3. Accounting concepts are not __________ forever.
4. The separate legal entity is recognised by law in the case of a _______ form of business organisation.
5. Though separate entity is not recognised by law in some types of organisations, the assumption of separate entity has to be followed in __________ types of business organisations.
6. The capital of the business is considered as a __________ of the business to its owners.
7. At cost or book value means cost __________ depreciation.
8. Periodicity concept emphasises __________ period assumption.
9. The cost concept is also referred at as _______ cost concept.
10. __________ concept assumes that the business entity will continue its activities independently.
11. The money measurement assumption which assumes that purchasing power of money is always __________.
12. The realisation concept emphasises the timing of __________.
13. The essence of accrual concept is that the earning of a revenue and consumption of expenses are related to a __________.
14. Disclosure is the__________ and __________ of financial information to its users.
15. Accounting records and statements must confirm to __________.

Answers

1. dual	2. guidelines
3. static	4. limited companies
5. all	6. liability
7. less (or minus)	8. accounting
9. historical	10. going concern
11. stable	12. revenue recognition
13. specific accounting period	14. communication and reporting
15. GAPP	

B Short Answer-type Questions

1. Explain GAPP?
2. Explain the meaning and significance of Entity Concept?
3. Explain the meaning and significance of Money Measurement Concept?
4. Explain the meaning and significance of Going Concern Concept?
5. Explain the meaning and significance of Accounting Period Concept?
6. Explain the meaning and significance of Cost Concept?
7. Explain the meaning and significance of Realisation Concept?
8. Explain the meaning and significance of Accrual Concept?
9. Explain the meaning and significance of Matching Concept?
10. What do you mean by Accounting Convention?

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Who Uses Accounting Data

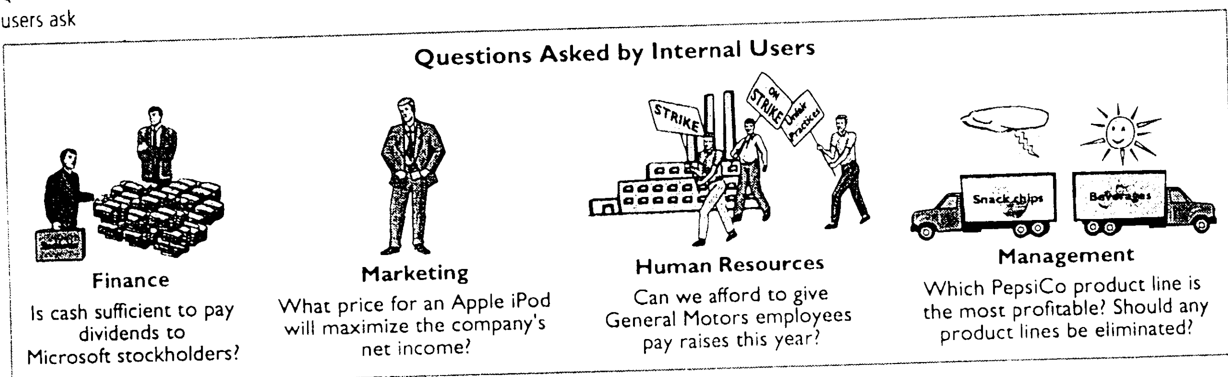
2
Identify the users and uses of accounting.

The information that a user of financial information needs depends upon the kinds of decisions the user makes. There are two broad groups of users of financial information: internal users and external users.

INTERNAL USERS

Internal users of accounting information are managers who plan, organize, and run the business. These include marketing managers, production supervisors, finance directors, and company officers. In running a business, internal users must answer many important questions, as shown in Illustration 1-2.

Illustration 1-2
Questions that internal users ask



External users

- Investors and potential investors – information on the risks and returns on investments.
- Unions and employee groups – information on the stability, profitability and distribution of wealth within the business.
- Lenders and financial institutions – information on the creditworthiness of the company and its ability to repay loans and pay interest.
- Suppliers and creditors – information on whether amounts owed will be repaid when due, and on the continued existence of the business.
- Customers – information on the continued existence of the business and thus the probability of a continued supply of products, parts and after sales service.
- Government and other regulators – information on the allocation of resources and the compliance to regulations.
- Social responsibility groups, such as environmental groups – information on the use of the environment.
- The public – information on the role and contribution of businesses to society.
- Competitors – information on the relative strengths and weaknesses of their competition and for comparative and benchmarking purposes. Whereas the above categories of users share in the wealth of the company, competitors require the information mainly for strategic purposes.

Types of businesses

There are three main types of businesses:

- *Trading*—these businesses sell products and can be either wholesale or retail. A wholesaler operates between the manufacturer and the retailer. Retail businesses sell products to customers (for example, household goods, clothes, food and computers).
- *Service industries*—these businesses provide services to customers and include plumbers, electricians, dentists and doctors.

- *Manufacturing*—these businesses convert material and labour into finished products that are then sold to trading businesses.

"Types of Ownership"

Ethics Notes help sensitize you to some of the ethical issues in accounting.

ETHICS NOTE

The importance of the economic entity assumption is illustrated by scandals involving **Adelphia (USA)**. In this case, senior company employees entered into transactions that blurred the line between the employees' financial interests and those of the company. For example, Aldephia guaranteed over $2 billion of loans to the founding family.

ECONOMIC ENTITY ASSUMPTION

An economic entity can be any organization or unit in society. It may be a company (such as Telefónica (ESP), a governmental unit (the city-state of Singapore), a municipality (Toronto, Canada), a school district (St. Louis District 48), or a church (Southern Baptist). The **economic entity assumption** requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities. To illustrate, Sally Rider, owner of Sally's Boutique, must keep her personal living costs separate from the expenses of the Boutique. Similarly, Metro (DEU), Coca-Cola (USA), and Cadbury Schweppes (GBR) are segregated into separate economic entities for accounting purposes.

(1) **Proprietorship.** A business owned by one person is generally a **proprietorship**. The owner is often the manager/operator of the business. Small service-type businesses (plumbing companies, beauty salons, and auto repair shops), farms, and small retail stores (antique shops, clothing stores, and used-book stores) are often proprietorships. **Usually only a relatively small amount of money (capital) is necessary to start in business as a proprietorship. The owner (proprietor) receives any profits, suffers any losses, and is personally liable for all debts of the business.** There is no legal distinction between the business as an economic unit and the owner, but the accounting records of the business activities are kept separate from the personal records and activities of the owner.

(2) **Partnership.** A business owned by two or more persons associated as partners is a **partnership**. In most respects a partnership is like a proprietorship except that more than one owner is involved. Typically a partnership agreement (written or oral) sets forth such terms as initial investment, duties of each partner, division of net income (or net loss), and settlement to be made upon death or withdrawal of a partner. Each partner generally has unlimited personal liability for the debts of the partnership. **Like a proprietorship, for accounting purposes the partnership transactions must be kept separate from the personal activities of the partners.** Partnerships are often used to organize retail and service-type businesses, including professional practices (lawyers, doctors, architects, and chartered public accountants).

(3) **Corporation.** A business organized as a separate legal entity under corporation law and having ownership divided into transferable shares is a **corporation**. The holders of the shares (shareholders) **enjoy limited liability**; that is, they are not personally liable for the debts of the corporate entity. Shareholders **may transfer all or part of their ownership shares to other investors at any time** (i.e., sell their shares). The ease with which ownership can change adds to the attractiveness of investing in a corporation. Because ownership can be transferred without dissolving the corporation, the corporation **enjoys an unlimited life.**

Although the combined number of proprietorships and partnerships in the world significantly exceeds the number of corporations, the revenue produced by corporations is much greater. Most of the largest enterprises in the world—for example, ING (NLD), Royal Dutch Shell (GBR and NLD), Wal-Mart (USA), Fortis (BEL), and Toyota (JPN)—are corporations.

Exercises

Q1: Which statement about users of accounting information is **incorrect**?

(1) Management is considered an internal user.
(2) Two people can form a sole proprietorship.
(3) Regulatory authorities are considered internal users.
(4) A sole proprietorship and its owner are legally the same entity.
(5) Present creditors are considered external users.
(6) The partners in a partnership are not liable for the debts of the partnership.
(7) A corporation and its investors are legally the same entity.
(8) The shareholders of a corporation are not liable for the debts of the corporation.
(9) Taxing authorities are considered external users.
(10) The two most common types of external users are investors and company officers.

MULTIPLE-CHOICE QUESTIONS

1. Which is **not** one of the three forms of business organization?

(a) proprietorship.
(b) Creditorship.
(c) Partnership.
(d) Corporation.

2.Match each of the following forms of business organization with a set of characteristics: sole proprietorship (SP), partnership (P), corporation (C).

(a) _____ Shared control, tax advantages, increased skills and resources.
(b) _____ Simple to set up and maintains control with owner.
(c) _____ Easier to transfer ownership and raise funds, no personal liability.

Q3: Match each term with its definition.

-----	Classification of costs	a- businesses convert material and labour into finished products.
-----	Trading business	b- business owned by one person.
-----	proprietorship	c- grouping of like items of costs into a common group.
-----	Financial Accounting	d- business sell products and can be either wholesale or retail.
-----	Manufacturing business	e- branch of accounting which deals with financial transactions of business.
		f- the amount which the proprietor has invested in the business.

CHAPTER 2
Accounting Books and Records

The purpose of preparation of Trading, Profit and Loss Account and Balance Sheet to ascertain the profit or loss made by business and to know the financial soundness of the concern as a whole. In order to achieve the objectives of the firm, it is essential to maintain several books and records. The number of books and records are maintained by an enterprise for the evidence of the recording business transactions. Cash Receipts, Invoice, Cash Memo, Cheque and other vouchers are the examples of documentary evidence supported for preparation of income statements.

According to double entry system of accounting each transaction is recorded in the books of accounts to ascertain the profits earned during a particular period. "Transaction" of a business refers to an event the recognition of which gives rise to an entry in account records.

While analyzing the review of accounting cycle, the whole process of accounting consists of the following important stages :

(1) Recording the transactions are done through Journals or Subsidiary Books.

(2) Classifying the transactions are achieved by Ledger.

(3) Summarizing the transactions are done through Trial Balance.

(4) The last stage is concerned with preparing Income Statements (Trading, Profit and Loss Account and Balance Sheet).

JOURNAL

In the first stage of double entry system each transactions are recorded in the 'Journal' or "Subsidiary Books." Journal is the book of "Original Entry or First Entry" which is used for recording of all business transactions in chronological order. Then it is posted to ledger. This process is known as "Entering." In other words record of the each transaction is called as "Journal Entry." The process of recording in the Journal is called as "Journalizing."

Specimen Ruling of Journal

The specimen ruling of Journal is shown below :

Date (1)	*Particulars (2)*	*L.F. (3)*	*Dr. (4) Rs.*	*Cr. (5) Rs.*
Date, Month	Name of Accounts to be Debited	...	...	...
a Year	Name of Accounts to be Credited	...	...	...

From the above specimen ruling of Journal, we can observe the following points:

Column 1 : It indicates the date, month and year on which each transaction takes place.

Column 2 : It represents (a) name of account to be debited; (b) name of account to be credited.

Column 3 : L.F. Stands for Ledger Folio, i.e, reference to the main book.

Column 4 : Dr. Stands for Debit, i.e., amount to be debited.

Column 5 : Cr. Stands for Credit, i.e., amount to be credited.

If two or more transactions of similar nature occur on the same day and either the debit account or credit account is common, such transactions can be conveniently entered in the Journal in the form of a Combined Journal Entry instead of making a separate entry for each transaction. Such type of entry is a "Compound Journal Entry."

Types of Journals

Journals broadly classified into (1) General Journals and (2) Special Journals. Special Journals are subsidiary books which are as follows :

1. Sales Book
2. Purchase Book
3. Purchase Returns Book
4. Sales Returns Book
5. Bills Receivable Book
6. Bills Payable Book
7. Cash Book.

These subsidiary books which are used for recording of each transactions. The following points to be considered before making journal entry :

(1) Capital Account : The initial influx of capital in the form of cash provided by the proprietor is known as "Capital." It may be further converted into plant and machinery, building etc. Hence it should be debited to Cash A/c or Plant & Machinery Property A/c and credited to Proprietor's A/c.

(2) Drawing Account : When proprietors withdrawn money or goods from business for personal use, it should be debited to Drawing A/c and credited Cash A/c or Purchase A/c.

(3) Goods Account : If any transactions relating to purchase or sale of goods, instead of making journal entries in one Goods Account, separate accounts may be maintained as Sales A/c, Purchase A/c, Sales Returns A/c, and Purchase Returns A/c.

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A journal is a record that keeps accounting transactions in chronological order i.e. as they occur. All accounting transactions are recorded through journal entries that show account names, amounts, and whether those accounts are recorded in debit or credit side of accounts. A journal entry is called "balanced" when the sum of debit side amounts equals to the sum of credit side amounts.

Kind of Entries انواع القيود

1- Simple entry :-

In this type of entry only two accounts affected,

one account is debit and another is account credit.

القيد البسيط: في هذا النوع فقط حسابين تؤثر احدها مدين والحساب الاخر دائن.

2- Compound entry:-القيد المركب

In this type of entry more than two accounts affected so the

entry may be :-

في هذا النوع من القيود اكثر من حسابين تؤثر لذلك القيد يمن ان يكون:

A- Several accounts are debit and one account is credit.

أ. عدة حسابات مدينة وحساب واحد دائن.

B- Several accounts are credit and one account is debit.

ب. عدة حسابات دائنة وحساب واحد مدين

C- Several accounts are debit and several accounts are credit.

جـ- عدة حسابات مدينة وعدة حسابات دائنة.

Form of Journal شكل اليومية

Date التاريخ	Particulars البيانات	Voucher No. رقم المستند	Ledger No. رقم الاستاذ	Debit مدين	Credit دائن
1/3/2011	Account name Account name Being of…	Xxx	Xx xx	xxx	 xxx

24 Received cheque from Mohan & Co. in full settlement of amount due to them Rs. 49,500
31 Paid rent by cheque Rs. 5,000

(13) Pass journal entries for the following transactions :

(1) Goods purchased from Kapil Dev for Rs. 80,000 at a trade discount of 10% and cash discount of 2% paid 75% of the amount immediately
(2) Received a cheque from Prem Kumar for Rs. 16,000 this cheque was deposited in to bank the next day
(3) Cheque received from Premkumar was dishonoured
(4) Sold old news papers Rs. 100
(5) Bought goods from Raj & Co. and paid by cheque Rs. 14,000
(6) Sold half of the above goods to Sam & Co. at a profit of 35% on cost

(14) Record the following transactions in the account of Hari & Co. :

2004
Jan. 1 Goods sold to Swaminathan Rs. 12,000
3 Cash received from Swaminathan Rs. 11,600 and allowed him discount Rs. 400
15 Bought goods from Rajan on Credit Rs. 16,000
20 Paid cash to Rajan in full settlement of his account Rs. 15,900
25 Paid cash for trade expenses Rs. 200
27 Paid cash for stationery Rs. 375
29 Paid wages Rs. 500
30 Cash Sales Rs. 12,000

(15) Journalize the following transactions :

(1) Bought goods for cash Rs. 50,000
(2) Paid cash for stationery Rs. 500
(3) Bought furniture for cash Rs. 4,000
(4) Sold goods for cash Rs. 16,000
(5) Sold goods to Jhon on credit Rs. 5,000
(6) Sold goods to William for cash Rs. 7,000
(7) Paid rent Rs. 1,500
(8) Paid salary Rs. 1,000
(9) Paid freight on goods purchased Rs. 500
(10) Paid wages Rs. 700
(11) Received from James Rs. 5,000
(12) Received Interest from James Rs. 1,000

LEDGER

Meaning and Definition

Ledger refers to the book of Main Entry and it contains various accounts such as Personal Accounts, Real Accounts and Nominal Accounts. In the first stage of accounting cycle, all business transactions are recorded separately through Journal or Subsidiary Books during a particular date or period. Hence, Journal fails to bring the similar transactions together and it is not useful for any reference. In order to have a consolidated view of the similar transactions, the transactions entered in the journal will have to be posted to Ledger Account.

A Ledger Account may be defined as a "Summary Statement of all transactions relating to a person, asset, expense or income which have taken place during a given period of time and showing their net effect." From the above definition, we can observe that Ledger is designed as the book of second stage in the accounting cycle which is used for recorded transactions which are classified and grouped into different heads of accounts.

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Specimen Rulings of Ledger

The specimen of ruling of each account in the ledger is as follows :

Dr. **Name of Account** **Cr.**

Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
	To Name of Debit A/c				By Name of Credit A/c		

From the above specimen rulings of ledger account, we can observe the following points :

(1) Ledger Account is usually in the "T" form which contain two sides–Debit side and Credit side.

(2) Left hand side is called Debit Side (Dr.)

(3) Right hand side is called Credit Side (Cr.)

(4) Each side further divided into four columns :

(a) Column 1 meant for date, month and year.

(b) Column 2 meant for particulars.

(c) 'F' stands for Folio (Page Number) of the Journal or Subsidiary Books.

(d) Accounts to be Debited or Credited.

(5) The name of accounts to be debited find an entry on the left side.

(6) The name of accounts to be credited find an entry on the right side.

Posting of Journal to Ledger

The term "Posting" refers to the process of entering in the ledger the information given in the journal. In other words, the process of transferring the transactions from the journal to the ledger during the particular period is known as "Posting." Accordingly separate account should be opened into the ledger for posting the transactions relating to the individual persons, assets, expenses or losses as shown in the journal. The following example will make you clear the process of posting.

Jan. 1
2003, Kannan Sold goods to Gupta Rs. 5,000.

Journal Entry

2003	Particulars		Debit Rs.	Credit Rs.
Jan. 1	Gupta Account To Sales Account (Being goods Sold to Gupta on Credit)	Dr.	5,000	 5,000

Dr. **Gupta Account** **Cr.**

Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
2003 Jan. 1	To Sales A/c		5,000				

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Dr. **Sales Account** **Cr.**

Date	*Particulars*	*J.F.*	*Amount Rs.*	*Date*	*Particulars*	*J.F.*	*Amount Rs.*
				2003 Jan.1	By Gupta A/c		5,000

Balancing of Ledger Account

In order to prepare the financial statements, balancing of various accounts in the ledger is essential. The following procedure to be adopted while balancing of various accounts in the ledger.

(1) Debit and Credit sides of an accounts are totalled separately.

(2) Find the difference between the total of both sides.

(3) The difference is entered on the side on which the total is smaller and this difference is the closing balance shown by the account and this will be carried forward to the next year as the "opening balance" in the account.

(4) If the debit side of an amount is more, it is called Debit Balance and it is entered on the credit side to close the account and written as by balance c/d.

(5) If the credit side of an amount is more it is called Credit Balance and it is entered on the debit side to close the account and written as To Balance c/d.

Difference between Journal and Ledger

In the process of accounting cycle, both the Journal and Ledger serve as important books which are indispensable for each other. The following are the important points that differentiate the Journal and Ledger:

	Journal		*Ledger*
(1)	Journal is the book of Original Entry or First Entry	(1)	Ledger is the book of Second entry
(2)	It is the book of Chronological Record	(2)	It is the book of Analytical Record
(3)	The process of recording in the journal is called journalizing	(3)	The process of recording in ledger is posting
(4)	Journal as a book supported by greater sources of evidence	(4)	Ledger is dependent on journal
(5)	Journal lays focus on recording transactions	(5)	Ledger focuses on process of classification of grouping of different heads of accounts.
(6)	The process of Journalizing is a continuous one.	(6)	The process of posting in ledger to be done according to the needs and convenience.

Illustration: 7

By Solving illustration 1, Chapter 3, "Accounting Books and Records."

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21 Goods returned from Pandey Rs. 500
25 Received cash from Jain & Co. Rs. 5,500 discount allowed Rs. 250
27 Withdrawn Rs. 1,500 from bank for personal use
31 Paid for advertisement Rs. 2,000

(4) From the following transactions, you are required to prepare Journal and Ledger Account of Mrs. Sam & Co.:

2003
Jan. 1 Started business with cash Rs. 2,00,000
1 Paid into Bank Rs. 50,000
2 Goods sold to Ramesh for Rs. 10,000 less 10% trade discount
4 Furniture purchased for cash Rs. 25,000
7 Withdrawn from bank for personal use Rs. 2,000
9 Machinery Purchased for cash Rs. 30,000
11 Goods sold to Ram on credit for Rs. 8,000
13 Good sold for cash Rs. 10,000
15 Purchased goods from Reddy & Co. Rs. 20,000
17 Goods returned from Reddy & Co. Rs. 1,000
20 Goods returned to Gupta Rs. 500
23 Cash paid to Reddy & Co. for full settlement of his account Rs. 15,000
25 Withdrawn cash from bank for office use Rs. 3,000
27 Paid telephone rent Rs. 1,500
27 Paid salaries to office staff Rs. 25,000
29 Cash received from John & Co. Rs. 8,000 and discount allowed to him Rs. 100
31 Goods sold for cash Rs. 5,000

(5) From the following transactions, you are required to prepare Journal and Ledger Account in the books of Hari Prasad & Co.:

2003
Jan. 1 Business started with cash Rs. 3,00,000
1 Cash paid into Bank Rs. 25,000
1 Purchased Furniture Rs. 5,000
2 Machinery purchased from Krisha on credit for Rs. 10,000
3 Goods sold for cash Rs. 10,000
5 Goods sold to Murugan less trade discount of 10% for Rs. 20,000
7 Goods purchased from Ramesh for Rs. 5,000 at 10% trade discount
9 Goods returned from Murugan for Rs. 500
11 Goods returned to Ramesh for Rs. 3,000
14 Paid for Advertisement Rs. 2,000
15 Withdrawn Rs.4,000 from bank for office use
17 Goods purchased for cash Rs. 5,000
19 Paid salaries to office staff Rs. 18,000
21 Goods sold for cash Rs. 10,000
23 Paid interest Rs. 1,500
25 Dividend received Rs. 3,400
27 Withdrawn cash from bank for personal use for Rs. 1,400
29 Cash paid to Ramesh in full settlement of his account for Rs. 5,000
30 Deposited cash into bank Rs. 3,000
31 Sold goods to Karthik on credit for Rs. 5,000

TRIAL BALANCE

Meaning

To ensure the proof of completion and arithmetical correctness of the books of account, it is essential to prepare the trial balance. In the first stage of accounting all business transactions are recorded in Journal or Subsidiary Books. Then they are transferred to ledger by posting to relevant accounts. The fundamental principle of double entry system of accounting is that for every debit, there must be a corresponding and equal credit. Therefore, when all the accounts of a concern are thus balanced in the ledger at the end of the

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period, a statement is prepared to show the list of debit balances on one side and credit balances on the other side. This list so prepared is called as "Trial Balance." Accordingly the total of the debit side of trial balance must be equal to that of its credit side.

Objectives of Trial Balance

The following are the important objectives of preparing the Trial Balance:

(1) To ensure the arithmetical correctness of the book of accounts.

(2) It is the statement that shows a summary of all business transactions recorded in the ledger accounts and reveals the net position at glance.

(3) To ensure that the preparation of Journal and Ledger are based on the principles of double entry system.

(4) To have a basis for preparation of income statements such as Trading, Profit and Loss Accounts.

Errors Not Disclosed by Trial Balance

The statement of Trial Balance is not a final and conclusive proof of the complete correctness of books. This is because, there are certain errors in the books of accounts which may be committed while recording, classifying or summarizing the financial transactions which are not disclosed by the trial balance. The following are some of the errors which will not affect the agreement of Trial Balance:

Classification of Errors

Errors can be classified on the basis of its nature :

I. Errors of Omission.

II. Errors of Commission.

III. Errors of Principles.

IV. Compensating Errors.

I. Errors of Omission : Errors of Omission refers to recording the transaction which is completely omitted in the books of journal or subsidiary books. Therefore errors are not disclosed by trial balance due to the transactions not being recorded and omitted in the book of original entry.

II. Errors of Commission : Errors of Commission may be occurred by wrong recording in the books of original entry. The committed errors arise due to the negligence of the Accountant while recording, totaling, carrying forward and balancing the accounting process. Therefore errors not disclosed by Trial Balance due to the errors committed by the negligence of the Accountants. The errors of commission may arise due to the following ways :

(1) Entering the wrong amount to the correct side of correct subsidiary books

(2) Entering the correct amount to the wrong side of correct subsidiary books

(3) Entering the correct amount to the correct side of wrong subsidiary books

(4) Posting wrong amount to the correct side of the accounts

(5) Posting correct amount to the wrong side of the accounts

(6) Posting to the correct side of the account but making double posting.

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III. Errors of Principles : Transactions are recorded on the basis of the fundamental principles of double entry system of accounting. Errors of principles arise due to ignorance of the principles of accounting. Such errors do not affect the agreement of trial balance. The errors of principles occur due to the following ways :

(1) Errors committed due to inability to properly allocate between revenue and capital items.

(2) Errors committed due to inability to make the difference between capital expenditure and revenue expenditure.

(3) Errors committed due to inability to make the difference between productive expenses and unproductive expenses.

IV. Compensating Errors : Compensating errors refer to those errors which are compensated by each other. In other words, the effect of one error is compensated by the other. Such errors which do not affect the agreement of the trial balance. For example, if wage paid Rs. 1,000 is debited in the Wage Account at Rs. 1,500 and dividend received Rs. 1,500 is credited in the Dividend Account at Rs. 2,000, the excess debit in Wage Account is compensated by an excess credit of Rs. 500 in Dividend Account.

Errors Disclosed by Trial Balance

A Trial Balance disclosed any errors due to affect the one side of account. The following are the examples of errors disclosed by the trial balance :

(a) Errors committed in casting the books of subsidiary books.

(b) Errors committed in carrying forward the total amount from one page to another.

(c) Errors committed during posting from the books of journal or subsidiary books to ledger.

(d) Errors committed in balancing the ledger accounts.

(e) Errors committed during preparation of debtors' and creditors' list of accounts.

(f) Errors committed due to ignorance in carrying forward a balance of an account to the Trial Balance.

Location of Errors

If the trial balance disagrees, it is essential to find out errors before proceeding further. The following is the usual procedure adopted to find out the errors :

(1) Check the total of two side of the trial balance once again.

(2) Divide the difference of the two sides of the trial balance by two and find out whether there appears an entry for the same amount either sides of the trial balance. It is possible that a balance may have been recorded in the wrong side of the trial balance thus resulting in the difference of double the amount.

(3) If the mistake is not located by the first step then divide difference by 9. If the difference is evenly divisible by 9, the error can be an error of transposition of figure. For example, if Rs. 816 is written as Rs. 618 the difference is Rs. 198, and Rs. 198 is evenly divisible by 9. Thus, it can be concluded that where the difference is divisible by 9 there can be a possibility of this type of error.

(4) Check the list of total balances of all debtors and creditors to find out the errors.

(5) Check whether balances of cash and balances of bank have been taken in the trial balance or not.

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(6) Check the totals of different ledger accounts and carry forward to trial balances.

(7) See the casting and carrying forward of subsidiary books.

(8) Check the posting from the subsidiary books to ledger.

Suspense Account

If the efforts are not to locate the errors, the difference of the trial balance is temporarily transferred to the Suspense Account. This is made because, the preparation of financial statements cannot be delayed further. In Suspense Account all those errors can be rectified only by making suitable journal entries.

Methods of Preparation of Trial Balance

The following are the two methods of preparing the Trial Balance :

I. Total Method.

II. Balance Method.

I. Total Method: Under this method, the total of debits and credits of all accounts are shown in the respective debit and credit side of the trial balance.

II. Balance Method: In this method, only balance of each account of ledger is recorded in trial balance. In other words, all the list of debit balances recorded in one column and the list of credit balances recorded in the other. Of the two methods, this method is very widely used in practice.

Specimen Ruling of Trial Balance

The following is the specimen ruling of Trial Balance:

Trial Balance as on Mrs. I. M. Pandey's Book

S. No.	*Name of Accounts*	*L.F.*	*Debit Balance Rs.*	*Credit Balance Rs.*

Illustration: 10

From the accounts prepared in illustration 7, of Chapter 3 [Accounting Books and Records], you are required to prepare a Trial Balance :

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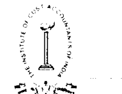
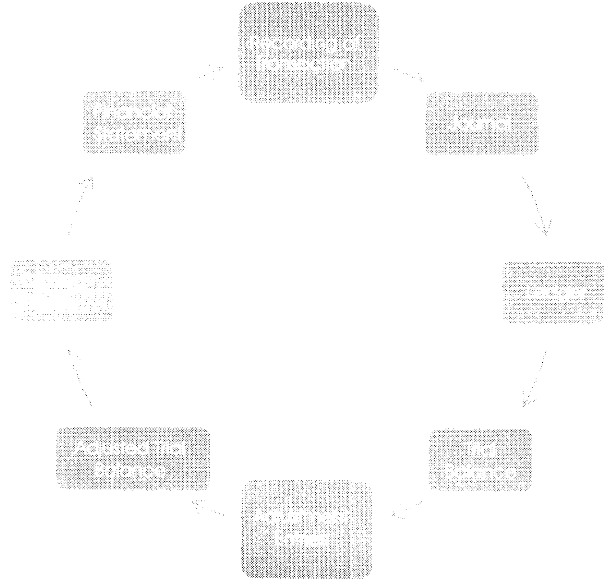


1.3 ACCOUNTING CYCLE

When complete sequence of accounting procedure is done which happens frequently and repeated in same directions during an accounting period, the same is called an accounting cycle.

Steps/Phases of Accounting Cycle

The steps or phases of accounting cycle can be depicted as under:



ACCOUNTING CYCLE

a) **Recording of Transaction:-** As soon as a transaction happens it is at first recorded in subsidiary books.

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 closing balances, a Trial Balance is prepared at the end of the period for the preparation 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 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.

1.4 OBJECTIVES OF ACCOUNTING

The main objective of Accounting is to provide financial information to stakeholders. This financial information is normally given via financial statements, which are prepared on the basis of Generally Accepted Accounting Principles (GAAP). There are various accounting standards developed by professional accounting bodies all over the world. In India, these are governed by The Institute of Chartered Accountants of India, (ICAI). In the US, the American Institute of Certified Public Accountants

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MULTIPLE-CHOICE QUESTIONS

1. Which of these statements about A **trial balance** is true:
(a) is a list of accounts with their balances at a given time.
(b) proves that proper account titles were used.
(c) will not balance if a correct journal entry is posted twice.
(d) proves that all transactions have been recorded.

2. Which of these statements about a **journal** is false?
(a) It contains only revenue and expense accounts.
(b) It provides a chronological record of transactions.
(c) It helps to locate errors because the debit and credit amounts for each entry can be readily compared.
(d) It discloses in one place the complete effect of a transaction.

3. Which of these statements about **Posting** is true:
(a) normally occurs before journalizing.
(b) transfers ledger transaction data to the journal.
(c) is an optional step in the recording process.
(d) transfers journal entries to ledger accounts.

4. Which is not part of the **recording** process?
(a) Analyzing transactions. (b) Preparing an income statement.
(c) Entering transactions in a journal. (d) Posting journal entries.

5. Which of these statements about A **ledger** is true:
(a) contains only asset and liability accounts.
(b) should show accounts in alphabetical order.
(c) is a collection of the entire group of accounts maintained by a company.
(d) provides a chronological record of transactions.

TEST YOUR KNOWLEDGE

1. Fill up the gaps with one of the given words :

(a) Excess of debit over credit is called .... balance. (Debit / Credit)
(b) The process of recording a transaction in Ledger is called .... (Journalising/ Posting)
(c) While balancing an account the difference of the two sides is recorded on .... side. (Larger / Smaller)
(d) Expenses normally show .... balance. (Debit / Credit)
(e) Liabilities normally show .... balance. (Debit / Credit)

Complete the following words.

This company has supplied goods but has not received any money for them yet.	CREDITOR
Companies make this when they sell their goods for more than it costs them to make them.	P _ _ _ _ T
Companies make this when they sell their goods for less than it costs them to make them.	L _ _ S
Goods which are bought by the company.	P _ _ _ _ _ _ E S
Goods which the company has available to sell.	S _ _ _ K
An amount of money which is taken out of an account.	W _ _ _ D _ _ _ _ L
Customers who have received goods but not paid for them yet.	D _ _ _ _ R S
A reduction in the price which is offered to customers.	D C T
This is the name of the difference between the credit and debit sides of an account.	B _ _ _ _ _ E

This is drawn up to check that the two sides of the accounts are the same.	T _ _ _ L B _ _ _ _ _ E
The cost of transporting goods is called this.	C _ _ _ _ _ G E
The official books for keeping accounts.	L_D _ _ _ S

FINANCIAL STATEMENTS

Financial information is conveyed to users in a variety of reports (statements) and schedules. There are so many parties who are interested in these reports, e.g. owner, management, creditors, research scholars, Government authorities etc. Generally, reports to internal users (management) are specially designed to meet their particular needs. Reports to external users tend to be more standardized and are often referred to as "**Financial Statements**". Traditionally, two principal statements are prepared for business concerns:-

(a) An income statement (Trading a Profit and Loss A/c) which is prepared to ascertain the net income (net profit) or net loss of the business for a specific accounting period and

(b) *A balance sheet, which is* prepared to know the financial position of a business on a particular date.

INCOME STATEMENT:

An income statement shows the results of operating for a period of time. It is sometimes called an operating statement or statement of operations, It shows how well an organisation performed during the period covered.

The terms, revenue, expense and profit should be somewhat familiar to you already. *Revenue* is the inflow of assets in return for services performed or products delivered during a period; an *expense* is a sacrifice, or cost, incurred to generate (produce) revenue; *net profit* is simply the amount by which the revenues for a particular period of time exceed the expenses incurred to generate them.

Revenues generally considered earned when services are performed or goods are sold, regardless of when money is actually received. In other words, revenues are identified with the period in which they are earned. For example, a retail trader earns 'revenue' when a sale is made on credit. A right to receive money is recongnized as an "*account receivable*". An account receivable (Debtor A/c) is an asset that will eventually be converted to cash.

Expenses are also recognized in the period that is benefited, regardless of when payment is made in cash. For example, salaries earned by employees are considered an expense of the period in which employees work, even though they may not be paid in cash until the following period.

Thus the amount by which the revenues for a particular period of time exceed the expenses incurred to generate them is called net income (net profit).

For example suppose during the month of January, a trader has a total revenue (sales) of Rs. 55,000 and has incurred total expenses of Rs. 46000, his net income will be Rs. 9000 (55000-46000) for the month of January.

Thus an income statement is a statement in which revenues for a period of time are matched with expenses for the same period of time. If revenues exceed the expenses, the result is *net income*, and if expenses exceed the revenues, the result is *net loss*.

The format of an income statement varies with the needs of users, preferences of accountants and other circumstances. The format of a common income statement is given below.

NAME OF BUSINESS

INCOME STATEMENT

for the year ended........

	Rs.	Rs.	Rs.	Rs.
			525000	
Sales		6500		
Less: { Sales Discounts		8500	15000	
Less: { Sales returns & allowances				
				510,000
Net sales				
Less cost of goods sold:			35000	
Merchandise inventory (opening)		320000		
Purchases	5000			
Less: Purchase discounts	3000	8000		
Purchase returns & allowances		312000		
Net Purchases		12500		
Plus: Carriage Inwards			324500	
Delivered cost of net purchases			359500	
Cost of goods available for sale			37500	
Less Merchandise Inventory (closing)				322000
Cost of goods sold				188000
Gross profit				
Less operating expenses:			91600	
Salaries			7000	
Advertising			8500	
Depreciation				107100
Total operating expenses				80900
Net operating income:				
Plus: other revenue:				2500
Commission received				83400
				900
Less other expenses: interest:				82500
Net income:				

DIFFERENT ITEMS OF INCOME STATEMENT

1. **SALES:**

   It is the gross amount of goods sold or services performed during an accounting period.

2. **NET SALES:**

   When sales discount, sales returns and allowances to customers are deducted or subtracted from sales (Gross Sales), the result is '*net sales*'.

3. COST OF GOODS SOLD:

It represents the sum of the costs of all goods which have been sold during the accounting period. It is ascertained by adding the value of unsold goods at the beginning of the year (opening inventory or stock) to the purchases made during the year and the deducting the values of unsold goods at the end of the year (closing inventory or stock) from the purchases. These are expired costs, and thus are actually expenses for the year.

It must be noted that purchases price of goods includes not only the cost price of goods but also all expenses connected with the purchases, such as freight inwards carriage, wages, customs duty etc. These expenses are collectively known as Direct Expenses. In determining cost of goods sold net purchases are taken into account. When all direct expenses are added to the purchase price of goods and purchases returns are deducted from purchases, the result is *net purchases*:

So, the schedule of cost of goods sold will be as follows;

COST OF GOODS SOLD:

Merchandise Inventory (goods) opening		xx
Add: Purchases	xx	
Less returns & allowances and discount	xx	
	xx	
Add: Direct expenses:	xx	xx
Cost of goods available for sale		xxx
Less: Merchandise Inventory (closing)......		xx
Cost of goods sold:		xx

For example, suppose:

(a)	Merchandise inventory on 1st Jan. 1991 was	Rs. 9100
(b)	Purchases during the year, 1991	Rs. 170,000
(c)	Purchases returns.	Rs. 2000
(d)	Purchases discount and allowances:	Rs. 1000
(e)	Transportation inwards	Rs. 5000
(f)	Customs duty etc.	Rs. 7000
(g)	Merchandise Inventory on 31st December, 1991	Rs. 10300

The cost of goods sold will be determined in the following way:

Merchandise inventory on 1.1.1991		Rs. 9100
Add purchases.....	170,000	
Less purchases returns:	2000	
	168000	
Less Purchases discount and allowances.	1000	
	167000	
Add: Direct expenses (5000 + 7000)	12000	179000
Cost of goods available for sale		188100
Less Merchandise inventory on 31.12.1991		10300
Cost of goods sold....		177800

4. GROSS PROFIT:

Merchandisers (Traders) naturally try to sell goods at a price more than the cost price. *Gross profit or gross margin,* is what remains after cost of goods sold is deducted from net sales. This is the margin that is available to cover the other expenses for a period and to yield net income, if there is any.

G.P = Net sales -- Cost of goods sold:

5. OPERATING EXPENSES:

Merchandising (Trading) concerns incur operating expenses in addition to cost of goods sold. So, the expenses which are incurred for the generation of revenues from the sales of goods are called *Operating expenses*. Operating expenses may be divided into two:

(a) **Selling Expenses:**

All expenses regarding sale of goods and sending them to the buyers belong to this class. e.g. Carriage outwards, Advertisements, Salesmen's Salaries, Salesmen's Commission, Travelling Expenses, Bad debts, Packing expenses etc.

(b) **Administrative Expenses:**

All expenses connected with the office and its conduct are called 'Administrative expenses' e.g., office salaries, office rent, electric charges, postage & Telegrams, Telephones, Printing & Stationery etc.

6. NET OPERATING INCOME:

Operating expenses are deducted from gross profit to arrive at net operating income. Net *operating income* is what is left after both cost of goods sold and operating expenses for a period have been deducted from net sales. For a merchandising concern, it is what has been earned from the normal operations of buying and selling merchandises.

Net operating Income = Gross profit - Operating expenses.

Or Net operating Income = Net sales - Cost of goods sold - Operating expenses:

7. OTHER REVENUES AND EXPENSES:

Non-sales revenues (which have not been earned by selling merchandise) and non-operating expenses are reported towards the bottom of an income statement under the heading, *other revenues and expenses*. Included in other revenues are revenue from rentals (rent received), Interest income (interest received), gain on sales of assets other than merchandise and other miscellaneous revenue items. Under other expenses are interest on borrowed money, losses on sales of assets other than merchandise, and other non-operating expenses and losses.

8. NET INCOME:

Other revenues are added to and other expenses are deducted from, net operating income to arrive at net income. N*et Income* is what is left after the other revenues have been added to net operating income and other expenses have been deducted from it.

Net Income = Net operating income + other revenues - other expenses

Or Net Income = Net Sales - Cost of goods sold - operating expenses
+ other revenues - other expenses.

SERVICE ENTERPRISES:

Service enterprises are the business concerns which are engaged to perform or provide services only. They do not deal with the purchase and sale of merchandise (goods). Their major source of revenue is fees, commission, rent or interest etc. which they receive from their customers or clients against the services provided to them. For example, Dectors, Lawyers, chartered firms, workshops etc.

The income statement for a service enterprise is prepared in the same way as we prepare for merchandising concerns except that the nature of revenues and expenses is different.

BALANCE SHEET:

Balance sheet shows the financial position or condition of an organisation at a particular point in time. In fact, it is sometimes referred to as a *position statement or a statement of condition.*

It shows the economic resources (properties, possessions) of an organisation, referred to as assets, and the claims that creditors and owners have against the assets. Economic obligations of an organisation (amount owed to creditors) are called *liabilities,* and owners' claims are referred to as *owners' equity, or capital,*

A common arrangement of the balance sheet is to list assets on the left side and liabilities and owner's equity on the right. This balances arrangement, with assets and equities (liabilities) side by side, is sometimes referred to as the *account form of balance sheet,* because it resembles the traditional T-form of an account.

An alternative arrangement, sometimes called the report form of balance sheet, centres the asset section under the heading, with the equity claims shown below the asset. The report form frequently fits on a standard sheet of paper better than the account form.

You may recall that assets are normally listed on a balance sheet in the order of their relative nearness to cash. For example, the Accounts Receivable (Sundry Debtors) account usually follows the cash account because the accounts receivable are likely to turn into cash very soon. On the other hand, assets like Land and Buildings are normally listed towards the end, because they are expected to be around a long time. So, the balance sheet that divides its accounts into subgroups within the major sections of the statement is called, *a classified balance sheet.* Generally assets are divided into two groups, current and non-current. Current assets are cash and other assets that are relatively close to being cash. In practice, an asset is classified as current if it can meet any of the following conditions within the year:

(a) If it can reasonably be expected to turn into cash.

(b) If it can easily be converted to cash by the managers of the entity.

(c) If it can take the place of cash (as with prepaid expenses).

When assets are divided into current and non-current groups, it is common practice to classify liabilities in a similar way. *Current liabilities* are liabilities that can reasonably be expected to be paid within one year. Naturally, the liabilities that are not expected to be paid within one year are referred to as *non-current liabilities*:

The format of a Balance Sheet in report form is given below:

NAME OF BUSINESS...

Balance sheet as at...

	Rs.	Rs.	Rs.
Assets:			
Current:			
Cash		2580	
Accounts receivable		2180	
Supplies		1520	
Total current assets:			6280
Non current:			
Land		6000	
Building	48000		
Less: accumulated depreciation	14800	33200	
Total non-current assets			39200
Total Assets			45480
Liabilities			
Current:			
Accounts payable and interest payable:	790		
Wages Payable:	50		
Total current Liabilities			840
Non-Current and owner's Equity			
Notes Payable (Bills Payable)		10000	
Owner's equity (capital):		34640	44640
Total liabilities and owner's equity.			45480

DIFFERENCE BETWEEN INCOME STATEMENT AND TRADING AND PROFIT AND LOSS ACCOUNT:

Both income statement and trading and profit and loss account are prepared to ascertain the net result of the business concerns. Some business concerns who have adopted British Accounting System, prepare Trading and profit and loss account to determine the net results of the business, while some others who have adopted American Accounting System, prepare income statement for the same purpose. Different terms are used under the two systems of accounting. Some American terms are given below which are equivalent to British terms.

QUESTIONS

1. What do you mean by Financial Statements? Why are these statements prepared?
2. What do you mean by cost of goods sold? How is it determined?
3. Explain and give the format of Income Statement, Balance Sheet and Cost of Goods Sold.

PROBLEMS

1. Ascertain the cost of goods sold from the following particulars:

		Rs.
(i)	Opening Merchandise Inventory	19500
(ii)	Purchases (gross)	150,000
(iii)	Purchases Discounts	3500
(iv)	Purchases returns and allowances	2900
(v)	Freight Inwards	7000
(vi)	Customs duty and clearing charges	2700
(vii)	Closing Merchandise inventory	30900

Ans: *[Cost of goods sold = Rs. 141900]*

2. Ascertain the gross income from the following particulars:

	Rs.
Purchases during the year, 1990	350,000
Purchases discounts	3700
Purchases returns and allowances:	2050
Sales: 470,000	
Sales discount	1500
Sales returns and allowances:	2200
Merchandise inventory on 1.1.1990	50500
Merchandise inventory on 31.12.1990	30,800
Transportation Inwards:	9500

Ans: *[Gross Income Rs. 92850]*

3. The following balances are extracted from the books of Asif & Bros. for the year ended 31st December, 1991. You are required to prepare an income statement for the year ended 31.12.1990.

	Rs.
Merchandise inventory on 1.1.90	36000
Purchases	140,000
Purchases discounts	3000
Purchases returns and allowances	2500
Sales	175000

Sales discounts	1200
Sales returns and allowances	1600
Carriage inwards	800
Wages:	1500
Sales Salaries	15000
Advertising expenses:	9600
Utilities expenses:	7000
Insurance:	950
Rent, rates and taxes	2300
Commission to salesmen:	1900

The Merchandise inventory on 31.12.1990 was valued at Rs. 53000:

Ans: *[Gross profit Rs. 52400; Net income Rs. 15650]*

4. The following Trial Balance was extracted from the books of Naeem & Sons on 31st March, 2000. From this you are required to prepare an income statement for the year ended on 31.3.2000 and a Balance Sheet as at that date:

Trial Balance On 31.3. 2000

	Dr. Rs.	Cr. Rs.
Cash	5000	
Account Receivable	9000	
Merchandise inventory on 1.4.1989	6000	
Plant and Machinery	24000	
Land and Building	82000	
Furniture and Fixtures	2600	
Capital:		136000
Accounts payable		3800
Purchases:	60,000	
Purchases returns and allowances		2200
Discount on purchases:		600
Sales:		70,000
Sales returns and allowances	3000	
Sales Discount	1600	
Insurance prepaid:	3400	
Advertisement expenses	4000	
Salaries expenses:	12000	
	212600	212600

ADDITIONAL INFORMATION:

1. Prepaid insurance on 31.3.2000 is Rs. 1400
2. Outstanding salaries Rs. 1000.
3. Depreciation on plant and machinery @ 10% p.a.
4. Merchandise inventory on 31.3.2000 was valued at Rs. 6000.

Ans: *[G.P. Rs. 8200, Net loss Rs. 13200; B/S 127600]*

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1.14 ACCRUAL BASIS AND CASH BASIS OF ACCOUNTING

(i) Accrual Basis of Accounting

Accrual Basis of Accounting is a method of recording transactions by which revenue, costs, assets and liabilities are reflected in the accounts for the period in which they accrue. This basis includes consideration relating to deferrals, allocations, depreciation and amortization. This basis is also referred to as mercantile basis of accounting. Under the Companies Act 1956, all companies are required to maintain the books of accounts according to accrual basis of accounting

(ii) Cash Basis of Accounting

Cash Basis of Accounting is a method of recording transactions by which revenues, costs, assets and liabilities are reflected in the accounts for the period in which actual receipts or actual payments are made.

Accrual- vs. Cash-Basis Accounting

Study Objective [2]
Explain the accrual basis of accounting.

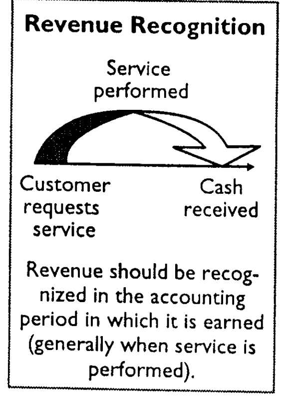
What you will learn in this chapter is **accrual-basis accounting**. Under the accrual basis, companies record transactions that change a company's financial statements **in the periods in which the events occur.** For example, using the accrual basis to determine net income means companies recognize revenues when earned (rather than when they receive cash). It also means recognizing expenses when incurred (rather than when paid).

An alternative to the accrual basis is the cash basis. Under **cash-basis accounting**, companies record revenue when they receive cash. They record an expense when they pay out cash. The cash basis seems appealing due to its simplicity, but it often produces misleading financial statements. It fails to record revenue that a company has earned but for which it has not received the cash. Also, it does not match expenses with earned revenues. **Cash-basis accounting is not in accordance with generally accepted accounting principles (GAAP).**

Individuals and some small companies do use cash-basis accounting. The cash basis is justified for small businesses because they often have few receivables and payables. Medium and large companies use accrual-basis accounting.

Recognizing Revenues and Expenses

It can be difficult to determine the amount of revenues and expenses to report in a given accounting period. Two principles help in this task: the revenue recognition principle and the expense recognition principle.



Revenue should be recognized in the accounting period in which it is earned (generally when service is performed).

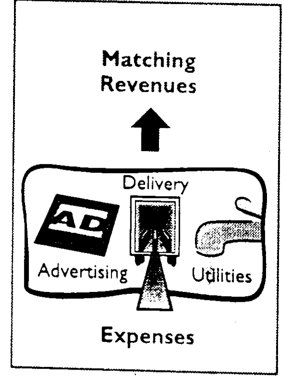
REVENUE RECOGNITION PRINCIPLE

The **revenue recognition principle** requires that companies recognize revenue in the accounting period **in which it is earned.** In a service enterprise, revenue is considered to be earned at the time the service is performed. To illustrate, assume that Dave's Dry Cleaning cleans clothing on June 30 but customers do not claim and pay for their clothes until the first week of July. Under the revenue recognition principle, Dave's earns revenue in June when it performed the service, rather than in July when it received the cash. At June 30, Dave's would report a receivable on its balance sheet and revenue in its income statement for the service performed.

EXPENSE RECOGNITION PRINCIPLE

Accountants follow a simple rule in recognizing expenses: "Let the expenses follow the revenues." Thus, expense recognition is tied to revenue recognition. In the dry cleaning example, this means that Dave's should report the salary expense incurred in performing the June 30 cleaning service in the same period in which it recognizes the service revenue. The critical issue in expense recognition is when the expense makes its contribution to revenue. This may or may not be the same period in which the expense is paid. If Dave's does not pay the salary incurred on June 30 until July, it would report salaries payable on its June 30 balance sheet.

This practice of expense recognition is referred to as the **expense recognition principle** (often referred to as the **matching principle**). It dictates that efforts (expenses) be matched with results (revenues). Illustration 3-1 (page 102) summarizes the revenue and expense recognition principles.



Adjusting entries are necessary because the **trial balance**—the first pulling together of the transaction data—may not contain up-to-date and complete data. This is true for several reasons:

1. Some events are not recorded daily because it is not efficient to do so. Examples are the use of supplies and the earning of wages by employees.
2. Some costs are not recorded during the accounting period because these costs expire with the passage of time rather than as a result of recurring daily transactions. Examples are charges related to the use of buildings and equipment, rent, and insurance.
3. Some items may be unrecorded. An example is a utility service bill that will not be received until the next accounting period.

Adjusting entries are required every time a company prepares financial statements. The company analyzes each account in the trial balance to determine whether it is complete and up to date for financial statement purposes. **Every adjusting entry will include one income statement account and one balance sheet account.**

International Note

Internal controls are a system of checks and balances designed to detect and prevent fraud and errors. The Sarbanes-Oxley Act requires U.S. companies to enhance their systems of internal control. However, many foreign companies do not have to meet strict internal control requirements. Some U.S. companies believe that this gives foreign firms an unfair advantage because developing and maintaining internal controls can be very expensive.

Types of Adjusting Entries

Adjusting entries are classified as either **deferrals** or **accruals**. As Illustration 3-2 shows, each of these classes has two subcategories.

Deferrals:

1. Prepaid expenses: Expenses paid in cash before they are used or consumed.
2. Unearned revenues: Cash received before services are performed.

Accruals:

1. Accrued revenues: Revenues for services performed but not yet received in cash or recorded.
2. Accrued expenses: Expenses incurred but not yet paid in cash or recorded.

Illustration 3-2
Categories of adjusting entries

Table 1. Comparison Between Accrual and Cash Basis of Accounting

Key Attributes	Cash Basis	Accrual Basis
Definition	Accounting method in which revenue is recorded when payment is received and expenses are recorded when payment is made.	Accounting method in which revenue is recorded when it is earned and expenses are recorded when they are incurred, regardless of when payment is received.
Income Recognized	When payment is received.	When product is delivered or service is performed.
Expenses Recognized	When paid.	When incurred.
Use with Accounts Payables and Receivables	Balance sheet does not report payables and receivables.	Balance sheet does report payables and receivables.
Partial Payment or Receipt of Payment	No method of tracking partial payment or receipt of payment is available.	Revenues and expenses are recorded in full, even though partial payments may be made over extended periods.
Uncollectible Accounts	Not reported on cash basis financial statements.	Reported if material to the proper presentation of the financial statements under accrual basis of reporting.
Inventory Tracking	With some exceptions, inventory is not tracked.	Tracks the use of inventory to record revenue and expenses.
Compliance with GAAP	Does not meet GAAP requirements.	Meets GAAP requirements.
Record Keeping Time	Less than accrual basis.	More than cash basis.
Advantages	Generally, an easier method for smaller entities and for entities that conduct business primarily in cash as opposed to credit.	Provides more information regarding revenue and expenses of an entity; accounting for outstanding commitments and prepaid cash receipts, this method allows for more accurate measurement of net income or loss.

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Let's look at a simple example that illustrates the differences between the two methods of accounting. Suppose Pointz Corporation has the following transactions during July 2014:

1. Provides services to a customer for $500 in cash.
2. Provides services to a customer for $800 on account.
3. Pays employees' salaries of $450 in cash.
4. Receives a $50 hydro bill for electricity used during July.

The income statements for Pointz Corporation under the accrual basis and the cash basis of accounting appear as follows:

Pointz Corporation
Income Statement Using Accrual Accounting
For the Month Ended July 31, 2014

Revenue	$1,300
Expenses:	
Salaries	450
Hydro	50
Net income	$ 800

Pointz Corporation
Income Statement Using Cash-Basis Accounting
For the Month Ended July 31, 2014

Revenue	$500
Expenses:	
Salaries	450
Hydro	0
Net income	$ 50

Illustration 7.

Mr. Anil Roy, a junior lawyer, provides the following particulars for the year ended 31st December, 2012:

	₹
Fees received in cash in 2012	60,000
Salary paid to Staff in 2012	8,000
Rent of office in 2012	14,000
Magazine and Journal for 2012	1,000
Travelling and Conveyance paid in 2012	3,000
Membership Fees paid in 2012	1,600
Office Expenses paid in 2012	10,000

Additional Information:-

Fees include ₹ 3,000 in respect of 2011and fees not yet received is ₹ 7,000.

Office rent includes ₹ 4,000 for previous year and rent of ₹ 2,000 not yet paid.

Membership fees is paid for 2 years.

Compute his net income for the year 2012, under – (a) Cash Basis, (b) Accrual Basis and (c) Mixed or Hybrid Basis.

Solution

(i)

Mr. Anil Roy

Statement of Income (Cash Basis)

For the year ended 31st December, 2012

Particulars	Amount (₹)	Amount (₹)
Fees received		60,000
Less :		
Salary	8,000	
Office Rent	14,000	
Magazine & Journal	1,000	
Travelling & Conveyance	3,000	
Membership Fees	1,600	
Office Expenses	10,000	37,600
Net Income		22,400

(ii)

Mr. Anil Roy

Statement of Income (Accrual Basis)

For the year ended 31st December, 2012

Particulars		Amount (₹)	Amount (₹)
Fees received		60,000	
Add: Accrued fees for 2012		7,000	
		67,000	
Less: Fees for 2011 received in 2012		3,000	64,000
Less :			
Salary		8,000	
Office Rent	14,000		
Add: Outstanding rent	2,000		
	16,000		
Less: Rent for 2011 paid in 2012	4,000	12,000	
Magazine & Journal		1,000	
Travelling & Conveyance		3,000	
Membership Fees	1,600		
Less: Advance fee paid for 2013 (½ x 1600)	800	800	
Office Expenses		10,000	34,800
Net Income			29,200

(iii)

Mr. Anil Roy

Statement of Income (Mixed or Hybrid Basis)

For the year ended 31st December, 2012

Particulars	Amount (₹)	Amount (₹)	Amount (₹)
Fees received			60,000
Less :			
Salary		8,000	
Office Rent	14,000		
Add: Outstanding rent	2,000		
	16,000		
Less: Fees for 2011	4,000	12,000	
Magazine & Journal		1,000	
Travelling & Conveyance		3,000	
Membership Fees	1,600		
Less: Advance	800	800	
Office Expenses		10,000	34,800
Net Income			25,200

1.14.3 Conversion of Cash Basis of Accounting into Accrual Basis of Accounting:

When accounting is done under Cash Basis and the final accounts are prepared, the same can be converted into Accrual Basis from the beginning of the next financial period. The following procedure should be followed for the purpose.

DO IT!

Timing Concepts

Several timing concepts are discussed on pages 100–101. A list of concepts is provided in the left column below, with a description of the concept in the right column below. There are more descriptions provided than concepts. Match the description of the concept to the concept.

1. ____Accrual-basis accounting.
2. ____Calendar year.
3. ____Time period assumption.
4. ____Expense recognition principle.
5. —— interim Periods.
6. —— Cash-basis accounting

(a) Monthly and quarterly time periods.
(b) Efforts (expenses) should be matched with results (revenues).
(c) Accountants divide the economic life of a business into artificial time periods.
(d) Companies record revenues when they receive cash and record expenses when they pay out cash.
(e) An accounting time period that starts on January 1 and ends on December 31.
(f) Companies record transactions in the period in which the events occur.

Action Plan

✔ Review the glossary terms identified on page 124.

✔ Study carefully the revenue recognition principle, the expense recognition principle, and the time period assumption.

Solution

1. f **2.** e **3.** c **4.** b

Related exercise material: **E3-1, E3-2, E3-3, and DO IT! 3-1.**

✔

GLOSSARY

Accrual-basis accounting Accounting basis in which companies record transactions that change a company's financial statements in the periods in which the events occur. (p. 100).

Accruals Adjusting entries for either accrued revenues or accrued expenses. (p. 103).

Accrued expenses Expenses incurred but not yet paid in cash or recorded. (p. 112).

Accrued revenues Revenues for services performed but not yet received in cash or recorded. (p. 110).

Adjusted trial balance A list of accounts and their balances after the company has made all adjustments. (p. 119).

Adjusting entries Entries made at the end of an accounting period to ensure that companies follow the revenue recognition and expense recognition principles. (p. 102).

Book value The difference between the cost of a depreciable asset and its related accumulated depreciation. (p. 107).

Calendar year An accounting period that extends from January 1 to December 31. (p. 100).

Cash-basis accounting Accounting basis in which companies record revenue when they receive cash and an expense when they pay cash. (p. 100).

Contra asset account An account offset against an asset account on the balance sheet. (p. 106).

Deferrals Adjusting entries for either prepaid expenses or unearned revenues. (p. 103).

Depreciation The process of allocating the cost of an asset to expense over its useful life. (p. 106).

Expense recognition principle (matching principle) The principle that companies match efforts (expenses) with accomplishments (revenues). (p. 101).

Fiscal year An accounting period that is one year in length. (p. 100).

Interim periods Monthly or quarterly accounting time periods. (p. 100).

Prepaid expenses (prepayments) Expenses paid in cash before they are used or consumed. (p. 104).

Revenue recognition principle The principle that companies recognize revenue in the accounting period in which the performance obligation is satisfied. (p. 101).

Time period assumption An assumption that accountants can divide the economic life of a business into artificial time periods. (p. 100).

Unearned revenues A liability recorded for cash received before services are performed. (p. 108).

Useful life The length of service of a long-lived asset. (p. 106).

Q1: The following data relate to Jones Company for the year ended December 31, 1999:

Sales on credit	$80,000
Cost of inventory sold on credit	65,000
Collections from customers	60,000
Purchase of inventory on credit	50,000
Payment for purchases	55,000
Cash collections for common stock	30,000
Dividends paid	10,000
Payment to salesclerk	10,000

Required

a. Determine income on an accrual basis.

b. Determine income on a cash basis.

Q2: Primo Industries collected $105,000 from customers in 2014. Of the amount collected, $25,000 was for services performed in 2013. In addition, Primo performed services worth $40,000 in 2014, which will not be collected until 2015.
Primo Industries also paid $72,000 for expenses in 2014. Of the amount paid, $30,000 was for expenses incurred on account in 2013. In addition, Primo incurred $42,000 of expenses in 2014, which will not be paid until 2015.

Instructions

(a) Compute 2014 cash-basis net income.

(b) Compute 2014 accrual-basis net income.

MULTIPLE-CHOICE QUESTIONS

1 . Which of the following statements about the accrual basis of accounting is **false**?

(a) Events that change a company's financial statements are recorded in the periods in which the events occur.

(b) Revenue is recognized in the period in which services are performed.

(c) This basis is in accord with generally accepted accounting principles.

(d) Revenue is recorded only when cash is received, and expense is recorded only when cash is paid.

2. Which of the following is NOT true concerning cash basis accounting?

a. Does not follow GAAP.

b. Records revenue when cash received.

c. Matches expenses with the revenues they help to produce.

d. Records expenses when cash is paid.

3. In order for revenues to be recorded in the period in which they are earned, and for expenses to be recognized in the period in which they are incurred:

a. adjusting entries are made. b. cash basis accounting is used.

c. closing entries are made. d. none of the above.

4. The principle or assumption dictating that efforts (expenses) be matched with accomplishments (revenues) is the:

(a) expense recognition principle. **(b)** cost assumption.

(c) time period assumption. **(d)** revenue recognition principle.

5. Unearned revenues are:

a. prepayments. b. liabilities. c. temporary accounts. d. both a and b.

6. All of the following are examples of prepaid expenses except:

a. prepaid rent. b. prepaid insurance. c. supplies. d. unearned revenues.

7. Under the accrual method, expenses are recognized

a. when cash is paid. b. at the end of the accounting period.

c. when they are incurred. d. when revenue is earned.

8. A landscaping business signs a contract with a new customer on April 1. New trees are planted for the customer on May 1, and the bill for the services is paid on June 1. Under the accrual basis, the business should recognize revenue on

a. April 1. b. May 1. c. June 1. d. December 31.

9. Under the revenue recognition principle, revenues are recognized

a. when they are realized, or realizable, and earned. b. when cash is received.

c. when expenses are incurred. d. at the end of the accounting period.

10. Which of the following would result in the recognition of revenue?

a. A manufacturer delivers a component to a supplier.

b. A retailer sells a product to a consumer.

c. A bank provides a service to a customer.

d. All of the above would result in the recognition of revenue.

TRANSACTIONS AND ACCOUNTING EQUATION

The main function of an accountant is to record properly the financial transactions of a business concern in the books of accounts and to ascertain its true result at the year end. Thus transaction is the foundation of accounting - the first and formest element of accounting. In a word, it is the life and blood of Accounting. Hence the accountant must have a fair idea about the term "transaction."

In ordinary language "transaction" means exchange of something. But in Accounting it is used in a special sense. ***If the financial position of a business concern changes on the happening of an event which is measurable in terms of money, that event is regarded as a "transaction" in Accounting.***

Or

A business event which can be measured in terms of money and which must be recorded in books of account is called a "transaction".

WHAT IS AN EVENT?

EVENT:

In ordinary language "Event" means anything that happens. Human life is full of events. So many events take place in the family and social life of a person. The events may be classified into two:

(a) **Monetary Events:**

Events which are related with money, i.e. which change the financial position of a person are known as "monetary events". For example, daily shopping, marriage ceremony, birthday anniversary, marriage anniversary etc.

(b) **Non-Monetary Events:**

Events which are not related with money i.e. which do not change the financial position of a person are known as "non-monetary events". For example, winning a game, delivering a lecture in a meeting etc.

In business accounting only those events which change the financial position of the business and which call for accounting are recognised as "Events". In other words, all monetary events are regarded as "business transactions."

Remember, it is not that anything which results in exchange of something will be regarded as transaction. On the other hand, something may be regarded as a transaction even though it involves no exchange. For example, Rehman sends a price-list to his customer, Akram. This involves exchange of price-list between Rehman and Akram, yet it is not regarded as a transaction, because it is not measurable in terms of money and it does not change the financial position of both the persons. Again, suppose, goods worth Rs. 1000 are destroyed by fire. This does not involve any exchange, yet it is regarded as a transaction, because it is measurable in terms of money and it changes the financial position of the business

It must be noted that an event, although measurable in terms of money, may not be regarded as a transaction. For example, we receive an order for supply of goods worth Rs. 1000. Although it is measurable in terms of money, it is not regarded as a transaction, since it has not changed the financial position. It will, however, be regard as a transaction when the goods are supplied according to the order.

It appears from the above discussion that the following two conditions must be satisfied in order that an event may be regarded as a transaction in Accounting;

1. The event must be measurable in terms of money.
2. The financial position of the business must change on account of that event.

FEATURES:

To become a transaction an event must have the following features;

1. THERE MUST BE TWO PARTIES:

No transaction is possible without two parties. Just as it takes two hands to clap, so it takes two parties for a transaction to take place. There cannot be a giver unless there is a receiver. Suppose, X borrows Rs. 10,000 from a bank. This is a transaction, since there are two parties here - X and bank.

2. THE EVENT MUST BE MEASURABLE IN TERMS OF MONEY:

An event will not be regarded as a transaction, unless it is capable of being measured in terms of money.

3. THE EVENT MUST RESULT IN TRANSFER OF PROPERTY OR SERVICE:

Suppose, we buy a motor-car from Saleem for Rs. 40000. This results in transfer of property from Saleem to us, so it is a transaction. Again suppose, we pay salary to our employee Rs. 2000. This results in transfer of service -- the employee renders service and we receive it. So it is a transaction.

4. THE EVENTS MUST CHANGE THE FINANCIAL POSITION OF THE BUSINESS:

Transaction takes place only when there is a change in the financial position of the business. The change in financial position may be of two kinds:

(a) **Quantitative change:**

This changes the total value of assets and liabilities of a business concern. Suppose, machinery of Rs. 50,000 is destroyed. This reduces the total value of the assets of the business. As a result, the financial position changes and hence it is a transaction.

(b) **Qualitative change:**

This causes increase or decrease in the different elements of assets or liabilities, but the value of total assets and total liabilities remains unchanged. Suppose, we buy machinery worth Rs. 50,000. This results in exchange of properties - cash Rs. 50,000 goes out of our possession and at the same time machinery of an equal value comes into our possession. This does not change the total value of our assets but this causes a qualitative change in our financial position, hence it is a transaction.

CLASSIFICATION

Transactions may be divided into three groups:

1. CASH TRANSACTION:

If the value of a transaction in met is cash immediately, it is called cash transaction. For example we buy furniture for Rs. 2000 from Asif and immediately pay him in cash. It is a cash transaction.

2. CREDIT TRANSACTION:

If the value of the transaction is not met in cash immediately, it is called credit transaction. In the above example, if we do not pay Asif Rs. 2000 immediately, it will be credit transaction.

3. **PAPER TRANSACTION:**

When there is no question of meeting the value of a transaction, it is regarded as a paper transaction. For example, I have lost Rs. 500. This changes my financial position-my properties decrease in value by Rs. 500. But there is no question of meeting the value of such a transaction. This is a paper transaction.

Transactions may again be divided into the following two classes;

1. **EXTERNAL TRANSACTIONS:**

A transaction taking place with an outside person or organisation, is called an external transaction. For example, a machine is purchased for Rs. 20,000 from Kashif Bros. This is an external transaction.

2. **INTERNAL TRANSACTIONS:**

A transaction with which no outside person or institution is involved, is called internal transaction. For example, loss of furniture by fire, decrease in the value of assets on account of use (depreciation) etc.

RULES FOR DECIDING WHETHER A TRANSACTION IS CASH OR CREDIT:

Sometimes transactions are worded in such a way that it becomes difficult to decide whether they are cash or credit transactions. The following rules will make the position clear;

1. **A transaction is regard as a cash transaction if:**

(a) The word "cash" is mentioned in the transaction. For example Bought goods for cash Rs. 5000 from Arshad.

(b) The name of the seller or buyer is not mentioned in the transaction. For example, Bought goods Rs.5000.

2. **A transaction is regarded as a credit transaction if:-**

(a) The words "on credit" or "on account" are mentioned in the transaction. For example, Bought goods Rs. 5000 on credit.

(b) The name of the seller or buyer is mentioned in the transaction and the word "Cash" is not mentioned. For example, Bought goods from Arshad Rs. 5000.

Thus we may conclude from the above discussion that every business transaction brings a double change in the financial position of the business. It brings a change in the assets, liabilities, owner's equity, expenses or revenues of a business.

ILLUSTRATION NO. 1

State with reasons whether the following events are transactions to my business;

1. I started a business with Rs. 50,000.
2. I bought furniture for Rs. 2,000 for business use.
3. Submitted a tender for goods worth Rs. 10,000.
4. Appointed a cashier on a salary of Rs. 2,000 per month.
5. Paid salary to cashier Rs. 2,000.
6. I took away goods worth Rs. 500 from the business for my private use.
7. Paid salary Rs. 1,000 to Salesman of the business.
8. Paid rent of my house from my own funds.

Account Types

In order to track money within an organization, different types of accounting categories exist. These categories are used to denote if the money is owned or owed by the organization. Let us discuss the three main categories: Assets, Liabilities, and Capital.

Assets

An Asset is a property of value owned by a business. Physical objects and intangible rights such as money, accounts receivable, merchandise, machinery, buildings, and inventories for sale are common examples of business assets as they have economic value for the owner. Accounts receivable is an unwritten promise by a client to pay later for goods sold or services rendered.

Assets are generally listed on a balance sheet according to the ease with which they can be converted to cash. They are generally divided into three main groups:

- Current
- Fixed
- Intangible

Current Asset

A **Current Asset** is an asset that is either:

- Cash – includes funds in checking and savings accounts
- Marketable securities such as stocks, bonds, and similar investments
- Accounts Receivables, which are amounts due from customers
- Notes Receivables, which are promissory notes by customers to pay a definite sum plus interest on a certain date at a certain place.
- Inventories such as raw materials or merchandise on hand
- Prepaid expenses – supplies on hand and services paid for but not yet used (e.g. prepaid insurance)

In other words, cash and other items that can be turned back into cash within a year are considered a current asset.

Fixed Assets

Fixed Assets refer to tangible assets that are used in the business. Commonly, fixed assets are long-lived resources that are used in the production of finished goods. Examples are buildings, land, equipment, furniture, and fixtures. These assets are often included under the title property, plant, and equipment that are used in running a business. There are four qualities usually required for an item to be classified as a fixed asset. The item must be:

- Tangible
- Long-lived
- Used in the business
- Not be available for sale

Certain long-lived assets such as machinery, cars, or equipment slowly wear out or become obsolete. The cost of such as assets is systematically spread over its estimated useful life. This process is called **depreciation** if the asset involved is a tangible object such as a building or **amortization** if the asset involved is an intangible asset such as a patent. Of the different kinds of fixed assets, only land does not depreciate.

Intangible Assets

Intangible Assets are assets that are not physical assets like equipment and machinery but are valuable because they can be licensed or sold outright to others. They include cost of organizing a business, obtaining copyrights, registering trademarks, patents on an invention or process and goodwill. Goodwill is not entered as an asset unless the business has been purchased. It is the least tangible of all the assets because it is the price a purchaser is willing to pay for a company's reputation especially in its relations with customers.

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Liabilities

A Liability is a legal obligation of a business to pay a debt. Debt can be paid with money, goods, or services, but is usually paid in cash. The most common liabilities are notes payable and accounts payable. Accounts payable is an unwritten promise to pay suppliers or lenders specified sums of money at a definite future date.

Current Liabilities

Current Liabilities are liabilities that are due within a relatively short period of time. The term Current Liability is used to designate obligations whose payment is expected to require the use of existing current assets. Among current liabilities are **Accounts Payable, Notes Payable, and Accrued Expenses**. These are exactly like their receivable counterparts except the debtor-creditor relationship is reversed.

Accounts Payable is generally a liability resulting from buying goods and services on credit

Suppose a business borrows $5,000 from the bank for a 90-day period. When the money is borrowed, the business has incurred a liability – a **Note Payable**. The bank may require a written promise to pay before lending any amount although there are many credit plans, such as revolving credit where the promise to pay back is not in note form.

On the other hand, suppose the business purchases supplies from the ABC Company for $1,000 and agrees to pay within 30 days. Upon acquiring title to the goods, the business has a liability – an **Account Payable** – to the ABC Company.

In both cases, the business has become a debtor and owes money to a creditor. Other current liabilities commonly found on the balance sheet include salaries payable and taxes payable.

Another type of current liability is **Accrued Expenses.** These are expenses that have been incurred but the bills have not been received

for it. Interest, taxes, and wages are some examples of expenses that will have to be paid in the near future.

Long-Term Liabilities

Long-Term Liabilities are obligations that will not become due for a comparatively long period of time. The usual rule of thumb is that long-term liabilities are not due within one year. These include such things as bonds payable, mortgage note payable, and any other debts that do not have to be paid within one year.

You should note that as the long-term obligations come within the one-year range they become Current Liabilities. For example, mortgage is a long-term debt and payment is spread over a number of years. However, the installment due within one year of the date of the balance sheet is classified as a current liability.

Capital

Capital, also called net worth, is essentially what is yours – what would be left over if you paid off everyone the company owes money to. If there are no business liabilities, the Capital, Net Worth, or Owner Equity is equal to the total amount of the Assets of the business.

4 Introducing accounting 2

Complete the following words.

■	This is the name for buildings, machinery, money in the bank and money owed by customers.	ASSETS
■	The loss of value of the things in number 1.	D _ P _ _ _ _ _ _ _ _ N
■	Money which is borrowed.	L _ _ _
■	The extra money a company or person pays for borrowing money.	I _ _ _ _ _ S T
■	The total sum of money which is supplied by the owners of a company to set it up.	C _ _ _ T _ _
■	Cash or goods which the owner takes from the company for his own private use.	D _ _ W _ _ _ S
■	These are bought by people wishing to invest in the company.	S _ _ _ _ S
■	The extra amount which is paid for a company above the value of its assets.	G O O _ _ _ _ _
■	The purchase of another company.	A C Q U _ _ _ _ _ _ _
■	An official examination of the accounts.	A _ _ _ T
■	A financial plan for the future.	B _ _ _ _ T
■	A statement of the financial position of the company.	B _ _ _ _ _ E SHEET

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Task 5 **In Column B**, circle or highlight the corresponding letter of the Accounting Element for each item in **Column A**. (Revise page 1.6 of your DECV Course Book). The five accounting elements are:

- **Asset** (A)
- **Expense** (E)
- **Liability** (L)
- **Owner's Equity** (OE)
- **Revenue** (R)

Column A	Column B				
1. Mortgage	A	E	L	OE	R
2. Electricity	A	E	L	OE	R
3. Debtors Control	A	E	L	OE	R
4. Capital	A	E	L	OE	R
5. Shop Cleaning	A	E	L	OE	R
6. Bank Overdraft	A	E	L	OE	R
7. Shop Fittings	A	E	L	OE	R
8. Interest paid	A	E	L	OE	R
9. Drawings	A	E	L	OE	R
10. Wages	A	E	L	OE	R
11. Creditors Control	A	E	L	OE	R
12. Credit Sales	A	E	L	OE	R
13. Cash Sales	A	E	L	OE	R
14. Interest earned	A	E	L	OE	R
15. Stock Control	A	E	L	OE	R

Test Your Understanding - V

Mr. Sunrise started a business for buying and selling of stationery with Rs. 5,00,000 as an initial investment. Of which he paid Rs.1,00,000 for furniture, Rs. 2,00,000 for buying stationery items. He employed a sales person and clerk. At the end of the month he paid Rs.5,000 as their salaries. Out of the stationery bought he sold some stationery for Rs.1,50,000 for cash and some other stationery for Rs.1,00,000 on credit basis to Mr.Ravi. Subsequently, he bought stationery items of Rs.1,50,000 from Mr. Peace. In the first week of next month there was a fire accident and he lost Rs. 30,000 worth of stationery. A part of the machinery, which cost Rs. 40,000, was sold for Rs. 45,000.

From the above, answer the following :

1. What is the amount of capital with which Mr. Sunrise started business.
2. What are the fixed assets he bought?
3. What is the value of the goods purchased?
4. Who is the creditor and state the amount payable to him?
5. What are the expenses?
6. What is the gain he earned?
7. What is the loss he incurred?
8. Who is the debtor? What is the amount receivable from him?
9. What is the total amount of expenses and losses incurred?
10. Determine if the following are assets, liabilities, revenues, expenses or none of the these: sales, debtors, creditors, salary to manager, discount to debtors, drawings by the owner.

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→ **1.2A** Complete the gaps in the following table:

	Assets	*Liabilities*	*Capital*
	£	£	£
(*a*)	55,000	16,900	?
(*b*)	?	17,200	34,400
(*c*)	36,100	?	28,500
(*d*)	119,500	15,400	?
(*e*)	88,000	?	62,000
(*f*)	?	49,000	110,000

1.3 Which of the items in the following list are liabilities and which of them are assets?

(*a*) Loan from A. Sangster
(*b*) We owe a supplier
(*c*) Equipment
(*d*) Bank overdraft
(*e*) Inventory of goods held for sale
(*f*) Loan to F. Wood

1.4A Classify the following items into liabilities and assets:

(*a*) Motor vehicles
(*b*) Premises
(*c*) Accounts payable for inventory
(*d*) Inventory
(*e*) Accounts receivable
(*f*) Owing to bank
(*g*) Cash in hand
(*h*) Loan from D. Jones
(*i*) Machinery

1.5 State which of the following are wrongly classified:

Assets	*Liabilities*
Loan to C. Smith	Delivery van
Mortgage on office building	Accounts payable
Accounts receivable	Office supplies
Warehouse	Computers
Our business website	Cash in hand

1.6A Which of the following are shown under the wrong headings?

Assets	*Liabilities*
Cash at bank	Loan from J. Graham
Fixtures	Machinery
Accounts payable	Motor vehicles
Building	
Inventory	
Accounts receivable	
Capital	

1.7 Luca Pacioli is setting up a new business. Before actually selling anything, he bought a van for £13,000, a transportable market stall for £1,050; a computer for £450; and an inventory of goods for £8,000. He did not pay in full for his inventory of goods and still owes £3,000 for them. He borrowed £10,000 from Basil Yamey. After the events just described, and before trading starts, he has £1,400 cash in hand and £4,700 in the bank. Calculate the amount of his capital.

1.8A F. Flint is starting a business. Before actually starting to sell anything, he bought fixtures for £1,200, a van for £6,000 and an inventory of goods for £2,800. Although he has paid in full for the fixtures and the van, he still owes £1,600 for some of the inventory. B. Rub lent him £2,500. After

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Chapter 6 Recording Financial Transactions

Accounting records can be prepared under any one of the following system:

1. Single Entry System.
2. Double Entry System.

(1) **Single Entry System:** Under this system, all transactions relating to a personal aspect are recorded in the books of accounts but leaves all impersonal transactions. Single Entry System is based on the Dual Aspect Concept and is incomplete and inaccurate.

Single–Entry book–keeping system may vary from a mere listing of events in a form called a day book to the use of special journals and ledgers. Typically, however, this system consists of the following book–keeping records: (a) a day book or general journal, (b) a cash book, and (c) ledger accounts for individual customers and creditors. No other accounts and records are maintained with the result that expenses, reveneus and some assets accounts balances are not available. Thus it is not possible to arrive at a trial balance, and the financial statements are not easy to prepare.

Many small business concerns are being run successfully by relatively untrained people. One does not need higher education to succeed in business – a tough character and a capacity for hard work are more important. Establishing the right business in the right place is even more vital.

How does the self made man, who conducts his entire affairs without written records or incomplete records, face up to the problem of discovering the profitability of his business? Years ago he would not have bothered; he would judge it by the gradual increase in his assets which he possessed. Today the revenue collecting authorities of whatever country he lives it will require an annual assessment of his profit or income, so that they can decide the government's share of that income.

PROFIT DETERMINATION BY INCREASED NET–WORTH METHOD:

The businessman who does not keep written records can see, as the years go by, a gradual increase in the assets of his business. An airline operating in Pakistan began forty seven years ago with two aircraft, and now has a capital (Net worth) of Rs. 100 billions. Where did this increased wealth come from? It was accumulated over the years by the profitable activities of the sole pilot who founded it. He did not withdraw all the profits he earned, but he clearly must have lived on these profits by drawing some of them. The rest were retained in the business–for buying new aircraft and premises, building booking offices, and so on.

Profit can therefore be measured as an increase in the Net worth of a business. Let us see an example given below.

STATEMENT OF PROFIT OR LOSS
for the year ending ....

		Rs.
Capital or Net–worth as at the end		x x x
Add:	Drawings made during the year	x x x
		x x x
Loss:	Additional Capital introduced during the year	x x x
Less:	Capital at the beginning of the year ...	x x x
	Profit made during the year	x x x

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(2) Double Entry System: This system was introduced by Iuco Pacioli, an Italian merchant during the year 1494. According to this system, every transaction has two aspects. Both the aspects are recorded in the books of accounts. Accordingly one is giving aspect and the other one is receiving aspect. Each aspect will be recorded in one account and this method of writing every transactions in two accounts is known as Double Entry System of bookkeeping. For example, Purchase of machinery for cash, in this transaction receiving machinery is one aspect is said to be an account is debited and giving cash is another aspect is said to be an account is credited with an equal amount. Thus, the basic principle of this system is that for every debit there must be a corresponding and equal credit and for every credit there must be a corresponding and equal debit.

Advantages of Double Entry System

(1) This system provides information about the concern as a whole.

(2) It is possible to evaluate the operational efficiency of the concern.

(3) This system helps to ascertain the profit or loss by preparing profit and loss account and balance sheet.

(4) Accuracy of accounting records can be verified by preparing a Trail Balance.

(5) This system helps to know the financial position of a concern for a particular period.

(6) It provides information for meeting various legal requirements.

(7) The values of assets and liabilities can be known at any time by preparing the balance sheet.

Factors Common to Every Business

In order to understanding the Double Entry System, it is essential to consider the following important factors which are common to every business.

(1) Every business has to enter into business transactions with a number of persons or firms. To record the transactions dealing with whom, accounts are opened in the name of each person or firm. Such accounts are known as Personal Accounts.

(2) Every business must necessarily have certain assets such as buildings, stocks, cash etc. for carrying on its activities. Therefore, an account of each asset is opened and such account is known as Real or Property Accounts.

(3) Every business earn incomes and gains in various sources and certain expenses and losses incurred to carry on its activities. Therefore, an account of each expense and income or gain is opened in the books. Such accounts are known as Nominal or Factious Accounts.

Types of Accounts

In order to keep a complete record of all transactions in the business the following are the important type of accounts, namely:

I. Personal Account

(a) Natural Person's Accounts.

(b) Artificial Person's Accounts.

(c) Representative Personal Accounts.

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II. Impersonal Accounts

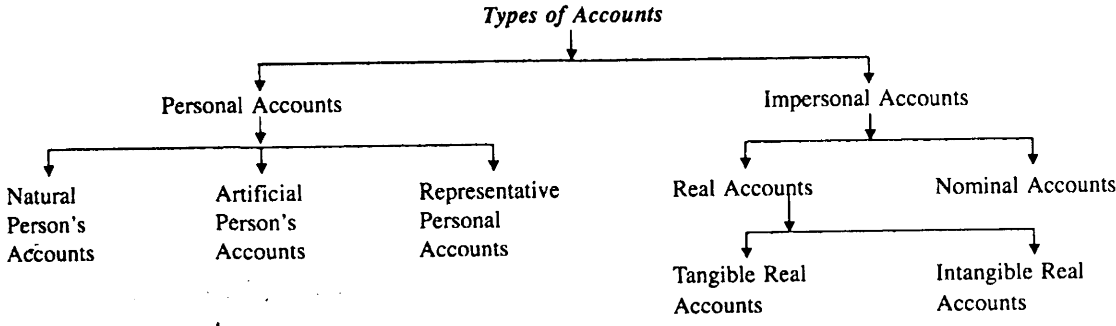
(1) ***Real Accounts***

(a) Tangible Real Accounts.

(b) Intangible Real Accounts.

(2) ***Nominal Accounts***

The following chart gives more explanation about the types of accounts:



I. Personal Accounts

An account recording transactions of business deals with person or firms or company is known as Personal Account. It takes the following forms:

(a) ***Natural Person's Account:*** Natural Person's Accounts are meant for recording transactions of business deals with individual persons. For example, Thomas Account, Raman's Account, Nancy Account etc.

(b) ***Artificial Persons or Legal Bodies:*** An account recording financial transaction of business deals with an artificial persons or legal bodies created by law or otherwise called an Artificial Personal Account. For example, Firm's Account, Limited Companies, Bank Account etc.

(c) ***Representative Personal Account:*** An account indirectly representing a person or persons is known as a Representative Personal Account. All accounts recording financial transactions of outstanding expenses and accrued or prepaid incomes are Representative Personal Account. For example, Salaries Outstanding Account is a personal account representing salaries payable to the staff.

II. Real Accounts (or) Property Accounts

Real Account refers to an account recording financial transactions of business connected with assets is known as Real Account or Property Accounts. The Real Accounts may be Tangible Real Account and Intangible Real Account. Tangible Real Account refers to an account relates to an asset which can be touched, felt and measured. For example, Building, Goods, Furniture, Machinery etc. On the other hand, Intangible Real Account refers to an account which relates to an asset which cannot be touched and measured physically. For example, Trade Mark, Goodwill, Patent, Copy Rights etc.

III. Nominal Account

Nominal Accounts are recording transactions of business connected with expenses, incomes, profit or losses etc. are known as Nominal Accounts. For example, Rent Account, Salaries Account, and Interest Account, etc.

Accounting Rules

According to Double Entry System of accounting every transaction of the business has two aspects. The transaction should be recorded in the books of accounts according to the two aspects. The two aspects are:

(1) Receiving Aspect otherwise known as Debit Aspect.

(2) Giving Aspect otherwise known as Credit Aspect.

Thus, every transaction involves two aspects:

(1) Debit Aspect.

(2) Credit Aspect.

There are three different rules for making entries under Double Entry System in respect of Personal Account, Real Account and Nominal Account.

(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

The rule of double entry are show in the following chart:

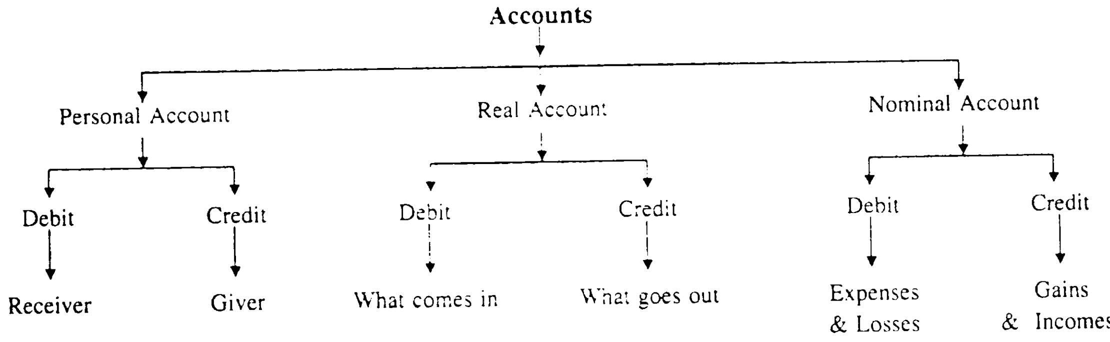


Illustration: 1

From the following transactions find out the nature of account and also state which account should be debited and which account should be credited:

(1) Salary paid
(2) Interest received
(3) Machinery purchased for cash
(4) Building sold
(5) Outstanding salary
(6) Received cash from Ramesh
(7) Proprietor introduced capital
(8) Dividend received
(9) Commission paid
(10) Furniture purchased for cash

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Analysis of Transactions

Solutions:

Transactions	*Accounts Involved*	*Types of Accounts*	*Rules of Debit and Credit*
(1) Salaries	Salary A/c Cash A/c	Nominal Real	Debit all expenses and losses Credit what goes out
(2) Interest received	Cash A/c Interest A/c	Real Nominal	Debit what comes in Credit all incomes and gains
(3) Machinery Purchase	Machinery A/c Cash A/c	Real Real	Debit what comes in Credit what goes out
(4) Building Sold	Cash A/c Building A/c	Real Real	Debit what comes in Credit what goes out
(5) Outstanding Salary	Salary A/c Outstanding Salary A/c	Nominal Personal	Debit all expenses and losses Credit the giver
(6) Received cash Cash from Remesh	Cash A/c Ramesh A/c	Real Personal	Debit what comes in Credit the giver
(7) Capital introduced	Cash A/c Capital A/c	Real Personal	Debit what comes in Credit the giver
(8) Dividend received	Cash A/c Dividend A/c	Real Nominal	Debit what comes in Credit all incomes and gains
(9) Commission paid	Commission A/c Cash A/c	Nominal Real	Debit all expenses and losses Credit what goes out
(10) Furniture purchased	Furniture A/c Cash A/c	Real Real	Debit what comes in Credit what goes out

Illustration: 2

Classify the following under Personal, Real and Nominal accounts:

(1) Stock. (2) Loan. (3) Insurance. (4) Salary.
(5) Interest. (6) Bank. (7) Cash. (8) Capital.
(9) Prepaid Interest. (10) Salary Outstanding. (11) Drawing. (12) Bank Overdraft.
(13) Salary Prepaid. (14) Fixtures. (15) Bills Receivable. (16) Machinery.
(17) Building. (18) Goodwill.

Solution:

(1) Stock = Real Account
(2) Loan = Personal Account
(3) Insurance = Nominal Account
(4) Salary = Nominal Account
(5) Interest = Nominal Account
(6) Bank = Personal Account
(7) Cash = Real Account
(8) Capital = Personal Account
(9) Prepaid Interest = Personal Account
(10) Salary Outstanding = Personal Account
(11) Drawings = Personal Account
(12) Bank Overdraft = Personal Account

(13)	Salary Prepaid	=	Personal Account
(14)	Fixtures	=	Real Account
(15)	Bills Receivable	=	Real Account
(16)	Machinery	=	Real Account
(17)	Building	=	Real Account
(18)	Goodwill	=	Real Account

QUESTIONS

1. What are the important system of accounting?
2. What do you understand by Double Entry System?
3. Explain the advantages of Double Entry System.
4. Explain the three important types of accounts.
5. What do you understand by Accounting Rules?
6. Write short notes on:
   (a) Single Entry System
   (b) Double Entry System
   (c) Personal Accounts
   (d) Nominal Accounts
7. Classify the following under Personal Account, Real Account and Nominal Account:
   (1) Cash Account. (2) Bank Account. (3) Capital Account. (4) Drawing Account. (5) Salaries Account. (6) Rent Account (7) Inventory Account. (8) William Account. (9) Goodwill Account. (10) Commission Account.
   [**Ans :** Personal Account – 2, 3, 4, 8;
   Real Account – 1, 7, 9;
   Nominal Account – 5, 6, 10.]
8. Which account is to be debited and credited in the following transactions?
   (1) Cash from Ramesh
   (2) Rent paid in cash
   (3) Goods purchased by cash
   (4) Salary paid by cheque
   (5) Bought furniture from Prem on credit
   (6) Received cash from Kumar
   (7) Cash paid to Ramesh
   (8) Goods sold to Ramesh
   (9) Cash paid in to Bank
   [**Ans :** (1) Debit Cash A/c and Credit Ramesh's A/c (2) Debit Rent A/c and Credit Cash A/c (3) Debit Purchase A/c and Credit Cash A/c (4) Debit Salary A/c and Credit Bank A/c (5) Debit furniture A/c and Credit Prem's A/c (6) Debit Cash A/c and Credit Kumar's A/c (7) Debit Ramesh A/c and Credit Cash A/c (9) Debit Bank A/c and Credit Cash A/c]
9. What accounts should be debited and credited in the following transactions?
   (1) Goods sold for cash
   (2) Goods sold to Siva on Credit
   (3) Cash paid to Ramesh
   (4) Cash paid in to Bank
   (5) Goods purchased for cash
   (6) Goods purchased from Ram on Credit
   (7) Interest received on investment
   (8) Drew cash from bank for office use
   (9) Paid rent in cash
   (10) Discount received on sales
   (11) Received cash from Ramesh
   (12) Started business with cash
   [**Ans :** (1) Debit Cash A/c and Credit Sales A/c (2) Debit Siva's A/c and Credit Sales A/c (3) Debit Ramesh's A/c and Credit Cash A/c (4) Debit Bank's A/c and Credit Cash A/c (5) Debit purchase A/c and Credit Cash A/c (6) Debit purchase A/c and Credit Ram's A/c (7) D[illegible]sh Account and Bank's A/c (9) Debit Rent A/c and Credit Cash A/c (10) Debit Cash A/c and Credit Sales A/[illegible] Debit Cash A/c and Credit Ramesh's A/c (12) Debit Cash A/c and Credit Capital A/c]

❑ ❑ ❑

EXERCISES

EX. 1-1 (S.O. 8) Some amounts are omitted in each of the following financial statements.

INCOME STATEMENT
For the Year Ended December 31, 1999

	Tang Company	June Company	Diana Company
Revenues	$48,000	$ (D)	$82,000
Expenses	(A)	52,000	64,000

OWNER'S EQUITY STATEMENT
For the Year Ended December 31, 1999

	Tang Company	June Company	Diana Company
Capital, January 1	$ (B)	$45,000	$50,000
Net income	15,000	24,000	(G)
Drawings	12,000	(E)	17,000
Capital, December 31	33,000	54,000	(H)

BALANCE SHEET
December 31, 1999

	Tang Company	June Company	Diana Company
Total assets	$75,000	$ (F)	$91,000
Total liabilities	(C)	56,000	40,000
Total owner's equity	33,000	54,000	(I)

Instructions
Determine the missing amounts and indicate your answers in the spaces provided below.

Q4: Financial statement information about tow companies is as follows:

	Karma Co.	McCain Co.
January 1,2011		
Assets	$ 95000	$ 110000
Liabilities	50000	(D)
Equity	(A)	60000
December 31,2011		
Assets	(B)	137000
Liabilities	55000	75000
Equity	60000	(E)
Equity changes in year		
Additional investment	(C)	15000
Withdraw	25000	(F)
Total revenues	350000	420000
Total expenses	320000	385000

Determine the missing amounts.

Dr. majeed musa

EXERCISE

Purpose: (S.O. 6, 7) This exercise will test your understanding of the components of the basic accounting equation.

Instructions
A list of **independent** situations appears below. Answer each question posed.

1. The total assets of Mitzer Company at December 31, 1999 are $380,000 and its total liabilities are $150,000 at that same date. **Question:** What is the amount of Mitzer Company's total owner's equity at December 31, 1999?

   Answer: ______________________________

2. The total assets of Heidi Company are $400,000 at December 31, 1999, and its total owner's equity is $280,000 at the same date. **Question:** What is the amount of Heidi Company's total liabilities at December 31, 1999?

   Answer: ______________________________

3. The total liabilities of Aaron Company are $128,000 at December 31, 1999. Total owner's equity for the company is $220,000 at that same date. **Question:** What is the amount of total assets for the company at December 31, 1999?

   Answer: ______________________________

4. The total liabilities of Malcohm Company are $80,000. The total assets of the company are three times the amount of its total liabilities. **Question:** What is the amount of Malcohm Company's total owner's equity?

   Answer: ______________________________

5. At January 1, 1999, Molly Company had total assets of $600,000 and total liabilities of $340,000. During the calendar year of 1999, total assets increased $80,000, and total liabilities decreased $30,000. **Question 1:** What was the change in owner's equity during 1999?

   Answer 1: ______________________________

   Question 2: What was the amount of owner's equity at December 31, 1999?

   Answer 2: ______________________________

6. At January 1, 1999, Blackford Company had total assets of $500,000 and total owner's equity of $280,000. During 1999, total assets decreased $40,000, and total liabilities decreased $22,000. **Question 1:** What was the amount of total liabilities at January 1, 1999?

   Answer 1: ______________________________

   Question 2: What was the change during 1999 in total owner's equity?

   Answer 2: ______________________________

   Question 3: What was the total owner's equity at December 31, 1999?

   Answer 3: ______________________________

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SOLUTION TO EXERCISE 1-1

Approach: Write down the basic accounting equation

The Accounting Equation المعادلة المحاسبية

The value of what a business owns equals the financial rights people have in the business.Anything of Value that a business owns is called an "asset". The financial rights to the assets of a business are called aquituis. In accounting assets always equal equities.

There are two kinds of equities.:

1- equity of persons outside a business to whom amounts are owed. It is called a " Liability"

2- equity of the owner of a business. and it is called the " Capital".

An equation showing the relationship beween the assets and equities of a business is called the " accounting equation" The basic accounting equation is writen as : Assets = Liabilities + Capital

Assets are listed on the left side of the balance sheet as follows:

Balance sheet

Assets	

Liabilities and capital are listed on the right side of the balance sheet as follows:

Balance sheet

	Liabilities + Capial

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Analysing the Transactions تحليل العمليات

Analysing the financial transaction means to show the accounts which has been affected by these transactions, and to know which of these accounts became debited or credited in order to record them in the accounting books.

There are two methods to analyse the accounting transactions :

a- The Balance - sheet Equation Method طريقة معادلة الميزانية

b- The Give - Take method طريقة الأخذ والعاطي

A- The Balance - Sheet Equation Method (طريقة معادلة الميزانية)

The balance- sheet of the business is a statement that Consists of two sides . The Left side includes the assets of the busines.and the right side which includes the liabilities of the business. The value of the assets must equal the value of the liabilities what ever the transactions that take place.

The occuring transactions may lead to the following possibilities:

1- An Increase in one asset and a decrease in another asset with the same value . eg:

The purchase of furniture in Cash for 1000 JD.

The furniture will increase by 1000 JD. while the cash will decrease by 1000 JD .

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2- A decrease in one asset and a decrease in one liability . eg:

The payment of 500 JD in cash to one of the creditors:

The Cash will decrease by 500J D. while the creditors will decrease by 500 JD .

3- An increase in one asset , and an increase in one liability . eg:

The purchase of goods for 1500 JD from one of the suppliers on account, the goods will increase by 1500 JD. whill the creditors will increase by the same amount.

4- A decrease in one liability and an increase in another liability with the same amount. e.g: to give one of the creditors a bill payable for 200 JD

5- A decrease in one asset and a decrease in one liability. eg: The owner of the business draw 50 JD. cash for personal Use. This means that the cash will decrease by 50JD. while the capital will decrease by the same amount.

b- Give Take Method طريقة الأخذ والعاطي

Evry financial operation has two sides. the first one which gives , and the other which takes. We debit the side that takes (increases). and we credit the side that gives (decreases).eg:

Purchases of furniture in cash for 1500 JD. This operation will increase the furniture by 1500JD. and will decrease cash by the same

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amount, for this we debit the Ac/furniture for 1500 JD, and we credit the Ac/cash by 1500JD.

After analysing the financial operation, we record it in the Journal. The pevious transaction of purchasing furniture for 1500 in cash is recorded in the Journal as: Dr Furniture 1500

Cr cash 1500

After recording the financial operation in the 'Jornal", we post the entries to their accounts in the "Ledger".

In the "Ledger" every account has a "T" shape . The left side of the account is called the debit side(Dr), and the righ- hand side is called the credit side (Cr).

Name of the account	
Dr. المدين	Cr. الدائن

Asset accounts are debited for increase and credited for decrease. Liability accounts are debited for decrease and credited for increase.

Assets (الموجودات)	
Dr.	Cr.
+	-

Liabilities (المطلوبات)	
Dr.	Cr.
-	+

Capital (رأس المال)	
Dr.	Cr.
-	+

Expenses (المصروفات)	
Dr.	Cr.
+	-

Revenues (الإيرادات)	
Dr.	Cr.
-	+

Drawings (المسحوبات)	
Dr.	Cr.
+	-

EXERCISE 1-2

Purpose: (S.O. 7) This exercise illustrates that:

(1) Each transaction has a dual effect on the basic accounting equation.

(2) The basic accounting equation remains in balance after each transaction is properly analyzed and recorded.

Biffy Bean owns and operates the Motorboat Repair Shop. A list of the transactions that took place in August 1999 follows:

1. August 1 — Biffy began the business by depositing $5,000 of his personal funds in the business bank account.
2. August 2 — Biffy rented space for the shop behind a strip mall and paid August rent of $800.
3. August 3 — The shop purchased supplies for cash, $3,000.
4. August 4 — The shop paid Cupboard News, a local newspaper, $300 for an ad appearing in the Sunday edition.
5. August 5 — Biffy repaired a boat for a customer. The customer paid cash of $1,300 for services rendered.
6. August 11 — Motorboat Repair Shop repaired a boat for a customer, Cheris Vasallo, on credit, $500.
7. August 13 — The shop purchased supplies for $900 by paying cash of $200 and charging the rest on account.
8. August 14 — The shop repaired a boat for Zonie Kinkennon, a champion skier, for $1,900. Biffy collected $1,000 in cash and put the rest on account.
9. August 22 — Biffy took home supplies from the shop that had cost $100 when purchased on August 3.
10. August 24 — The shop collected cash of $400 from Cheris Vasallo.
11. August 28 — The shop paid $200 to Mini Maid for cleaning services for the month of August.
12. August 29 — Biffy repaired a boat for Burt Reynolds for $1,200 on account.
13. August 31 — Biffy transferred $500 from the business bank account to his personal bank account.

Instructions

Prepare a tabular analysis of the transactions above to indicate the effect of each of the transactions on the various balance sheet items. Use a "+" to indicate an increase and a "-" to indicate a decrease. Indicate the new balances after each transaction. In the owner's equity column, indicate the cause of each change in the owner's total claim on assets. Use the following column headings:

	ASSETS					=	LIABILITIES	+	OWNER'S EQUITY
Transaction	Cash	+	Accounts Receivable	+	Supplies	=	Accounts Payable	+	B. Bean Capital

EX. 1-2 (S.O. 7) On March 1, Laurie Fiala opened the Wahoo Beauty Salon. During the first month, the following selected transactions occurred.

1. Deposited $5,000 cash in the City Bank in the name of the business.
2. Paid $800 cash for beauty supplies.
3. Purchased equipment at a cost of $12,000, paying $2,000 in cash and the balance on account.
4. Received $1,200 cash for services rendered.
5. Paid $500 cash as a salary to a beautician.
6. Withdrew $400 cash for personal expenses.

Instructions

Prepare a tabular summary of the transactions, using the following column headings: Cash Supplies, Equipment, Accounts Payable, and L. Fiala, Capital.

Trans-action	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	L. Fiala Capital
1.									
2.									
3.									
4.									
5.									
6.									

ILLUSTRATION 1-1

DUAL EFFECT OF TRANSACTIONS ON THE BASIC ACCOUNTING EQUATION (S.O. 6, 7)

Each transaction affects items in the basic accounting equation in such a manner as to maintain equality in the basic accounting equation. The possible combinations of dual effects are illustrated below with examples of transactions that fit each category of combinations. Some examples are too advanced to be comprehended at this level in your accounting study so references are made to future chapters for those items. Do not attempt to research those items at this time—just accept the fact that in the future you will more readily understand those examples. These advanced examples are included here to show you that there are illustrations of every conceivable combination of dual effects on the equation.

Effects of Transaction on Basic Equation	A	= L	+ OE	Examples
1.	↑		↑	a. Owner investment of personal assets into the business. b. Sale of services for cash or on account.
2.	↓		↓	a. Owner withdrawal of assets from the business for personal use. b. Cash payment for various expenses, such as salaries expense and advertising expense. (Also, Chapter 3, consumption of noncash assets in operations, such as the consumption of supplies.)
3.	↑	↑		a. Acquisition of any asset on credit. Borrowing money.
4.	↓	↓		a. Paying off any debt.
5.	↓↑			a. Exchanging any asset for another asset, such as purchase of equipment for cash or collection of an account receivable.
6.		↑↓		a. Exchanging one liability for another, such as settling an account payable by issuing a note payable.
7.			↑↓	a. (Chapter 15—Corporation declares a stock dividend).

ILLUSTRATION 1-1 (Continued)

8. A = L + OE
   (L ↓, OE ↑)

   a. Liquidating a debt by giving an ownership interest in the entity.
   b. (Chapter 3—Entity earns revenue after cash was previously received and recorded).

9. A = L + OE
   (L ↑, OE ↓)

   a. (Chapter 15—Corporation declares cash dividends on stock).
   b. (Chapter 3—Incurring expense--consuming benefits in carrying out operations--before paying for the goods or services, such as repairs made to an entity's equipment before the vendor is paid.)

Q1: select the later that **not** best answers each of the following statements. (***10 Degrees***)

1- A = L + OE
   (A ↓, OE ↓)
   a) Interest paid for cash.
   b) paid rent in cash.
   c) cash paid in to bank.
   d) salary paid by cheque.

2- A = L + OE
   (A ↑, OE ↑)
   a) sale of services on account.
   b) setting an account payable by issuing a note payable.
   c) sale of services for cash.
   d) Discount received on sales.

3- A = L + OE
   (A ↓↑)
   a) Goods purchased by cash.
   b) Bought furniture from prem in cash.
   c) Corporation declares cash dividends on stock.
   d) Machinery purchased for cash.

4- A = L + OE
   (A ↑, L ↑)
   a) Goods purchased from Ram on credit.
   b) asset purchased from Ram on account.
   c) received cash from by bank overdraft.
   d) started business with cash.

5- A = L + OE
   (A ↓, L ↓)
   a) Purchased goods by paying cash halve it and charging the rest on account.
   b) cash paid to Ramesh.
   c) cash paid to Kumar.
   d) note payable had paid .

Date	Particulars		L.F.	Dr. Amount	Cr. Amount
20.04.08*	Sales Promotion A/c To Purchases A/c (Being the goods distributed as free samples)	Dr.		1,000	1,000
22.04.08*	Loss by Fire A/c To Purchases A/c (Being the goods destroyed by fire)	Dr.		800	800

* These transactions are recorded at cost price as they are not real sales, so profit cannot be expected.

Descriptive Questions

1. " Each transaction has a double aspect." Explain this statement giving suitable examples. (3.1 and 3.2)
2. What do you mean by 'Double Entry System'? Explain with a suitable illustration. (3.1 and 3.2)
3. Explain the different types of accounts and the rules for recording in books of accounts. (3.3)

Check Your Understanding

(A) State whether the following statements are True or False:

1. Both cash and bank accounts are real accounts.
2. Assets are equal to equities.
3. Equities are equal to the total value of capital and liabilities.
4. There is no difference between trade discount and cash discount.
5. Drawings in cash are recorded in books of accounts while drawings in kind are not recorded.
6. Cash purchase and credit purchase are treated in a similar manner so far as debit entry is concerned.
7. For every debit, there is a corresponding credit for the same amount.
8. Journal is a book of prime entry.
9. Loss results in increase of asset or reduction of liability.
10. Profit or loss is finally transferred to capital account.
11. In an accounting equation, assets are equal to capital and liabilities.
12. When sales returns are made, sales returns account is credited.
13. When entertainment expenditure is incurred and payment is not made, entertainment expenditure account is credited.
14. Dividend received is a personal account.
15. Double Entry Book-keeping ensures arithmetical accuracy alone, would not guarantee financial correctness.
16. Cash book is a journal as well as a ledger.
17. It is necessary to record all non-cash transactions, first, in the journal before posting is made into the concerned accounts in the ledger.

Answers

1. False 2. True 3. True 4. False 5. False 6. True 7. True 8. True 9. False 10. True 11. True 12. False 13. False 14. False 15. True 16. True 17. True

(B) Pick up the most appropriate answer

1. The term "double entry" in accounting refers to which of the following:
   - (a) Keeping second set of books of accounts.
   - (b) Accounting records reflect both cash and accrued income.
   - (c) The fact that all transactions affect at least two accounts.
   - (d) A type of embezzlement scheme.
2. At which of the following stages, income is typically be recognized under Generally Accepted Accounting Principles?
   - (a) Product is manufactured and stored
   - (b) Customer places the order
   - (c) Product is delivered to the customer
   - (d) Customer pays for the product, finally, after enjoying credit period allowed.
3. Which set of terms are synonymous in accounts?
   - (a) Revenue, expense, income
   - (b) Asset, resource, liability
   - (c) Revenue, sales, loss
   - (d) Earnings, profit, income
4. Purchase of land for cash will have what effect on total liabilities?
   - (a) Increase
   - (b) Decrease
   - (c) No effect
   - (d) Uncertain.
5. Liabilities appear on which of the following statements?
   - (a) Statement of Cash Flows
   - (b) Statement of Owner's Equity
   - (c) Balance Sheet
   - (d) Income Statement
6. Purchase of furniture on credit will have what effect on total assets?
   - (a) Increase
   - (b) Decrease.
   - (c) No effect
   - (d) Indeterminate.
7. The amount brought in by the proprietor is called
   - (a) Drawings
   - (b) Capital
   - (c) Cash account
   - (d) Credit account.
8. Return of goods purchased from a manufacturer should be credited to
   - (a) Purchase returns
   - (b) Sales returns
   - (c) Purchases
   - (d) Sales.
9. Amount of salary paid to Kishore should be debited to
   - (a) Kishore account
   - (b) Salary account
   - (c) Salary outstanding account
   - (d) Cash account.

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10. Trade discount allowed by the supplier is to be debited to
   - (a) Purchase account
   - (b) No entry for trade discount, net purchase is debited
   - (c) Supplier account
   - (d) Discount is added to purchase amount.
11. Cash discount received from a customer should be credited to
   - (a) Discount account
   - (b) Customer account
   - (c) Cash account
   - (d) No entry.
12. In case of a debt becoming bad, amount of bad debts is credited to
   - (a) Sales account
   - (b) Debtor's account
   - (c) Purchase account
   - (d) Cash account.
13. In Double Entry system of Book-keeping, every business transaction affects
   - (a) one account
   - (b) two accounts
   - (c) the same account on both debit and credit sides
   - (d) the two sides of the same account on different dates.
14. What type of account is Prepaid Insurance?
   - (a) Asset
   - (b) Liability
   - (c) Revenue
   - (d) Expense.
15. The cost of earning the revenue of the current period is referred to as:
   - (a) Liability
   - (b) Expense
   - (c) Net loss
   - (d) Cash outflow.
16. Which financial statement provides information about a company's capital structure?
   - (a) Profit and Loss Account
   - (b) Balance Sheet
   - (c) Funds flow statement
   - (d) Cash flow statement.

Answers

1. (c) 2. (c) 3. (d) 4. (c) Land and cash are both assets. One asset is exchanged for another. So, total liabilities are unaffected. 5. (c), 6. (a) Purchase of Furniture on credit has created an asset as well as a liability, so total assets have increased. 7. (b) 8. (a) 9. (b) 10. (b) 11. (a) 12. (b) 13. (b) 14. (a) The prepayment creates an asset in the form of future insurance coverage. 15. (b) 16. (b) Capital structure deals with the way in which an entity has financed its assets. This information is provided by the liabilities side of the balance sheet.

Interview Questions

Q.1. What is "Accounting Equation"?

Ans. In every business, resources (assets) are provided by the owner as well as outsiders. These persons have a claim against those assets. Due to dual aspect of accounting, the assets are equal to the claims of the owners and outsiders. In simple words, the assets are equal to capital and liabilities, which is known as 'Accounting Equation'.

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Quiz

Test your understanding of transaction analysis by answering the following questions. Select the best choice from among the possible answers.

Q2-29 An investment of cash into the business will (p. 57–58)

a. Decrease total assets.
b. Decrease total liabilities.
c. Increase stockholders' equity.
d. Have no effect on total assets.

Q2-30 Purchasing a computer on account will (p. 58–59)

a. Increase total assets.
b. Increase total liabilities.
c. Have no effect on stockholders' equity.
d. All of the above.

Q2-31 Performing a service on account will (p. 59–60)

a. Increase total assets.
b. Increase stockholders' equity.
c. Both a and b.
d. Increase total liabilities.

Q2-32 Receiving cash from a customer on account will (p. 60–61)

a. Have no effect on total assets.
b. Increase total assets.
c. Decrease liabilities.
d. Increase stockholders equity.

Q2-33 Purchasing computer equipment for cash will (p. 58–59)

a. Increase both total assets and total liabilities.
b. Decrease both total assets and stockholders' equity.
c. Decrease both total liabilities and stockholders' equity.
d. Have no effect on total assets, total liabilities, or stockholders' equity.

Q2-34 Purchasing a building for $100,000 by paying cash of $20,000 and signing a note payable for $80,000 will (p. 58–59)

a. Increase both total assets and total liabilities by $100,000.
b. Increase both total assets and total liabilities by $80,000.
c. Decrease total assets and increase total liabilities by $20,000.
d. Decrease both total assets and total liabilities by $20,000.

Q2-35 What is the effect on total assets and stockholders' equity of paying the electric bill as soon as it is received each month? (p. 59–60)

	Total assets	Stockholders' equity
a.	Decrease	No effect
b.	No effect	No effect
c.	Decrease	Decrease
d.	No effect	Decrease

Q2-36 Which of the following transactions will increase an asset and increase a liability? (p. 58–59)

a. Buying equipment on account.
b. Purchasing office equipment for cash.
c. Issuing stock.
d. Payment of an account payable.

Q2-37 Which of the following transactions will increase an asset and increase stockholders' equity? (p. 59–60)

a. Collecting cash from a customer on an account receivable.
b. Performing a service on account for a customer.
c. Borrowing money from a bank.
d. Purchasing supplies on account.

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■ Transaction Analysis

Q2-38 Where do we first record a transaction? (p. 70–71)

a. Ledger
b. Trial balance
c. Account
d. Journal

Q2-39 Which of the following is not an asset account? (pp. 55–56, 63–64)

a. Common Stock
b. Salary Expense
c. Service Revenue
d. None of the above accounts is an asset.

Q2-40 Which statement is false? (p. 70–71)

a. Revenues are increased by credits.
b. Assets are increased by debits.
c. Dividends are increased by credits.
d. Liabilities are decreased by debits.

Q2-41 The journal entry to record the receipt of land and a building and issuance of common stock (p. 72–73)

a. Debits Land and Building and credits Common Stock.
b. Debits Land and credits Common Stock.
c. Debits Common Stock and credits Land and Building.
d. Debits Land, Building, and Common Stock.

Q2-42 The journal entry to record the purchase of supplies on account (p. 73–74)

a. Credits Supplies and debits Cash.
b. Debits Supplies and credits Accounts Payable.
c. Debits Supplies Expense and credits Supplies.
d. Credits Supplies and debits Accounts Payable.

Q2-43 If the credit to record the purchase of supplies on account is not posted, (p. 73–74)

a. Liabilities will be understated.
b. Expenses will be overstated.
c. Assets will be understated.
d. Stockholders' equity will be understated.

Q2-44 The journal entry to record a payment on account will (p. 74–76)

a. Debit Accounts Payable and credit Retained Earnings.
b. Debit Cash and credit Expenses.
c. Debit Expenses and credit Cash.
d. Debit Accounts Payable and credit Cash.

Q2-45 If the credit to record the payment of an account payable is not posted, (p. 74–76)

a. Liabilities will be understated.
b. Expenses will be understated.
c. Cash will be overstated.
d. Cash will be understated.

Q2-46 Which statement is false? (p. 77–78)

a. A trial balance lists all the accounts with their current balances.
b. A trial balance is the same as a balance sheet.
c. A trial balance can verify the equality of debits and credits.
d. A trial balance can be taken at any time.

Q2-47 A business's purchase of a $100,000 building with an $85,000 mortgage payable and issuance of $15,000 of common stock will (p. 62–63)

a. Increase stockholders' equity by $15,000.
b. Increase assets by $15,000.
c. Increase assets by $85,000.
d. Increase stockholders' equity by $100,000.

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Accounting Principles and Inventories

Several accounting principles affect inventories. Among them are consistency, disclosure, materiality, and accounting conservatism.

1 Define accounting principles related to inventory

Consistency Principle

The **consistency principle** states that businesses should use the same accounting methods from period to period. Consistency helps investors compare a company's financial statements from one period to the next.

Suppose you are analyzing a company's net income over a two-year period. The company switched to a different inventory method from the method it had been using. Its net income increased dramatically but only as a result of the change in inventory method. If you did not know about the change, you might believe that the company's income really increased. Therefore, companies must report any changes in the accounting methods they use. Investors need this information to make wise decisions about the company.

Disclosure Principle

The **disclosure principle** holds that a company should report enough information for outsiders to make wise decisions about the company. In short, the company should report *relevant*, *reliable*, and *comparable* information about itself. This includes disclosing the method being used to account for inventories. **All major accounting decisions are described in the footnotes to the financial statements.** Suppose a banker is comparing two companies—one using inventory method A and the other using inventory method B. The B company reports higher net income but only because of the inventory method it selected. Without knowledge of these accounting methods, the banker could lend money to the wrong business.

Materiality Concept

The **materiality concept** states that a company must perform strictly proper accounting *only* for significant items. **Information is significant—or, in accounting terms, *material*—when it would cause someone to change a decision.** The materiality concept frees accountants from having to report every last item in strict accordance with GAAP. For example, $1,000 is material to a small business with annual sales of $100,000. However, $1,000 isn't material to a large company like Apple.

Accounting Conservatism

Conservatism in accounting means exercising caution in reporting items in the financial statements. Conservatism says,

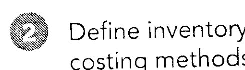
- "Anticipate no gains, but provide for all probable losses."
- "If in doubt, record an asset at the lowest reasonable amount and a liability at the highest reasonable amount."
- "When there's a question, record an expense rather than an asset."
- "When you are faced with a decision between two options, you must choose the option that undervalues, rather than overvalues, your business."

The goal of conservatism is to report realistic figures.

Key Takeaway

The accounting principles are the foundations that guide how we record transactions.

Inventory Costing Methods



Define inventory costing methods

As we saw in Chapter 5,

$$\text{Ending inventory} = \text{Number of units } \textit{on hand} \times \text{Unit cost}$$

$$\text{Cost of goods sold} = \text{Number of units } \textit{sold} \times \text{Unit cost}$$

Companies determine the number of units from perpetual inventory records backed up by a physical count. The cost of each unit of inventory is as follows:

Cost per unit = Purchase price − Purchase discounts − Purchase returns + Freight in

Exhibit 6-2 gives the inventory data for DVD0503 (Basic Excel Training DVD) for Smart Touch.

EXHIBIT 6-2 **Perpetual Inventory Record—Showing Cost**

Item: DVD0503

Date	Quantity Purchased	Quantity Sold	Cost per Unit	Quantity on Hand
FIFO → Jul 1			40	2
5	6		45	8
15		4		4
LIFO → 26	9		47	13
31		10		3
Totals	15	14	N/A	3

In this exhibit, Smart Touch began July with 2 DVD0503s in inventory. It had 3 DVD0503s at the end of July. The company plans on selling each DVD for $80 to its customers.

Measuring inventory cost is easy when prices do not change. But unit cost does change often. Looking at Exhibit 6-2, you can see that Smart Touch's cost per unit did change each time it made a purchase. The July 1 beginning inventory cost $40 each, the purchases made July 5 cost $45 each, and the purchases made July 26 cost $47 each. How many of the DVD0503s that were sold cost $40? How many cost $45? To compute ending inventory and cost of goods sold, Smart Touch must assign a unit cost to each item. The four costing methods we'll illustrate that GAAP allows are as follows:

1. Specific unit cost
2. First-in, first-out (FIFO) cost
3. Last-in, first-out (LIFO) cost
4. Average cost

A company can use any of these methods to account for its inventory.

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The **specific-unit-cost method** is also called the **specific-identification method.** This method uses the specific cost of each unit of inventory to determine ending inventory and to determine cost of goods sold. **In the specific-unit-cost method, the company knows exactly which item was sold and exactly what the item cost.** This costing method is best for businesses that sell unique, easily identified inventory items, such as automobiles (identified by the vehicle identification number [VIN]), jewels (a specific diamond ring), and real estate (identified by address). For instance, a **Chevrolet** dealer may have two Camaro vehicles with *exactly* the same colors, interior, and options package. Assume one of the Camaros was purchased by the dealership on January 5 for $16,000 and the other was purchased on March 8 for $19,000. The dealer would determine the cost of each of the identical vehicles sold based on the vehicle identification number. If the dealer sells the model whose VIN is on the March 8 invoice, the cost of goods sold is $19,000. Suppose the other Camaro is the only unit left in inventory at the end of the period. In that case, ending inventory would be $16,000—the cost of the January 5 vehicle.

Amazon.com uses the specific-unit-cost method to account for its inventory. But very few other companies use this method, so we'll shift our focus to the more popular inventory costing methods.

- Under the **FIFO (First-In, First-Out) inventory costing method**, the cost of goods sold is based on the oldest purchases—that is, the First In is the First Out of the warehouse (sold). In Exhibit 6-2, this is illustrated by the Cost of goods sold coming from the *first* goods purchased, which are from the July 1 beginning inventory. FIFO costing is consistent with the physical movement of inventory (for most companies). **That is, under the FIFO method, companies sell their oldest inventory first.**
- LIFO is the opposite of FIFO. Under the **LIFO (Last-In, First-Out) inventory costing method**, ending inventory comes from the oldest costs (first purchases) of the period. The cost of goods sold is based on the most recent purchases (new costs)—that is, the Last In is the First Out of the warehouse (sold). This is illustrated by the Cost of goods sold coming from the *last* goods in the warehouse—the July 26 purchase in Exhibit 6-2. **Under the LIFO method, companies sell their newest inventory first.**
- Under the **average-cost inventory costing method**, the business computes a new average cost per unit after each purchase. Ending inventory and cost of goods sold are then based on the same average cost per unit. So, cost per unit sold falls somewhere between the low cost of $40 and the highest cost of $47 in Exhibit 6-2. **Under the average-cost method, an average price is calculated and applied to all goods.**

Key Takeaway

Inventory costing methods include specific-unit-cost, FIFO, LIFO, and average cost. Specific unit identifies the specific cost of each unit of inventory that is in ending inventory and each item that is in cost of goods sold. Under FIFO, the cost of goods sold is based on the oldest purchases. Under LIFO, the cost of goods sold is based on the newest purchases. Under the average-cost method, the business computes a new average cost per unit after each purchase. Keep in mind the cost paid to purchase goods is the same under all inventory costing methods. The difference is where we divide up the dollars between the asset, Inventory, and the expense, COGS, on the income statement.

Stop & Think...

Think about going to the grocery store to buy a gallon of milk. Which gallon is in front of the milk cooler: the older milk or the newer milk? The older milk is in front. That's FIFO. Now visualize reaching all the way to the back of the cooler to get the newer milk. That's LIFO.

Now let's see how Smart Touch would compute inventory amounts under FIFO, LIFO, and average costing for all of July. We use the transaction data from Exhibit 6-2 for all the illustrations. Keep in mind the cost paid to purchase goods is the same under all inventory costing methods. The difference is where we divide up the dollars between the asset Inventory and the expense, COGS, on the income statement.

In the body of the chapter, we show inventory costing in a perpetual system. Appendix 6A shows inventory costing in a periodic system.

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Inventory Accounting in a Perpetual System

Account for perpetual inventory using the three most common costing methods

The different inventory costing methods produce different amounts for

- ending inventory, and
- cost of goods sold.

For each calculation, we'll use the information in Exhibit 6-2 about Smart Touch's purchases of DVD0503. Recall that Smart Touch sold the units to customers for $80 each.

First-In, First-Out (FIFO) Method

Assume that Smart Touch uses the FIFO method to account for its inventory. Under FIFO, the first costs incurred by Smart Touch are the first costs assigned to cost of goods sold. FIFO leaves in ending inventory the last—the newest—costs. This is illustrated in the FIFO inventory record in Exhibit 6-3.

EXHIBIT 6-3 **Perpetual Inventory Record: FIFO**

DVD0503									
	Purchases			Cost of Goods Sold			Inventory on Hand		
Date	Quantity	Unit Cost	Total Cost	Quantity	Unit Cost	Total Cost	Quantity	Unit Cost	Total Cost
Jul 1							2	$40	$80
5	6	$45	$270				2	40	80
							6	45	270
15				2	$40	$ 80			
				2	45	90	4	45	180
26	9	47	423				4	45	180
							9	47	423
31				4	45	180			
				6	47	282	3	47	141
31	15		$693	14		$632	3		$141

Smart Touch began July with 2 DVD0503s that cost $40 each. After the July 5 purchase, the inventory on hand consists of 8 units.

8 units on hand	2 @ $40	=	$ 80
	6 @ $45	=	270
	Inventory on hand	=	$350

On July 15, Smart Touch sold 4 units. Under FIFO, the first 2 units sold had the oldest cost ($40 per unit). The next 2 units sold cost $45 each. That leaves 4 units in inventory on July 15 at $45 each. The remainder of the inventory record follows the same pattern. Consider the sale on July 31 of 10 units. The oldest cost is from July 5 (4 units @ $45). The next oldest cost is from the July 26 purchase at $47 each (6 units @ $47). This leaves 3 units in inventory on July 31 at $47 each.

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Last-In, First-Out (LIFO) Method

Exhibit 6-4 gives a perpetual inventory record for the LIFO method.

EXHIBIT 6-4 **Perpetual Inventory Record: LIFO**

DVD0503									
	Purchases			Cost of Goods Sold			Inventory on Hand		
Date	Quantity	Unit Cost	Total Cost	Quantity	Unit Cost	Total Cost	Quantity	Unit Cost	Total Cost
Jul 1							2	$40	$80
5	6	$45	$270				2	40	80
							6	45	270
15				4	$45	$180	2	40	80
							2	45	90
26	9	47	423				2	40	80
							2	45	90
							9	47	423
31				9	47	423			
				1	45	45	2	40	80
							1	45	45
31	15		$693	14		$648	3		$125

Again, Smart Touch had 2 DVD0503s at the beginning. After the purchase on July 5, Smart Touch holds 8 units of inventory (2 @ $40 plus 6 @ $45). On July 15, Smart Touch sells 4 units. Under LIFO, the cost of goods sold always comes from the most recent purchase. That leaves 4 DVD0503s in inventory on July 15.

4 units on hand	2 @ $40	= $ 80
	2 @ $45	= 90
	Inventory on hand	= $170

The purchase of 9 units on July 26 adds a new $47 layer to inventory. Now inventory holds 13 units.

13 units on hand	2 @ $40	= $ 80
	2 @ $45	= 90
	9 @ $47	= 423
	Inventory on hand	= $593

Connect To: IFRS

The LIFO method, although permitted by U.S. GAAP, is not permitted under IFRS. Companies currently utilizing LIFO will have to change inventory methods when they convert to IFRS reporting standards.

Then the sale of 10 units on July 31 peels back units in LIFO order. The LIFO monthly summary at July 31 is as follows:

- Cost of goods sold: 14 units that cost a total of $648
- Ending inventory: 3 units that cost a total of $125

Under LIFO, Smart Touch could measure cost of goods sold and inventory in this manner to prepare its financial statements.

Journal Entries Under LIFO

The journal entries under LIFO follow the data in Exhibit 6-4. On July 5, Smart Touch purchased inventory of $270. The July 15 sale brought in sales revenue (4 units @ $80 = $320) and cost of goods sold ($180). The July 26 and 31 entries also come from the data in Exhibit 6-4. Amounts unique to LIFO are shown in blue.

LIFO Journal Entries (All purchases and sales on account)
The sales price of a DVD0503 is $80

Date	Accounts	Debit	Credit
Jul 5	Inventory (6 × $45) (A+)	270	
	Accounts payable (L+)		270
	Purchased inventory on account.		
15	Accounts receivable (4 × $80) (A+)	320	
	Sales revenue (R+)		320
	Sale on account.		
[illegible]	[illegible]	180	
	[illegible]		180
	[illegible]		
26	Inventory (9 × $47) (A+)	423	
	Accounts payable (L+)		423
	Purchased inventory on account.		
31	Accounts receivable (10 × $80) (A+)	800	
	Sales revenue (R+)		800
	Sale on account.		
31	Cost of goods sold ([illegible])	[illegible]	
	Inventory [illegible]		468
	Cost of goods sold.		

Average-Cost Method

Suppose Smart Touch uses the average-cost method to account for its inventory of DVD0503s. Exhibit 6-5 shows a perpetual inventory record for the average-cost method. We round average unit cost to the nearest cent and total cost to the nearest dollar.

EXHIBIT 6-5 Perpetual Inventory Record: Average Cost

DVD0503

Date	Purchases			Cost of Goods Sold			Inventory on Hand		
	Quantity	Unit Cost	Total Cost	Quantity	Unit Cost	Total Cost	Quantity	Unit Cost	Total Cost
Jul 1							2	$40.00	$ 80
5	6	$45	$270				8	43.75	350
15				4	$43.75	$175	4	43.75	175
26	9	47	423				13	46.00	598
31				10	46.00	460	3	46.00	138
31	15		$693	14		$635	3		$138

Consider again the purchases made by Smart Touch during July. Smart Touch had total inventory in July as follows:

Jul	1	2 @ $40	$ 80
	5	6 @ $45	$270
	26	9 @ $47	$423
Total cost of July inventory available for sale			$773

Only one of two things can happen to the DVDs—either they remain in the warehouse (Inventory) or they are sold (Cost of goods sold). Consider the results from each of the costing methods for July for Smart Touch.

Key Takeaway

The Total spent on goods, $773 [(2 @ $40) + (6 @ $45) + (9 @ $47)] is divided between Inventory and COGS based on the costing method used. When more of the $773 goes to COGS (LIFO in this example), gross profit will be lower. When less of the $773 goes to COGS (FIFO in this example), gross profit will be higher.

Jul 2013	FIFO	LIFO	Average
Cost of goods sold	$632	$648	$635
+ Ending Inventory	$141	$125	$138
= Cost of goods available for sale	$773	$773	$773

The sum of cost of goods sold plus inventory equals the **cost of goods available for sale**, $773 for each costing method. Verifying that COGS plus Ending inventory equals Cost of good available for sale is a good way to verify your final calculation results.

Summary Problem 6-1

Fossil specializes in designer watches and leather goods. Assume **Fossil** began June holding 10 wristwatches that cost $50 each. During June, **Fossil** bought and sold inventory as follows:

Jun	3	Sold 8 units for $100 each
	16	Purchased 10 units @ $56 each
	23	Sold 8 units for $100 each

Requirements

1. Prepare a perpetual inventory record for **Fossil** using FIFO, LIFO, and Average cost.
2. Journalize all of **Fossil's** inventory transactions for June under all three costing methods.
3. Show the computation of gross profit for each method.
4. Which method maximizes net income? Which method minimizes income taxes?

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Solution

1. Perpetual inventory records:

FIFO

Wristwatches

Date	Purchases			Cost of Goods Sold			Inventory on Hand		
	Quantity	Unit Cost	Total Cost	Quantity	Unit Cost	Total Cost	Quantity	Unit Cost	Total Cost
Jun 1							10	$50	$500
3				8	$50	$400	2	50	100
16	10	$56	$560				2	50	100
							10	56	560
23				2	50	100			
				6	56	336	4	56	224
30	10		$560	16		$836	4		$224

LIFO

Wristwatches

Date	Purchases			Cost of Goods Sold			Inventory on Hand		
	Quantity	Unit Cost	Total Cost	Quantity	Unit Cost	Total Cost	Quantity	Unit Cost	Total Cost
Jun 1							10	$50	$500
3				8	$50	$400	2	50	100
16	10	$56	$560				2	50	100
							10	56	560
23				8	56	448	2	50	100
							2	56	112
30	10		$560	16		$848	4		$212

AVERAGE COST

Wristwatches

Date	Purchases			Cost of Goods Sold			Inventory on Hand		
	Quantity	Unit Cost	Total Cost	Quantity	Unit Cost	Total Cost	Quantity	Unit Cost	Total Cost
Jun 1							10	$50.00	$500
3				8	$50.00	$400	2	50.00	100
16	10	$56	$560				12	55.00	660
23				8	55.00	440	4	55.00	220
30	10		$560	16		$840	4		$220

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Summary Problem 6-2

Suppose Greg's Tunes, Inc., has the following inventory records for July 2013: Operating expense for July was $1,900.

Date	Item	Quantity	Unit Cost	Sale Price
Jul 1	Beginning inventory	100 units	$ 8	
10	Purchase..............................	60 units	9	
15	Sale	70 units		$20
21	Purchase..............................	100 units	10	
30	Sale	90 units		25

Requirement

1. Prepare the July income statement in multi-step format. Show amounts for FIFO, LIFO, and Average cost. Label the bottom line "Operating income." Show your computations using periodic inventory, using the income statement on page 326 as your guide to compute cost of goods sold.

Solution

GREG'S TUNES, INC.
Income Statement for Computer Parts
Month Ended July 31, 2013

	FIFO		LIFO		Average Cost	
Sales revenue		$3,650		$3,650		$3,650
Cost of goods sold:						
Beginning inventory	$ 800		$ 800		$ 800	
Net purchases	1,540		1,540		1,540	
Cost of goods available	$ 2,340		$2,340		$2,340	
Ending inventory	(1,000)		(800)		(900)	
Cost of goods sold		1,340		1,540		1,440
Gross profit		$2,310		$2,110		$2,210
Operating expenses		1,900		1,900		1,900
Operating income		$ 410		$ 210		$ 310

Computations

Sales revenue:	(70 × $20) + (90 × $25)	= $3,650
Beginning inventory:	100 × $8	= $800
Purchases:	(60 × $9) + (100 × $10)	= $1,540
Ending inventory:		
FIFO	100* × $10	= $1,000
LIFO	100 × $8	= $800
Average cost:	100 × $9~	= $900

* Number of units in ending inventory = 100 + 60 − 70 + 100 − 90 = 100
~ Average cost per unit = $2,340/(100 + 60+ 100) total available units or $9.00 periodic average cost per unit

000080

E6-20 **Journalizing perpetual inventory transactions—cost of sales given [10–15 min]**

Accounting records for Josh's Shopping Bags yield the following data for the year ended May 31, 2012:

Inventory, May 31, 2011	$ 8,000
Purchases of inventory (on account)	46,000
Sales of inventory – 81% on account; 19% for cash (cost $38,000)	76,000
Inventory, May 31, 2012	?

Requirements

1. Journalize the inventory transactions for the company using the data given.
2. Report ending inventory on the balance sheet, and sales, cost of goods sold, and gross profit on the income statement.

E6-21 **Comparing amounts for ending inventory—perpetual inventory—FIFO and LIFO [5–10 min]**

Assume that a Models and More store bought and sold a line of dolls during December as follows:

Beginning inventory	13	units @	$ 11
Sale	9	units	
Purchase	17	units @	$ 13
Sale	13	units	

Models and More uses the perpetual inventory system.

Requirements

1. Compute the cost of ending inventory using FIFO.
2. Compute the cost of ending inventory using LIFO.
3. Which method results in a higher cost of ending inventory?

E6-22 **Comparing cost of goods sold in a perpetual system—FIFO and LIFO [15–20 min]**

Review the data in Exercise 6-21.

Requirements

1. Compute the cost of goods sold under FIFO.
2. Compute the cost of goods sold under LIFO.
3. Which method results in the higher cost of goods sold?

E6-23 **Comparing cost of goods sold in a perpetual system—FIFO, LIFO, and average-cost methods [15–20 min]**

Assume that a JR Tire Store completed the following perpetual inventory transactions for a line of tires:

Beginning inventory	16	tires @	$ 65
Purchase	10	tires @	$ 78
Sale	12	tires @	$ 90

Requirements

1. Compute cost of goods sold and gross profit using FIFO.
2. Compute cost of goods sold and gross profit using LIFO.
3. Compute cost of goods sold and gross profit using average-cost. (Round average cost per unit to the nearest cent and all other amounts to the nearest dollar.)
4. Which method results in the largest gross profit and why?

000081

Acquisition Cost of Tangible Assets

Accounting for a long-lived asset begins with its purchase. The acquisition cost of long-lived assets is the cash-equivalent purchase price, including incidental costs to complete the purchase, to transport the asset, and to prepare it for use.

OBJECTIVE 2

Measure the acquisition cost of tangible assets such as land, buildings, and equipment.

Land

The acquisition cost of land includes charges to the purchaser for the cost of land surveys, legal fees, title fees, transfer taxes, and even the demolition costs of old structures that must be torn down to get the land ready for its intended use. Consider the following example for the acquisition of a piece of land that is to be used as the site of a new building. There is an existing building on the land that will be torn down.

Purchase price	$500,000
Closing costs, including attorney's fees	9,500
Title search and transfer taxes	1,000
Costs of demolition of old building	6,000
Costs of clearing, grading, and filling in preparation for new building	19,000
Assumption of unpaid property taxes	10,000
Proceeds from the sale of materials salvaged from the old building	(2,500)
Total acquisition cost	$543,000

Under historical-cost accounting, companies report land in the balance sheet at its original cost. Of course, after years of rising real estate values and inflation, the carrying amount of land is often far below its current market value. Should land acquired and held since 1940 still appear at its 1940 cost on balance sheets prepared nearly 65 years later? Accountants do exactly that. International accounting standards permit periodic revaluation of certain assets. However, the FASB requires companies in the United States to be conservative and carry land and other long-lived assets at their original historical cost.

Buildings and Equipment

The cost of buildings, plant, and equipment should include all costs of acquisition and preparation for use. Consider the following example for used packaging equipment:

Invoice price, gross	$100,000
Deduct 2% cash discount for payment within 30 days	(2,000)
Invoice price, net	$ 98,000
State sales tax at 8% of $98,000	7,840
Transportation costs	3,000
Installation costs	8,000
Repair costs prior to use	7,000
Total acquisition cost	$123,840

As you can see, several individual costs make up the total acquisition cost. We capitalize the total of $123,840 and add it to the Equipment account. Why do we include repair costs in the amount that we capitalize as the acquisition cost of the asset? Normally, we would expense repair costs in the income statement as incurred. The difference is that repair costs incurred prior to the first use of an asset are part of getting the asset ready to use and, therefore, we include them in the acquisition cost on the balance sheet. In contrast, after the machine is in use, we should charge repair costs as expenses in the income statement.

Companies may surrender assets other than cash in exchange for fixed assets. This practice was particularly common in the dot.com and high-tech sectors during the boom years of the late 1990s. Start-up companies that did not have sufficient cash, but whose stock was highly valued, frequently paid for assets using stock. This type of exchange of goods or services in which the assets or liabilities exchanged are not cash is a **nonmonetary exchange.** For example, the owner of a piece of land might sell it in exchange for stock because the owner could either sell the stock immediately or hold the stock in hopes that it would increase in value. According to GAAP, we record a nonmonetary exchange at the fair market value of the asset, land in this example, or the fair market value of the stock, whichever is the more reliably determinable.

nonmonetary exchange *An exchange of goods or services in which the assets or liabilities exchanged are not cash.*

fair market value *The value of an asset based on the price for which a company could sell the asset to an independent third party.*

Fair market value of an asset is the price for which a company could sell the asset to an independent third party. When a stock trades actively, we typically assume that the fair market value of the stock is the best indicator of the value of the transaction. After all, if we asked four different appraisers to appraise the land, they would probably arrive at four different values. Suppose that Woodside Corporation sold land to Tryon Company in exchange for shares of Tryon stock. Tryon is a publicly traded stock whose share price is observable each day. An appraiser valued the land at $100,000, whereas the stock had a market value at the time of the sale of $108,000. Tryon would record the following entry:

Land	$108,000	
Paid-in-capital		$108,000
Purchase of land in exchange for $108,000 of common stock.		

Basket Purchases

Frequently, companies acquire more than one type of long-lived asset for a single overall purchase price. The acquisition of two or more types of assets for a lump-sum cost is

Distinguishing capital expenditure from revenue expenditure

The expenditure incurred by a business must be accounted for as either capital expenditure or revenue expenditure. The basic test applied to distinguish between the two types of expenditure is the effect that the outlay has on the company's long-term ability to earn profits. If it is enhanced, the expenditure is capital; if the expenditure merely enables the business to continue to operate at its existing level, it is revenue. The distinction is of crucial importance because it affects how the expenditure is reported in the profit and loss account and balance sheet. Capital expenditure on fixed assets is recorded in the balance sheet at cost, and is subsequently charged against revenue over the period of years that benefit from the use of the asset. Revenue expenditure, on the other hand, is normally charged in the profit and loss account against revenue arising during the period when the cost is incurred. A proper classification is important, otherwise the reported balances for profit and net assets will be incorrectly stated and wrong conclusions may be reached regarding the performance and position of the firm. The effects of incorrect allocations are shown in Figure 8.1.

	Effect on	
	Profit	*Net Assets*
Capital expenditure wrongly allocated to revenue	Understated	Understated
Revenue expenditure wrongly allocated to capital	Overstated	Overstated

FIGURE 8.1 Effect of wrongly allocating expenditure to capital or revenue

Most items of expenditure are easily classified as capital or revenue, but there are some 'grey areas' where judgement is needed to help make a proper allocation in the light of all the available facts. The cost of fixed assets acquired or built by the firm itself, to form the basis for business activity, is clearly capital expenditure. Difficulties arise in connection with expenditure incidental to the acquisition of the fixed asset and expenditure on fixed assets currently in use. The following rules should be followed to achieve a proper allocation:

1 Expenditure incurred in getting a new fixed asset ready for business use is a capital expense. This includes, for example, any transportation costs, import duties and solicitors' fees. In addition, costs incurred in modifying existing premises to accommodate a new fixed asset should also be capitalized (i.e. put on the balance sheet).
2 Expenditure on an existing fixed asset that enhances its value to the business, e.g. by increasing its capacity, effectiveness or useful life, should be capitalized.
3 Expenditure on an existing fixed asset intended to make good wear and tear and keep it in satisfactory working order is a revenue expense. Where the expenditure contains an element of improvement, as well as repair, an apportionment between capital expenditure and revenue expenditure must be made.

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sometimes called a **basket purchase**. The acquisition cost of a basket purchase is split among the assets purchased according to some estimate of the relative sales value for the assets. For instance, suppose Gap Inc. acquires land and a building for $1 million. How much of the $1 million should Gap allocate to land and how much to the building? If an independent appraiser indicates that the market values of the land and the building are $480,000 and $720,000, respectively, the cost would be allocated as follows:

basket purchase
The acquisition of two or more types of assets for a lump-sum cost.

	(1)	(2)	(3)	(2) × (3)
	Appraised Value	Weighting	Total Cost to Allocate	Allocated costs
Land	$ 480,000	480/1,200 (or 40%)	$1,000,000	$ 400,000
Building	720,000	720/1,200 (or 60%)	1,000,000	600,000
Total	$1,200,000			$1,000,000

Allocating a basket purchase cost to the individual assets can significantly affect future reported income if the useful lives of various assets differ. In our example, if less cost is allocated to the land, more cost is allocated to the building, which is depreciable. In turn, depreciation expenses are higher, operating income is lower, and fewer income taxes are paid. Within the bounds of the law, tax-conscious managers load as much cost as possible on depreciable assets instead of land.

Expenditures During Useful Life

During the useful life of a plant asset, a company may incur costs for ordinary repairs, additions, or improvements. **Ordinary repairs** are expenditures to **maintain** the operating efficiency and productive life of the unit. They usually are fairly small amounts that occur frequently. Examples are motor tune-ups and oil changes, the painting of buildings, and the replacing of worn-out gears on machinery. Companies record such repairs as debits to Maintenance and Repairs Expense as they are incurred. Because they are immediately charged as an expense against revenues, these costs are often referred to as **revenue expenditures**.

In contrast, **additions and improvements** are costs incurred to **increase** the operating efficiency, productive capacity, or useful life of a plant asset. They are usually material in amount and occur infrequently. Additions and improvements increase the company's investment in productive facilities. Companies generally debit these amounts to the plant asset affected. They are often referred to as **capital expenditures**.

Companies must use good judgment in deciding between a revenue expenditure and capital expenditure. For example, assume that Rodriguez Co. purchases a number of wastepaper baskets. Although the proper accounting would appear to be to capitalize and then depreciate these wastepaper baskets over their useful life, it would be more usual for Rodriguez to expense them immediately. This practice is justified on the basis of **materiality**. Materiality refers to the impact of an item's size on a company's financial operations. The **materiality principle** states that if an item would not make a difference in decision making, the company does not have to follow GAAP in reporting that item.

Distinguishing capital expenditure from revenue expenditure

The expenditure incurred by a business must be accounted for as either capital expenditure or revenue expenditure. The basic test applied to distinguish between the two types of expenditure is the effect that the outlay has on the company's long-term ability to earn profits. If it is enhanced, the expenditure is capital; if the expenditure merely enables the business to continue to operate at its existing level, it is revenue. The distinction is of crucial importance because it affects how the expenditure is reported in the profit and loss account and balance sheet. Capital expenditure on fixed assets is recorded in the balance sheet at cost, and is subsequently charged against revenue over the period of years that benefit from the use of the asset. Revenue expenditure, on the other hand, is normally charged in the profit and loss account against revenue arising during the period when the cost is incurred. A proper classification is important, otherwise the reported balances for profit and net assets will be incorrectly stated and wrong conclusions may be reached regarding the performance and position of the firm. The effects of incorrect allocations are shown in Figure 8.1.

	Effect on	
	Profit	*Net Assets*
Capital expenditure wrongly allocated to revenue	Understated	Understated
Revenue expenditure wrongly allocated to capital	Overstated	Overstated

FIGURE 8.1 Effect of wrongly allocating expenditure to capital or revenue

Most items of expenditure are easily classified as capital or revenue, but there are some 'grey areas' where judgement is needed to help make a proper allocation in the light of all the available facts. The cost of fixed assets acquired or built by the firm itself, to form the basis for business activity, is clearly capital expenditure. Difficulties arise in connection with expenditure incidental to the acquisition of the fixed asset and expenditure on fixed assets currently in use. The following rules should be followed to achieve a proper allocation:

1 Expenditure incurred in getting a new fixed asset ready for business use is a capital expense. This includes, for example, any transportation costs, import duties and solicitors' fees. In addition, costs incurred in modifying existing premises to accommodate a new fixed asset should also be capitalized (i.e. put on the balance sheet).
2 Expenditure on an existing fixed asset that enhances its value to the business, e.g. by increasing its capacity, effectiveness or useful life, should be capitalized.
3 Expenditure on an existing fixed asset intended to make good wear and tear and keep it in satisfactory working order is a revenue expense. Where the expenditure contains an element of improvement, as well as repair, an apportionment between capital expenditure and revenue expenditure must be made.

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EXAMPLE 8.1

Indicate for each of the following items whether the expenditure is of a capital or revenue nature:

1 Legal expenses incurred when acquiring a new building.
2 Giving the factory a fresh coat of paint.
3 Replacing 200 tiles on a roof damaged by a gale.
4 Expenditure incurred demolishing part of a wall to make room for a recently purchased machine.
5 Replacing wooden office windows by double-glazed metal windows.
6 Installing a system of ventilation in the factory.

Solution

1 *Capital.* This is part of the cost of acquiring the new asset.
2 *Revenue.* This makes good wear and tear.
3 *Revenue.* This merely restores the roof to its pre-gale condition.
4 *Capital.* This is part of the cost of bringing the fixed asset into use.
5 *Part capital, part revenue.* The new windows should be more effective in eliminating draughts and making the office sound-proof
6 *Capital.* Working conditions and employee performance should improve.

ACTIVITY 8.1

Indicate for each of the following items whether it is capital or revenue expenditure:

1 Repairs and maintenance of factory machinery.
2 Replacement parts for machinery.
3 Lubrication oil for machinery.
4 Import duties on the purchase of a new machine.
5 Delivery costs associated with the purchase.

Readers should now attempt Questions 8.1 and 8.2 at the end of this chapter.

Depreciation is charged in the accounts to reflect the fact that the business has benefited from using fixed assets that, as a result, have declined in value. The pattern of benefit that arises differs from one type of fixed asset to another. For example, some fixed assets produce a greater benefit in the early years of ownership, when the asset is more efficient, whereas others make a fairly steady contribution over their entire useful life. There are a number of different methods of charging depreciation and management should choose the one that most closely reflects the forecast pattern of benefits receivable.

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Depreciation

Meaning and Definition

The term depreciation refers to fall in the value or utility of fixed assets which are used in operations over the definite period of years. In other words, depreciation is the process of spreading the cost of fixed assets over the number of years during which benefit of the asset is received. The fall in value or utility of fixed assets due to so many causes like wear and tear, decay, effluxion of time or obsolescence, replacement, breakdown, fall in market value etc.

According to the Institute of Chartered Accountant of India, "Depreciation is the measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes.

Depreciation, Depletion and Amortization

In order to correct measuring of depreciation it is essential to know the conceptual meaning of depreciation, depletion and amortization.

Depreciation: Depreciation is treated as a revenue loss which is recorded when expired utility fixed assets such as plant and machinery, building and equipment etc.

Depletion: The term depletion refers to measure the rate of exhaustion of the natural resources or assets such as mines, iron ore, oil wells, quarries etc. While comparing with depreciation, depletion is generally applied in the case of natural resources to ascertain the rate of physical shrinkage but in the case of depreciation is used to measure the fall in the value or utility of fixed assets such as plant and machinery and other general assets.

Amortization: The term Amortization is applied in the case of intangible assets such as patents, copyrights, goodwill, trade marks etc., Amortization is used to measure the reduction in value of intangible assets.

Obsolescence: Obsolescence means a reduction of usefulness of assets due to technological changes, improved production methods, change in market demand for the product or service output of the asset or legal or other restrictions.

Purpose of Charging Depreciation

The following are the purpose of charging depreciation of fixed assets:

(1) To ascertain in the true profit of the business.

(2) To show the true presentation of financial position.

(3) To provide fund for replacement of assets.

(4) To show the assets at its reasonable value in the balance sheet.

Factors Affecting the Amount of Depreciation

The following factors are to be considered while charging the amount of depreciation :

(1) The original cost of the asset.

(2) The useful life of the asset.

(3) Estimated scrap or residual value of the asset at the end of its life.

(4) Selecting an appropriate method of depreciation.

Methods of Charging Depreciation

The following are the various methods applied for measuring allocation of depreciation cost :

(1) Straight Line Method

(2) Written Down Value Method

(3) Annuity Method

(4) Sinking Fund Method

(5) Revaluation or Appraisal Method

(6) Insurance Policy Method

(7) Depletion Method

(8) Sum of the Digits Method

(9) Machine Hour Rate Method

(1) Straight Line Method

This method is also termed as Constant Charge Method. Under this method, depreciation is charged for every year will be the constant amount throughout the life of the asset. Accordingly depreciation is calculated by deducting the scrap value from the original cost of an asset and the balance is divided by the number of years estimated as the life of the asset. The following formula for calculating the periodic depreciation charge is :

$$\text{Depreciation} = \frac{\text{Original Cost of Asset} - \text{Scrap Value}}{\text{Estimated Life of Asset}}$$

(or)

$$\text{Depreciation} = \frac{C - S}{N}$$

Where
D = Depreciation Rate
C = Original Cost of Asset
S = Salvage or Scrap Value
N = Estimated Useful Life

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Illustration: 1

From the following information you are required to calculate depreciation rate :

Cost of the Machine	Rs. 30,000
Erection Charges	Rs. 3,000
Estimated useful life	10 years
Estimated Scarp Value	Rs. 3000

Solution:

Calculation of depreciation rate for every year :

$$\text{Depreciation} = \frac{\text{Original Cost of Asset} - \text{Scrap Value}}{\text{Estimated Life of an Asset}}$$

$$= \frac{\text{Rs. } 33{,}000 - \text{Rs. } 3{,}000}{10} = \frac{\text{Rs. } 30{,}000}{10} = \text{Rs. } 3{,}000$$

Thus, the amount of depreciation would be Rs. 3,000 for every year.

Merits

(1) Simple and easy to calculate.

(2) Original cost of asset reduced up to Scrap Value at the end of estimated life.

(3) Estimated useful life of the asset can be estimated under this method.

Demerits

(1) It does not consider intensity of use of assets.

(2) It ignores any additions or opportunity cost while calculating depreciations.

(3) It ignores effective utilization of fixed assets, it becomes difficult to calculate correct depreciation rate.

(4) Under the assumption of constant charges of maintance of assets it is impossible to calculate true depreciation.

Illustration: 2

A company charges depreciation on plant and machinery under constant charge method @ 25% per annum. On 1st January, 2000 Machinery was Purchased for Rs. 1,00,000 is estimated to have a life of four years.

From the above information, you are required to prepare a Machinery account.

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		25,000		25% on Rs.1,00,000	25,000
		25,000			25,000

Illustration: 3

On 1st January, 2000, a firm purchased Ist January, 2001 and on Ist July 2003 to the value of Rs. 28,500 and Rs. 25,200. Residual values being Rs. 1,500 and Rs. 1,200 respectively. You are required to prepare a Machinery Account for the first four years if depreciation is written off according to Straight Line Method assuming that the estimated Working life of the asset is 10 years and its Scrap Value Rs. 15,000 at the end of its life.

Solution:

Calculation of depreciation for every year:

$$\text{Depreciation} = \frac{\text{Original Cost of Asset} - \text{Scrap Value}}{\text{Estimated Life of an Asset}}$$

$$\text{I year Depreciation (Original Cost of Asset)} = \frac{\text{Rs.}1{,}65{,}000 - \text{Rs.}15{,}000}{10}$$

$$= \frac{\text{Rs.}1{,}50{,}000}{10} \quad \text{Rs.}15{,}000 \text{ P.A.}$$

$$\text{II year Depreciation (for additional Value of Asset)} = \frac{\text{Rs.}28{,}500 - \text{Rs.}1{,}500}{10}$$

$$\frac{\text{Rs. } 27{,}000}{10} = \text{Rs. } 2{,}700 \text{ P.A.}$$

$$\text{III year Depreciation (for additional Value of Asset)} = \frac{\text{Rs. } 25{,}200 - \text{Rs. } 1{,}200}{10}$$

$$\frac{\text{Rs. } 24{,}000}{10} = \text{Rs. } 2{,}400 \text{ P.A.}$$

Dr. **Machinery Account** Cr.

Date	*Particulars*	*Amount Rs.*	*Date*	*Particulars*	*Amount Rs.*
2000 Jan. 1	To Bank A/C (for original Cost of machine)	1,65,000	2000 Dec. 31	By Depreciation By Balance c/d	15,000 1,50,000
		1,65,000			1,65,000

Jan. 1	To Balance b/d	1,49,400			

Note: Depreciation Calculated for additional cost of machine of Rs. 25,200 is only six months for Rs. 1,200.

(2) Written-Down Value Method (WDV)

This method is also known as Fixed Percentage On Declining Base Method (or) Reducing Installment Method. Under this method depreciation is charged at fixed rate on the reducing balance (i.e., Cost less depreciation) every year. Accordingly the amount of depreciation gradually reducing every year.

The depreciation charge in the initial period is high depreciation charge in the initial period is high and negligible amount in the later period of the asset. The following formula used for computing depreciation rate under Written-Down Value Method.

$$r = I - \sqrt[n]{\frac{S}{C}} \times 100 = \left[I - \frac{S}{C}^{\frac{1}{n}} \right] \times 100$$

Where ,

R = Rate of Depreciation

S = Estimated Scrap Value

N = Estimated Life of the Asset

C = Original Cost of the Machine or Asset

Illustration: 4

From the following information you are required to calculate depreciation rate under WDV Method.

Cost of the Machine	Rs. 10,000
Estimated Useful Life	3 years
Estimated Scrap or Salvage Value	Rs. 1,000

Solution:

Calculation of Depreciation Rate Under Declining Base Method

$$r = I - \sqrt[n]{\frac{S}{C}} \times 100$$

Where

R = Rate of Depreciation

S = Scrap Value

C = Cost of the Machine

n = Estimated Useful Life

$$r = I - \sqrt[3]{\frac{1,000}{10,000}}$$

$$r = I \left[\frac{1}{10} \right]^{\frac{1}{3}} = \left[\sqrt[n]{\frac{S}{C}} \text{ is the same as } \left[\frac{S}{C} \right]^{\frac{1}{n}} \right]$$

$$r = I - \frac{1}{\frac{1}{10^3}} = I - \frac{1}{2.154} = I - 464 = 0.536$$

Rate of Depreciation = 0.536 x 100 = 53.6 %

Amount of Depreciation = $10{,}000 \ \frac{53.6}{100}$ = Rs. 5,360

Illustration: 5

From the following information you are required to calculate depreciation rate for two years under Written Down Value Method:

Original Cost of the Machine	Rs. 30,000
Erection Charges	Rs. 3,000
Estimated Useful Life	10 years
Estimated Scrap Value	Rs. 3,000

Depreciation to be charged at 10% on the WDV Method.

Solution:

Calculation of Depreciation charges under Written Down Value Method.

Original Cost of the Machine	33,000
Less : Salvage Value at the end	3,000
	30,000
Depreciation for the First year at 10% of Rs. 10,000	3,000
	27,000
Depreciation for the Second year at 10% of Rs. 9,000	2,700
	24,300

Merits

(1) This method is accepted by Income Tax Authorities.

(2) Impact of obsolescence will be reduced at minimum level.

(3) Fresh calculation is not required when additions are made.

(4) Under this method the depreciation amount is gradually decreasing and it will affect the smoothing out of periodic profit.

Demerits

(1) Residual Value of the asset cannot be correctly estimated.

(2) It ignores interest on investment on opportunity cost which will lead to difficulty while determining the rate of depreciation.

(3) It is difficult to ascertain the true profit because revenue contribution of the asset are not constant.

(4) The original cost of the asset cannot be brought down to zero.

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Date	Particulars	Amount Rs.	Date	Particulars	Amount Rs.
2001 Jan.1	To Bank A/c	1,00,000			

(7) Depletion Method

Depletion Method is mostly used for natural resources such as mines, quarries, oil and gas etc. from which certain quantity of he resources can be obtained on the basis of the availability of minerals. The quantity of output exhaust to reaches a stage of depletion. The rate of depreciation is determined on the basis of the quantity obtained for every year. The formula is :

$$\text{Rate of Depreciation} = \frac{\text{Cost of Mines}}{\text{Estimated Minerals to be Extracted}}$$

$$\text{Depreciation} = \text{Annual Quantity x Rate of Depreciation}$$

Illustration: 15

A mine was purchased for Rs. 20,00,000 on 1st Jan. 2000. And it was estimated content of being 1,00,000 tones. The actual quantity was 2001 – 20,000 tonnes, 2002 – 25,000 tonnes and 2003 – 30,000 tonnes. You are required to prepare a Mine Account using Depletion Method of depreciation for the above said years.

Solution:

Calculation for Rate of Depreciation

$$\text{Rate of Depreciation} = \frac{\text{Cost of Mines}}{\text{Estimated Minerals to be Extracted}}$$

$$= \frac{\text{Rs. 20,000,000}}{\text{Rs. 1,00,000}} = \text{Rs. 20 Per tone}$$

$$\text{Rate of Depreciation} = \text{Rs. 20 Per tone.}$$

2003 Jan.1	To Balance b/d	11,00,000	*2003* Dec.31	By Depreciation A/c (30,000 x 20)	6,00,000
			Dec.31	By Balance c/d	5,00,000
		11,00,000			11,00,000
2004 Jan.1	To Balance b/d	5,00,000			

(8) Sum of Years Digits (SYD) Method

This method also termed as SYD Method. The Sum of years Digits Method is designed on the basis of Written-Down Value Method. Under this method the amount of depreciation to be charged to the Profit and Loss Account goes on decreasing every year throughout the life of the asset. The formula for calculating the amount of depreciation is as follows :

$$\text{Rate of Depreciation} = \frac{\text{Remaining Life of the Asset (Including current year)}}{\text{Sum of all the digits of the life of the assets in years}} \times \text{Original Cost of the Asset}$$

Illustration: 16

A machine was purchased for a sum of Rs.20,000 having useful life of 3 years. From the above particulars, you are required to calculate depreciation under Sum of Years Digits Method.

Solution:

Calculation of Depreciation Under SYD Method :

$$\text{Rate of Depreciation} = \frac{\text{Remaining Life of the Asset (Including current year)}}{\text{Sum of all the digits of the life of the assets in years}} \times \text{Original Cost of the Asset}$$

$$\text{I Year} = \frac{3}{1+2+3} \times \text{Rs. } 20{,}000$$

$$= \frac{3}{6} \times \text{Rs. } 20{,}000 = \text{Rs.}10{,}000$$

$$\text{II Year} = \frac{2}{6} \times \text{Rs. } 20{,}000 = \text{Rs.}6{,}667$$

$$\text{III Year} = \frac{1}{6} \times \text{Rs. } 20{,}000 = \text{Rs.}3{,}333.33$$

(9) Machine Hour Rate Method

This method is similar to the Depletion Method but instead of taking estimated available quantities in advance, the working life of the machine is estimated in terms of hours. The hourly rate of depreciation is determined by dividing the cost of the machine minus scrap value of the machine by the estimated total number of hours utilized every year.

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Illustration: 17

A machine was purchased on 1st Jan. 2001 at a cost of Rs. 1,50,000, the cost of installation being Rs. 10,000. The estimated working life of the machine was 40,000 hours. During 2001 it was worked for 5,000 hours and during 2002 for 10,000 hours. You are required to prepare Machine Account for the above said years.

Solution:

Calculation of Machine Hour Rate :

$$\text{Machine Hour Rate} = \frac{\text{Cost of the Machine}}{\text{Estimated Total Hours of Life}}$$

$$= \frac{\text{Rs. } 1{,}50{,}000 + \text{Rs. } 10{,}000}{\text{Rs. } 40{,}000}$$

$$= \frac{\text{Rs. } 1{,}60{,}000}{\text{Rs. } 40{,}000} = \text{Rs. 4 Per hour.}$$

Dr. **Machine Account** **Cr.**

Date	Particulars	Amount Rs.	Date	Particulars	Amount Rs.
2001			2001		
Jan.1	To Bank A/c (Rs.1,50,000 + 10,000)	1,60,000	Dec.31	By Depreciation A/c (5000 hours x Rs.4)	20,000
			Dec.31	By Balance c/d	1,40,000
		1,60,000			1,60,000
2002			2002		
Jan.1	To Balance b/d	1,40,000	Dec.31	By Depreciation A/c (10,000 hrs x Rs.4)	40,000
			Dec.31	By Balance c/d	1,00,000
		1,40,000			1,40,000
2003					
Jan.1	To Balance b/d	1,00,000			

QUESTIONS

1. What do you understand by Depreciation?
2. Define Depletion and Amortization.
3. What are the purpose of charging depreciation?
4. Explain briefly the various methods of charging depreciation.
5. Write short notes on :
   (a) Straight Line Method.
   (b) Written - Down Value Method.
   (c) Annuity Method.
   (d) Insurance Policy Method.
   (e) Depletion Method.
   (f) Revaluation Method.
6. What do you understand by Sinking Fund Method? Explain it briefly.
7. Discuss the merits and demerits of Straight Line Method.
8. What do you understand by Machine Hour Rate method of depreciation?
9. What are the factors affecting the amount of depreciation?

PRACTICAL PROBLEMS

(1) On 1st March 2003, a machinery was purchased by Govind for Rs. 1,00,000 and installation expenses of Rs. 10,000. On 1st June 2003 a new machine was purchased for a sum of Rs. 40,000. Assuming that rate of depreciation is @ 15% premium. You are required to prepare Machinery Account for 5 years under (1) Straight Line Method and (2) Diminishing Balance Method.

(2) On 1st Jan. 2003 A Ltd. Company purchased a lease for three years for Rs. 80,000. It is decided to provide write off depreciation on Annuity Method. Assuming that rate of depreciation is @ 5% P.A. Annuity Table shows that Re. 367208 at 5% rate of interest is required for an Annuity of Re.1 in three years.

[**Ans** : Balance fo Rs. 27,978.40]

(3) You are asked to calculate the depreciation for the first three years under Sum of Years Digit Method. Mrs. Govind & Co. purchased an asset for Rs. 2,10,000. Estimated life of the asset is 6 years. The Scrap Value of an asset is estimated for Rs. 10,000.

[**Ans** : Balance at the end of third years Rs. 28571.41]

(4) Y Co. Ltd. purchased a lease of mine worth of Rs. 2,00,000 on1st Jan. 2003. It is estimated that total quantity of output available in the mine is 50,000 tones. The annual output is as follows :

Year	Quantities
1999	8,000
2000	15,000
2001	12,000
2002	10,000

From the above information, you are required to prepare Mine Account using the Depletion Method of Depreciation.

(5) X Y Z Ltd. purchased a machine for Rs. 14,400 on 1st Jan. 2003. It is estimated that the Scrap Value of Rs. 3,400 at the end of ten years. Find out depreciation and written down value by equal installments of every year. And also you are required to calculate rate of depreciation and prepare Machinery Account for the above said years.

[**Ans** : Balance of Machinery A/c Rs. 11,100; Rate of Depreciation 7.64%]

(6) A Company purchased a lease worth of Rs. 60,000 on 1st Jan. 2000 for 3 years. It decided to provide for its replacement by means of Insurance policy for Rs. 60,000. The annual premium is Rs. 19,000. On 1st Jan. 2003 the lease is renewed for a further period of 3 years for Rs. 60,000. You are required to show the necessary ledger accounts.

[**Ans** : Lease A/c Balance at the end of 3rd year Rs. 60,000; Depreciation Reserve A/c Rs. 3,000; Depreciation Insurance Policy A/c Rs. 3000; (Profit transferred to Depreciation Reserve A/c)]

(7) A & B Ltd. purchased a lease for 3 years for Rs. 3,00,000. On 1st Jan. 2000 it decided to provide for its replacement by taking an insurance policy for Rs. 3,00,000. The annual premium was Rs. 95,000. On 1st Jan. 2003 the lease is renewed for a further period of 3 years for Rs. 3,00,000 show necessary accounts.

[**Ans** : Profit Rs. 15,000]

(8) Gowda & Co. purchased a machine for Rs. 2,00,000 on 1st Jan. 2000. The estimated useful life at 3 years with a Scrap Value Rs. 20,000. You are required to calculate depreciation charged from Profit and Loss Account by Sinking Fund Method. The Sinking Fund Table shows that 0.317208 at 5% P.A. will be in 3 years accumulate to Re.1.

[**Ans** : Depreciation Rs. 57097.44]

(9) Gupta Ltd. purchased a machine for sum of Rs. 9,000 on 1st April 2001 and it spend installation charge of Rs. 1000. Estimated total life of working hours will be 2000 hours. During 2001 it worked for 1600 hours and 2002 for 2400 hours. You are required to prepare Machinery Account for 2002 and 2003.

[**Ans** : Balance Rs. 8,000]

(10) Himalaya Ltd. purchased a lease worth of Rs. 2,00,000 on 1st Jan. 1999 for a term of 4 years. You find from Annuity tables that in order to write off lease on the Annuity Method at 6% P.A. interest, the amount to be written off annually works out to be Re. 0.288591 for every rupee. Prepare Lease A/c for 4 years.

[**Ans** : Balance at the end of 4th year is Rs.54452]

(11) A Company purchased an old lorry for Rs. 1,00,000 on 1St April 1996 and wrote off depreciation @ 15% on the diminishing value balance. At the end of 1996, it decided that the depreciation should be on the basis of 15% of the original cost from the very beginning and write off necessary amount in 1996. Assuming the company closes the books on 31St March, write up the lorry account up to the end of 2003.

[**Ans:** Balance Rs. 40,000: Excess depreciation to be written off for 1996-97 Rs. 6412.50]

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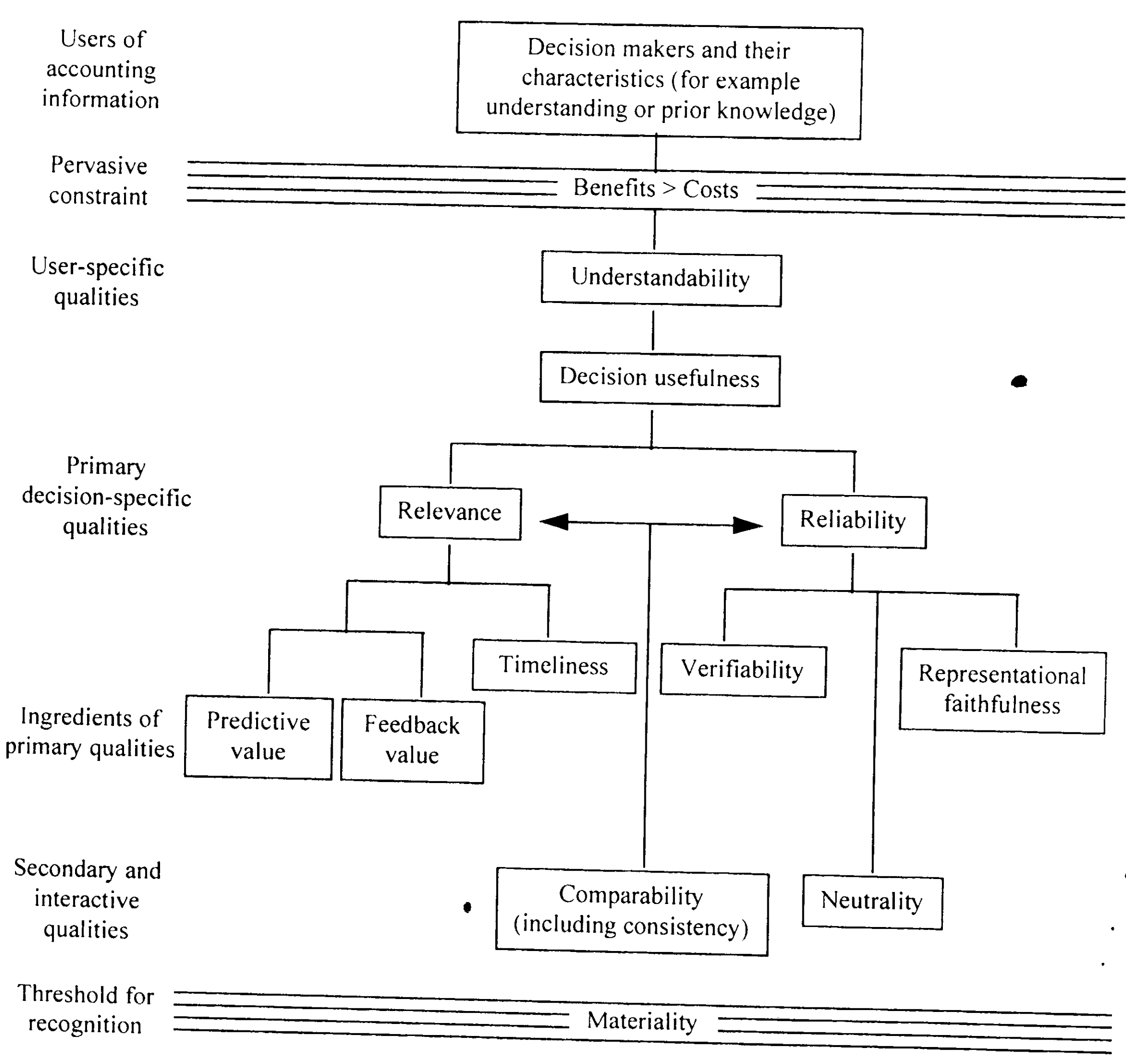
Chapter 9 - Accounting Theory

The purpose of this research is to introduce information on flexibility into the accounting information system, which meets the objective of being useful in decision making. In order to assess whether accounting information is decision useful, a number of qualitative characteristics are identified from the accounting literature.

Figure 2.1 : A hierarchy of accounting qualities



Source: Hendriksen, E. S. & Van Breda, M. F. (1992), *Accounting theory*, 5th ed., Homewood, Ill.: Irwin, p.132.

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Qualitative Characteristics of Accounting Information

تعريف ⇒ In this section, you will be exposed to the qualitative characteristics of accounting information. Qualitative characteristics of accounting information refer to the characteristics that must be present in the accounting information to make it useful. These characteristics are divided into two categories; primary and secondary qualities.

The primary qualities of accounting information are relevant and reliability, while the secondary qualities are comparability and consistency. In summary, accounting information is only useful if it has relevant, reliability, comparability and consistency qualities.

(a) Relevant

In everyday terms, we might describe relevant as important or being related. In accounting, relevant is described as something that makes a difference in arriving at a decision. In other words, something is said to be relevant if it influences or affects the decision being made.

The extent to which information is considered relevant depends on its importance in decision making and may differ between one decision maker to another. Information that is relevant to you might not be relevant to another person and vice versa.

After knowing the meaning of relevant, you must also know how certain information are said to be relevant. To become relevant, the information must have three characteristics, namely feedback value, forecast value and timeliness.

(i) Feedback Value
Relevant information must be able to assist users in substantiating or correcting early expectations matters at hand.

(ii) Forecast Value (predictive value)
Relevant information must be able to assist users in forecasting.

(iii) Timeliness
Relevant information must be obtained before it becomes obsolete or unusable.

(b) Reliability

Reliability means that users can rely or depend on the said information to make good decisions. This characteristic is important because users might not have the time or expertise to evaluate some information. Generally, users simply depend on the information presented by the related entity and assume it to be true. This information is then used in decision making.

Reliability does not mean that the said information must be precise. This is because in accounting there are a lot of information that involves estimation and approximation that might not be precise. What is important is that the estimation and approximation made must be reliable.

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Reliable information must have the following characteristics:

(i) Verifiable

This means that the accounting information could be verified objectively by another person using the same method.

(ii) Neutrality

in this case means that the information is not biased. Information contained in the financial statements must be able to fulfil the requirements of various users and not concentrating on certain groups only.

(iii) Representational faithfulness

Information presented is based on the actual result of economic activities using specified methods.

(c) Comparability

Comparability means that the information can be compared whether among companies, industries or different periods. This will enable users to identify the similarities or differences that might exist in the said information. This characteristic is important because information that can be compared is more useful.

(d) Consistency

Consistency means that an entity must use the same accounting procedures in every period. It is for the purpose of enabling comparison to be made more effectively. In other words, a company cannot change their accounting procedure every year. This does not mean that the company cannot change the accounting procedure at all. Changes can still be made, but the company must make complete disclosure in the financial statement to explain to the users why they are making the changes and the effect of the changes towards the financial statements.

Materiality

3. Information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality depends on the size and nature of the item, judged in the particular circumstances of its misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful.

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Generally Accepted Accounting Principles

Study Objective 4

Explain generally accepted accounting principles.

The accounting profession has developed standards that are generally accepted and universally practiced. This common set of standards is called **generally accepted accounting principles (GAAP)**. These standards indicate how to report economic events.

The primary accounting standard-setting body in the United States is the **Financial Accounting Standards Board (FASB)**. The **Securities and Exchange Commission (SEC)** is the agency of the U.S. government that oversees U.S. financial markets and accounting standard-setting bodies. The SEC relies on the FASB to develop accounting standards, which public companies must follow. Many countries outside of the United States have adopted the accounting standards issued by the **International Accounting Standards Board (IASB)**. These standards are called International Financial Reporting Standards (IFRS).

As markets become more global, it is often desirable to compare the result of companies from different countries that report using different accounting standards. In order to increase comparability, in recent years the two standard-setting bodies have made efforts to reduce the differences between U.S. GAAP and IFRS. This process is referred to as **convergence**. As a result of these convergence efforts, it is likely that someday there will be a single set of high-quality accounting standards that are used by companies around the world. Because convergence is such an important issue, we highlight any major differences between GAAP and IFRS in *International Notes* (as shown in the margin here) and provide a more in-depth discussion in the *A Look at IRFS* section at the end of each chapter.

International Note

Over 100 countries use International Financial Reporting Standards (called IFRS). For example, all companies in the European Union follow international standards. The differences between U.S. and international standards are not generally significant.

International Notes highlight differences between U.S. and international accounting standards.

1.5 Development of financial accounting standards

Several organizations are influential in the establishment of generally accepted accounting principles (GAAP) for businesses or governmental organizations. These are the American Institute of Certified Public Accountants, the Financial Accounting Standards Board, the Governmental Accounting Standards Board, the Securities and Exchange Commission, the American Accounting Association, the Financial Executives Institute, and the Institute of Management Accountants. Each organization has contributed in a different way to the development of GAAP.

The American Institute of Certified Public Accountants (AICPA) is a professional organization of CPAs. Many of these CPAs are in public accounting practice. Until recent years, the AICPA was the dominant organization in the development of accounting standards. In a 20-year period ending in

1959, the AICPA Committee on Accounting Procedure issued 51 *Accounting Research Bulletins* recommending certain principles or practices. From 1959 through 1973, the committee's successor, the **Accounting Principles Board (APB)**, issued 31 numbered *Opinions* that CPAs generally are required to follow. Through its monthly magazine, the *Journal of Accountancy*, its research division, and its other divisions and committees, the AICPA continues to influence the development of accounting standards and practices. Two of its committees—the Accounting Standards Committee and the Auditing Standards Committee—are particularly influential in providing input to the Financial Accounting Standards Board (the current rule-making body) and to the Securities and Exchange Commission and other regulatory agencies.

In 1973, an independent, seven-member, full-time **Financial Accounting Standards Board (FASB)** replaced the Accounting Principles Board. The FASB has issued numerous *Statements of Financial Accounting Standards*. The old *Accounting Research Bulletins* and *Accounting Principles Board Opinions* are still effective unless specifically superseded by a Financial Accounting Standards Board Statement. The FASB is the *private sector* organization now responsible for the development of new financial accounting standards.

The Emerging Issues Task Force of the FASB interprets official pronouncements for general application by accounting practitioners. The conclusions of this task force must also be followed in filings with the Securities and Exchange Commission.

In 1984, the **Governmental Accounting Standards Board (GASB)** was established with a full-time chairperson and four part-time members. The GASB issues statements on accounting and financial reporting in the governmental area. This organization is the *private sector* organization now responsible for the development of new governmental accounting concepts and standards. The GASB also has the authority to issue interpretations of these standards.

Created under the Securities and Exchange Act of 1934, the **Securities and Exchange Commission (SEC)** is a government agency that administers important acts dealing with the interstate sale of securities (stocks and bonds). The SEC has the authority to prescribe accounting and reporting practices for companies under its jurisdiction. This includes virtually every major US business corporation. Instead of exercising this power, the SEC has adopted a policy of working closely with the accounting profession, especially the FASB, in the development of accounting standards. The SEC indicates to the FASB the accounting topics it believes the FASB should address.

Consisting largely of accounting educators, the **American Accounting Association (AAA)** has sought to encourage research and study at a theoretical level into the concepts, standards, and principles of accounting. One of its quarterly magazines, *The Accounting Review*, carries many articles

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reporting on scholarly accounting research. Another quarterly journal, *Accounting Horizons*, reports on more practical matters directly related to accounting practice. A third journal, *Issues in Accounting Education*, contains articles relating to accounting education matters. Students may join the AAA as associate members by contacting the American Accounting Association, 5717 Bessie Drive, Sarasota, Florida 34233.

The **Financial Executives Institute** is an organization established in 1931 whose members are primarily financial policy-making executives. Many of its members are chief financial officers (CFOs) of very large corporations. The role of the CFO has evolved in recent years from number cruncher to strategic planner. These CFOs played a major role in restructuring American businesses in the early 1990s. Slightly more than 14,000 financial officers, representing approximately 7,000 companies in the United States and Canada, are members of the FEI. Through its Committee on Corporate Reporting (CCR) and other means, the FEI is very effective in representing the views of the private financial sector to the FASB and to the Securities and Exchange Commission and other regulatory agencies.

The **Institute of Management Accountants** (formerly the National Association of Accountants) is an organization with approximately 70,000 members, consisting of management accountants in private industry, CPAs, and academics. The primary focus of the organization is on the use of management accounting information for internal decision making. However, management accountants prepare the financial statements for external users. Thus, through its Management Accounting Practices (MAP) Committee and other means, the IMA provides input on financial accounting standards to the Financial Accounting Standards Board and to the Securities and Exchange Commission and other regulatory agencies.

Many other organizations such as the Financial Analysts Federation (composed of investment advisers and investors), the Securities Industry Associates (composed of investment bankers), and CPA firms have committees or task forces that respond to Exposure Drafts of proposed FASB Statements. Their reactions are in the form of written statements sent to the FASB and testimony given at FASB hearings. Many individuals also make their reactions known to the FASB.

1.6 Ethical behavior of accountants

Several accounting organizations have codes of ethics governing the behavior of their members. For instance, both the American Institute of Certified Public Accountants and the Institute of Management Accountants have formulated such codes. Many business firms have also developed codes of ethics for their employees to follow.

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44. Relevant financial information
a. is free from bias and error.
b. is measured in a similar manner among different companies.
c. can be independently verified.
d. is capable of making a difference in a decision.

45. Financial information that is provided to decision makers before it loses its capacity to influence their decisions is
a. neutral.
b. verifiable.
c. timely.
d. consistent.

46. Timeliness is a qualitative characteristic of accounting information that indicates that information should be provided to users
a. within one month after the close of the books.
b. before it loses its capacity to influence their decisions.
c. before statutory deadlines.
d. every month.

47. Reliable information is
a. consistent, unbiased, and relevant.
b. relevant, comparable, and timely.
c. relevant, consistent, and timely.
d. factual, truthful, and unbiased.

48. Financial information that is verifiable, faithfully represented, and neutral is
a. reliable.
b. consistent.
c. comparable.
d. relevant.

49. When independent measurers get similar results when using the same accounting measurement methods, the financial information is
a. relevant.
b. verifiable.
c. timely.
d. faithfully represented.

50. Financial information that does **not** favor one set of interested parties over another is
a. relevant.
b. verifiable.
c. neutral.
d. faithfully represented.

51. If a company fails to disclose information about a lawsuit because it might be embarrassing to the company, it is violating
a. relevance.
b. verifiability.
c. neutrality.
d. timeliness.

52. When financial information is measured and reported in a similar manner across different companies in the same industry it is
a. consistent.
b. comparable.
c. neutral.
d. faithfully represented.

53. Using the same accounting methods to record and report similar events from period to period demonstrates
a. consistency.
b. comparability.
c. neutrality.
d. faithful representation.

54. When a company changes from straight-line to the declining balance method of accounting for depreciation, it violates
a. comparability.
b. consistency.
c. neutrality.
d. faithful representation.

55. When a financial statement contains omissions or misstatements that would alter the judgment of a reasonable person, it violates
a. neutrality.
b. consistency.
c. conservatism.
d. materiality.

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Chapter 10 Cost Accounting

- Introduction
- Costing and Cost Accounting
- Objectives of Costing
- Cost Centre and Cost Unit
- Elements of Cost
- Classification of Costs
- Difference between Allocation and Apportionment
- Methods of Costing
- Techniques of Costing
- Importance (Advantages) of Cost Accounting
- Limitations of Cost Accounting
- Check Your Understanding
- Descriptive Questions
- Interview Questions

13.1 INTRODUCTION

Cost Accounting, essentially a branch of Accounting, has been developed to meet the managerial needs of business. Cost Accounting is, relatively, a recent development due to the growth of modern complexities in business. Cost Accounting is a formal system of accounting costs in the books of accounts by means of which costs of products and services are ascertained and

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controlled. This information helps the business operations for the purpose of analysis and control. Cost Accounting is used in profit and non-profit sectors of the economy by manufacturing and non-manufacturing organizations. Cost Accounting facilitates presentation of information to management for the ultimate purpose of decision-making.

13.2 COSTING AND COST ACCOUNTING

Costing should not be confused with cost accounting. They are two different terms. Costing, simply, means finding out cost, by any process or technique. It can be:

(A) Cost of manufacturing a product e.g. mobile, television, chemical etc.

(B) Cost of providing a service e.g. transport by a specific mode, electricity etc.

Cost Accounting is the formal system for recording costs. However, both the terms costing and cost accounting are often used, interchangeably.

Costing is defined as 'the technique and process of ascertaining costs' by Chartered Institute of Management Accountants (CIMA).

The terminology of Cost Accountancy published by the Institute of Cost and Management Accountants, London gives the following definition to Cost Accounting:

'The process of accounting for cost which begins with recording of income and expenditure and ends with the preparation of periodical statements and reports for ascertaining and controlling costs.'

13.3 OBJECTIVES OF COSTING

The main objectives of costing are:

(1) To ascertain the cost of products and/or services

(2) To determine selling price

(3) To control costs and

(4) To provide guidance to the management for formulation of policy.

1.3.1 *Cost* :- Cost can be defined as the expenditure (actual or notional) incurred on or attributable to a given thing. It can also be described as the resources that have been sacrificed or must be sacrificed to attain a particular objective. In other words, cost is the amount of resources used for something which must be measured in terms of money. For example – Cost of preparing one cup of tea is the amount incurred on the elements like material, labor and other expenses, similarly cost of offering any services like banking is the amount of expenditure for offering that service. Thus cost of production or cost of service can be calculated by ascertaining the resources used for the production or services.

13.4 COST CENTRE AND COST UNIT

Cost Centre: A cost centre is "a location, person or item or equipment (or group of these) for which costs may be ascertained and used for purpose of control".

Cost centre may be

(1) a location (department like production department, sales department)

(2) a person (salesman, foreman)

(3) an item of equipment (a lathe machine or delivery van)

(4) a group of those equipments (two automatic machines operated by one workman)

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Importance: The determination of cost centre is very important for ascertainment of cost and cost control. Cost accountant sets up cost centres to enable him to ascertain the costs, he needs to know. The manager incharge of cost centre is held responsible for the purpose of cost control. The size and number of cost centers are dependent upon the amount of expenditure and requirements of management for cost control.

Cost Unit: Cost centre helps in ascertaining the cost by location, equipment or person. Cost unit is a further step, which breaks up the cost into smaller sub-divisions and helps in ascertaining the cost of a saleable product or service.

A cost unit is a unit of product, service or time in relation to which cost may be ascertained or expressed. For example, the cost of steel is ascertained in terms of cost per tonne, cost of carrying a passenger in terms of per kilometer.

A few examples of cost units in different industries are given below:

Industry	Cost Unit
Cement	Per Tonne
Textile	Per Metre
Chemical	Per kg or per Tonne
Power	Per Kilowatt hour (kWH)
Automobile	Per car, vehicle

Difference between Cost Accounting and Financial Accounting

The distinguishing features of financial accounting and cost accounting are given below.

	Financial Accounting		Cost Accounting
1.	It aims at finding out results of accounting year in the form of Profit and Loss Account and Balance Sheet.	1.	It aims at computing cost of production/service in a scientific manner and then cost control and cost reduction.
2.	It is more attached with reporting the results and position of business to persons and authorities other than management like government, creditors, investors, owners etc.	2.	It is an internal reporting system for an organization's own management for decision making.
3.	Financial Accounting data is historical in nature	3.	It not only deals with historical data but is also futuristic in approach.
4.	In financial accounting, the major emphasis is in cost classification based on type of transactions, e.g. salaries, repairs, insurance, stores etc.	4.	In cost accounting, classification is basically on the basis of functions, activities, products, process and on internal planning and control and information needs of the organization.
5.	In financial accounting, only those transactions are recorded which can be expressed in monetary terms.	5.	Cost accounting uses both monetary as well as quantitative information.
6.	It aims at presenting 'true and fair' view of the profit and loss position as well as financial position.	6.	It aims at computing 'true and fair' view of the cost of production/services offered by the firm.
7.	Financial Accounts are subject to statutory audit to verify whether they disclose a true and fair view of the profit and loss as well as financial position	7.	Cost accounts are subject to cost audit which verifies whether the cost accounts disclose true and fair view of the cost of production of the company.

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13.5 ELEMENTS OF COST

A cost is composed of three elements – Materials, Labour and Expenses. Each of these can be direct or indirect.

Material Cost: This is the cost of inputs supplied to an undertaking. For example, cotton used in a cotton mill is a direct material. However, in many cases, though material forms part of the finished product, yet it is not considered direct material. For example, nails used in furniture, thread used in stitching garments are indirect material. The value of these materials is so small that it is difficult and futile to count or measure them.

Labour Cost: This is the cost of remuneration (wages, salaries, commission, bonus etc). Direct labour consists of wages paid to workers, directly, engaged in converting raw materials into finished products. These wages can be identified with a particular product. Wages paid to a machine operator is an example of direct wages. Indirect wages is of a general character and cannot be, conveniently, identified with a particular cost unit. In other words, indirect labour is not, directly, engaged in the production operation, but to assist or help in production operation. Labour engaged in cleaning the workshop is an example of indirect labour.

Expenses: All costs other than materials and labour are termed as expenses. Direct expenses are those, which can be identified with and allocated to cost centers or units. Direct expenses

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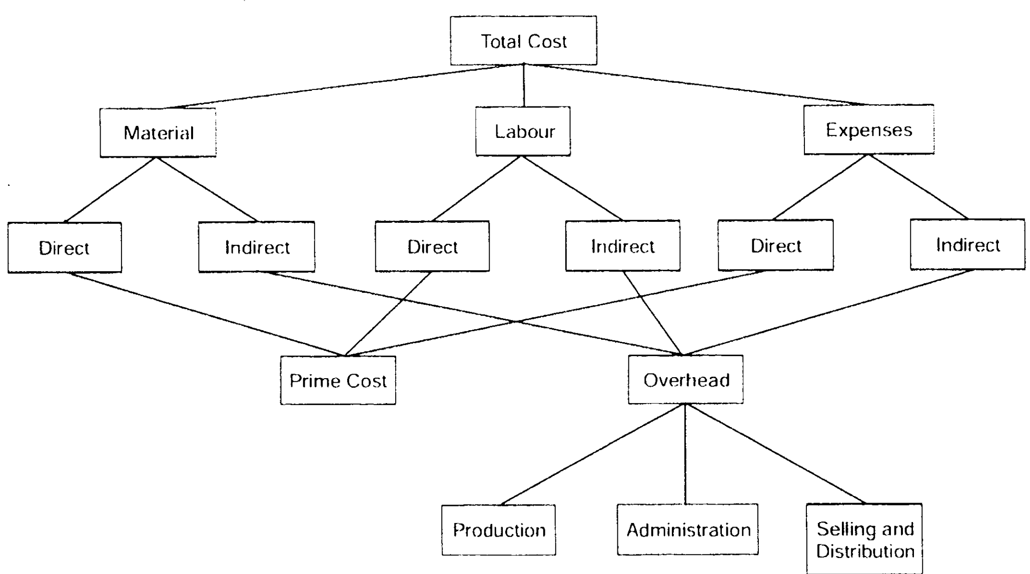
are those expenses, which are specifically incurred in connection with a particular job or cost unit. Direct expenses are also known as chargeable expenses.

Indirect expenses are indirect costs, other than indirect materials and indirect labour costs. These cannot be, directly, identified with a particular job, process or work order and are common to cost units and cost centres.

Indirect expenses are also known as Overheads.

The chart below summarises the elements of cost.

1. Direct Material + Direct Labour + Direct Expenses = Prime Cost
2. Prime Cost + Production overhead = Factory Cost or Works Cost
3. Works Cost + Administration Overheads = Cost of Production
4. Cost of Production + Selling and Distribution Overheads = Total Cost or Cost of Sales



Elements of Cost

13.6 CLASSIFICATION OF COSTS

There are various ways of classifying costs. Each classification serves different purpose.

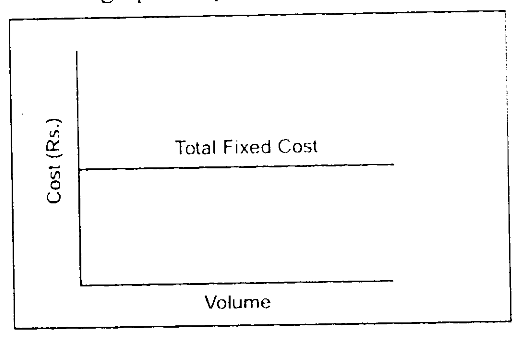
(A) Classification According to Functions: This is a traditional classification. A business has to perform a number of functions such as manufacturing, administration, selling, distribution and research. On the basis of function, they are classified as manufacturing cost, administration cost, selling and distribution cost and research and development cost.

(B) Classification According to Variability and Behaviour: Costs, sometimes, have a definite relationship to the volume of production. Some costs change with the volume of production and some others do not change at all, irrespective of the volume of production, while some of the costs, partly, change.

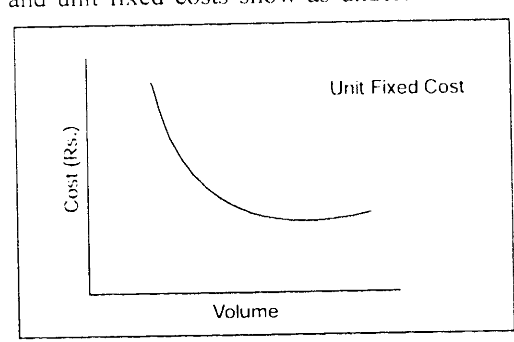
Under this category, costs are classified as fixed costs, variable costs, and semi-variable or semi-fixed costs.

Fixed Costs: When a cost does not change with increase in volume, it is called Fixed Cost. Fixed costs are constant. Fixed costs do not change, irrespective of the level of production. Examples are rent, insurance, depreciation and repairs. The total fixed cost is one and the same, whether one unit is produced or one hundred units are produced, till the production does not exceed the capacity of machine. However, the unit fixed cost decreases as the volume of production increases. In the pictorial presentation of behaviour of fixed costs, unit fixed cost curve descends while total fixed cost is constant at all levels of production. In other words, unit fixed cost decreases as and when volume increases. But, there is no change in total fixed cost at different production volume levels.

The graphical presentation of total fixed cost and unit fixed costs show as under:



Total Fixed Cost



Unit Fixed Cost

Behaviour of Fixed Costs

Variable Costs: When a cost changes in proportion to the change in volume, it is called Variable Cost. The typical example is raw materials. If production increases, total cost of raw materials increases, in the same proportion of production level. If production is suspended or closed, cost of raw materials becomes zero. **Mathematically, a linear relationship exists between a variable cost and volume.** If volume increases or decreases by 20%, in the same proportion, the cost of production varies. So, unit variable cost is constant and total variable costs changes, proportionately, to volume of production.

The graphical presentation of total variable cost and unit variable cost is as under:

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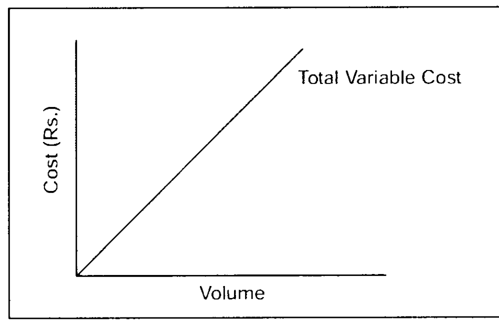
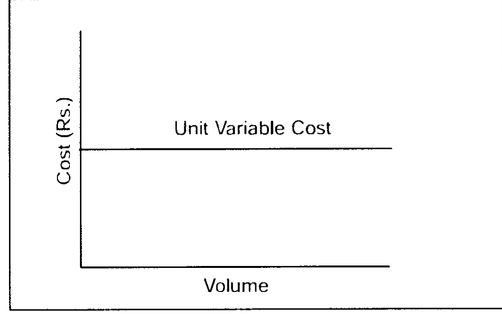




Total Variable Cost

Unit Variable Cost

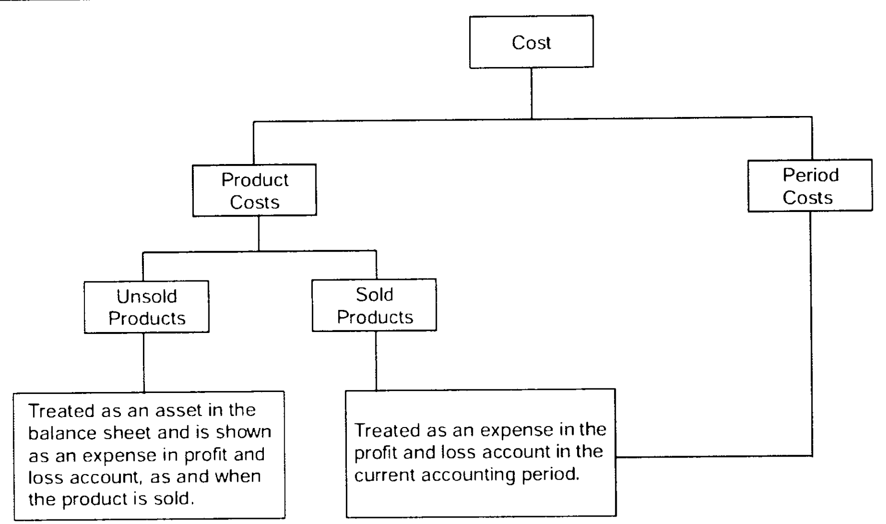
Behaviour of Variable Costs

(C) Classification According to Controllability: On this basis, the costs can be classified into controllable and uncontrollable costs. Controllable costs are those costs, which can be influenced by the action of a specified member of a firm. Controllable costs do not imply that they are 100% controllable. In other words, costs are at least, partly, within the control of the management. Generally speaking, all direct material, direct labour and some of the overhead expenses are controllable by the lower level of management. Some costs can be controlled by joint action. For example, the production manager as well as the purchase manager controls the cost of raw materials. The production manager controls the quantity level, exercising control on wastages, while the purchase manager can exercise control on the price front. On the other hand, costs which cannot be influenced by the action of any member of undertaking or beyond control is known as uncontrollable cost. For example, fixed expenses like salary, rent, insurance and taxes.

Cost is a fact while price is a matter of Strategy.

(D) Classification on the basis of Traceability to the Product: Based on traceability, costs are divided into Direct and Indirect costs. Direct cost means that cost which can be, conveniently, identified with and allocated to a particular unit of cost, i.e. job, product or process. On the other hand, indirect cost means those costs, which cannot be identified with a particular unit of cost. It has to be shared or distributed. Examples are cost of consumables, salary of a foreman or supervisor, rent of factory etc.

(E) Product Costs and Period Costs: Product costs are those costs, which can be identified with the product and included in stock valuation. In a manufacturing concern, it is composed of four elements. They are direct materials, direct labour, direct expenses and manufacturing overhead. That is, product cost is a factory cost. Period cost is associated with the time period. Examples are rent, salary, insurance etc. They are not included in the stock valuation and are treated as expenses during the period in which they are incurred.



Treatment of Product and Period Costs

13.7 DIFFERENCE BETWEEN ALLOCATION AND APPORTIONMENT

For cost ascertainment, it is necessary to understand the difference between the terms 'Allocation' and 'Apportionment'.

The difference between Allocation and Apportionment is as follows:

Allocation: Cost Allocation is defined as allotment of the whole cost to cost centres or cost units. In other words, whole expenses, which can be identified or traced, are allocated to a particular department, cost centre, cost unit or machine, without division of expenses. There are two important matters, in case of allocation of cost. First, the cost should be traceable or identifiable to a particular department, cost centre or machine. Second, the exact amount incurred in cost centre must be known. Once the cost is traceable, no division is made.

Examples: Overtime wages incurred in a particular department is allocated, wholly, to that department. Similarly, repairs incurred to a particular machine are allocated to that particular machine.

Apportionment: Cost apportionment is the allotment of proportionate items of cost to cost centres or cost units. Where the cost is common and cannot be identified, wholly, to a particular department or cost centre, the cost is apportioned. Where the expenses relate to more than one department, the expenses are divided. So, cost apportionment occurs where the cost or expenses are common to more than one department.

Examples: Canteen expenses of a factory are apportioned, proportionately, to the production and service departments, based on the number of employees working in various departments.

Canteen number of employees
Cleaning
maintenance wage
lighting & heating

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Where expenses can be traced or identified with a particular department, it is allocation and if this is not possible, costs are apportioned.

13.8 METHODS OF COSTING

The methods used for ascertainment of cost of production differ from industry to industry. Basically, there are two methods of costing. They are:

(A) Job Costing and

(B) Process Costing

All other methods of costing are improvements, extensions or combination of the above two methods. The principles in every method of costing are the same but the methods of analyzing and presenting the costs differ with the nature of business.

Job Costing: Under this method, costs are collected and accumulated for each job or work order or project, separately. A job card is prepared for each job for cost accumulation. This method is suitable for printers, machine tool manufacturers, general engineering workshops, foundries etc.

Batch Costing: Batch costing is a special type of job costing, where articles are manufactured in definite batches. For example, in a ready-made garment factory, shirts are made in suitable batches according to size and kept in stock for sale and it will not be worthwhile to maintain cost for each shirt made. The costing procedure is similar to job costing. Instead of a job, batch constitutes the cost unit for which costs are completed. Cost per unit is calculated by dividing total cost of a batch by the number of units produced in that batch. This method is mainly used in biscuit manufacture, garment manufacture and spare parts components manufacture industries.

Process Costing: A process here refers to a stage of production. If a product passes through different stages, process costing is used to ascertain the cost of each stage or process. Normally, the finished product of one process becomes the raw material of the subsequent process and a final product is obtained in the last process. As the products are manufactured in continuous process, this is also known as Continuous Costing. Process costing is generally followed in textile units, chemical industries, refineries, tanneries, paper manufacturing etc.

Operating Costing: This is suitable for firms, which render services as distinct from those, which manufacture goods. This type of costing is applied to transport undertakings, power supply companies, gas, water works, hospitals and hotels etc. It is used to ascertain the cost of services rendered. There is, usually, a compound unit in such undertakings. Examples are passenger–kilometers in transport companies, kilo–watt–hour in power supply, patient–day in hospital etc.

Multiple Costing: Where more than one method of costing is applied, it is called multiple costing. This is suitable for industries, where a number of components parts are, separately, produced.

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and later assembled into a final product. In such industries, materials and components used differ in the products manufactured. In other words, all components and materials are not used in all the products manufactured. So, it will be necessary to ascertain the cost of each component. Cost of component is calculated through the process costing. To ascertain the cost of final product, batch costing method is applied. This method is used in manufacturing cycles, automobiles, radios, typewriters, aeroplane and other complex products.

Methods of costing are different from techniques of costing.

13.9 TECHNIQUES OF COSTING

To produce useful information to management, cost data collected is to be processed according to costing principles, using one or more costing techniques. The techniques of costing are used to link or relate costs to cost units or cost centers. Costing techniques are not independent. They are used along with various methods of costing. Costing techniques are not independent methods of cost ascertainment, such as job costing or operating costing.

Important costing techniques are as follows:

Marginal Costing: Marginal Costing is a special technique of analysis and presentation of costs, which helps the management in decision-making. This technique enables the management to understand the effect of a change in volume of output on costs and profit. Its importance lies in solving the managerial problems.

Marginal Costing is also known as Variable Costing.

Marginal costing is not an independent system of costing similar to process costing, operating costing or Job costing. In marginal costing, the cost of a unit comprises only variable costs. Fixed costs are treated as period costs and written off to costing Profit and Loss Account. Consequently, finished goods and work in progress are valued at marginal cost i.e. Prime cost plus variable overheads.

Absorption Costing: Absorption costing technique is also termed as Traditional or Full Cost Method. Under this method, the cost of a product is determined, after considering both fixed and variable costs. The variable cost, such as direct materials, direct labour, etc. is directly charged to the products. The fixed costs are apportioned on a suitable basis over different products. manufactured during a period.

Under absorption costing, all costs, both variable and fixed, are charged to the products for cost determination.

Thus, in case of Absorption costing, all costs are identified with the products manufactured. Both Fixed costs and Variable costs are also treated as product costs. The cost unit is made to bear the burden of full cost, irrespective of the current level of operations.

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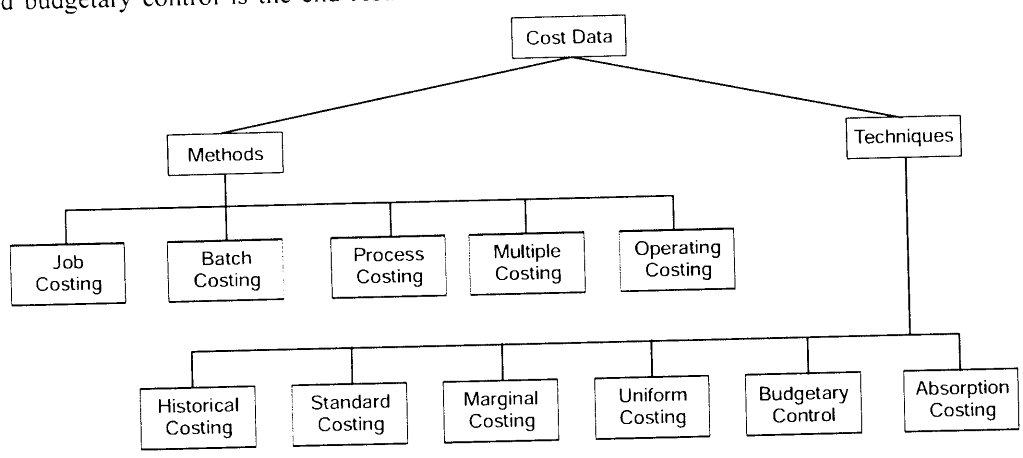
Uniform Costing: Several undertakings follow the same costing principles and/or practices for common control or comparison. This technique facilitates inter-firm comparisons and help in establishing realistic pricing policies.

Historical Costing: In historical costing, costs are ascertained, after they are actually incurred. It has a limited utility, though comparisons of different periods may yield good utility.

Standard Costing: In standard costing, a comparison of actual cost is made with the pre-determined costs. Any deviation, variance, is investigated by the management for the reasons of variances and suitable corrective action is taken.

Budgetary Control: Budgetary control is the process of determining various budgeted figures for the enterprise and then comparing the actual performance with the budgeted figures for calculating the variances, if any. In this process, first budgets are to be prepared. Second, Actual results are to be recorded. Third, comparison is to be made, between the actual with the planned action for calculating the variances. Once the discrepancies are known, remedial measures are to be taken, at proper time. Then only, results planned can be achieved. A budget is a means and budgetary control is the end result.



Methods and Techniques of Costing

Different methods of costing facilitate ascertainment of costs, while techniques of costing help the management in achieving the objective of controlling costs. Both methods of costing and techniques of costing go together to achieve the basic objective of improving the profitability of the firm.

13.10 IMPORTANCE (ADVANTAGES) OF COST ACCOUNTING

In the following areas, the advantages of cost accounting are significant:

(A) **Assists in Improving Profitability:** It enables management to maintain effective control over inventory to maximize efficiency and minimize wastages and losses by providing detailed

costing information. Profitable and unprofitable activities are disclosed. Management can take steps to eliminate unprofitable products and develop profitable products for improving profitability of the firm.

(B) Information for Estimates and Tenders: It helps cost estimation and fixation of prices. In case of big contracts or jobs, it is difficult to give quotation, without knowing estimated cost.

(C) Helps in Preparation of Interim Final Accounts: Value of closing stock is available, at any time. It provides a perpetual inventory system, which helps in the preparation of interim profit and loss account and balance sheet, without any stock taking.

(D) Reconciliation of Accounts and Reliability: It provides an independent and reliable check on the accuracy of financial accounts, through reconciliation of cost records and financial records.

(E) Fixation of Responsibility in Controlling Costs: When variances are to be corrected, responsibility has to be fixed for corrective action. It helps in controlling costs, with the application of standard costing and budgetary control.

(F) Aid in Decision-making: Costing helps the management in taking vital decisions such as

(i) Whether it would be profitable to purchase a component or commence its production, instead of purchasing, done presently.

(ii) Whether to accept the order, below its total cost.

(iii) Comparing the costs involved in different methods of production and choosing the cost effective method.

(G) Guides Future Production Policy: Cost data helps the management in formulating future production policy. They can rely on costing records to form their judgment about the profitability and future of the firm.

(H) Aid to Employees: When the organization benefits, it would be able to share the benefit of higher operating results in the form of performance bonus, incentives etc with employees of the firm.

(I) Aid to the Nation: Costing system brings the benefits of cost reduction, cost control and elimination of wastages and inefficiencies, which would lead to the growth of the nation, as a whole.

13.11 LIMITATIONS OF COST ACCOUNTING

The limitations of cost accounting are as under:

1. **Not exact Science:** Like any other accounting system, Cost Accounting is not an exact science but an art, which has developed through theories and practices.
2. **Solution not Available:** The cost accounting provides information for taking decisions, but does not give the exact solution to the problem.

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3. **Historical Data:** Cost data are essentially 'post facto' and historical in nature.
4. **Expensive:** Installation of cost accounting system is costly, which small firms cannot afford to have. Before installing, care must be exercised to ensure that the benefit derived is more than the cost on investment.
5. **System is more Complex:** As the cost accounting system involves number of steps in ascertaining costs such as collection, classification of expenses, allocation and apportionment of expenses, users consider it as a complicated system. More so, the system requires use of several documents and forms in preparing reports. Staff requires expertise in using the system.
6. **Lack of Accuracy:** The accuracy of cost accounting gets distorted due to use of estimated costs.

Descriptive Questions

1. Distinguish between Costing and Cost Accounting? **(13.1 and 13.2)**
2. State the objectives of Cost Accounting? **(13.2 and 13.3)**
3. Explain the terms 'Cost Centre' and 'Cost Unit'? **(13.4)**
4. What are the different Elements of Cost? **(13.5)**
5. Name the different ways of classification of costs? **(13.6)**
6. What is the difference between absorption and allocation? **(13.7)**
7. Write a detailed note about the different methods of costing? **(13.8)**
8. What are the different techniques of costing? **(13.9)**
9. 'Costing is an aid to management and society' – Enumerate the main points in support of this statement? **(13.10)**
10. What are the advantages you would expect from the costing system? What are its limitations? **(13.10 and 13.11)**

Check Your Understanding

1. Cost centre facilitates cost ascertainment and cost control.
2. Overheads and indirect expenses are different.
3. Cost allocation refers to charging of direct costs fully and directly to cost centres and cost units, while cost apportionment refers to charging of indirect expenses, proportionately, to cost centres and cost units.
4. The basic methods of costing are Job Costing and Process Costing.
5. If a product passes through different stages, process costing is used to ascertain the cost of each stage or process.
6. Methods of costing are different from techniques of costing.
7. Marginal costing is a method of Costing.

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Fill in the missing words in the terms below. Choose from the box.

> apportionment centre conversion ~~direct~~ fixed integrated
> indirect interlocking labour marginal

Term	Definition
■ direct costs	Costs which are directly related to making a product (e.g. materials, labour and expenses).
■ __________ costs	Costs of changing materials into products.
■ __________ costs	Costs which are not directly related to making a product, e.g. rent, administration.
■ costs __________	This could be a location, a function, a piece of equipment or a group of employees where you can identify and allocate costs for control purposes.
■ costs __________	You divide the common overhead costs between the various activities which use them according to how much they use.
■ __________ costs	Costs which always stay the same even if the number of items produced changes.
■ __________ costs	The cost of paying workers to make the product.
■ __________ cost	The cost of making a single extra unit above the number already planned.
■ __________ cost accounts	You don't separate financial and cost accounting.
■ __________ cost accounts	Separate cost and financial accounts which are reconciled sometimes.

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REVIEW PROBLEM 1: COST TERMS

Many new cost terms have been introduced in this chapter. It will take you some time to learn what each term means and how to properly classify costs in an organization. Consider the following example: Chippen Corporation manufactures furniture, including tables. Selected costs are given below:

1. The tables are made of wood that costs $100 per table.
2. The tables are assembled by workers, at a wage cost of $40 per table.
3. Workers making the tables are supervised by a factory supervisor who is paid $38,000 per year.
4. Electrical costs are $2 per machine-hour. Four machine-hours are required to produce a table.
5. The depreciation on the machines used to make the tables totals $10,000 per year. The machines have no resale value and do not wear out through use.
6. The salary of the president of the company is $100,000 per year.
7. The company spends $250,000 per year to advertise its products.
8. Salespersons are paid a commission of $30 for each table sold.
9. Instead of producing the tables, the company could rent its factory space for $50,000 per year.

Required:

Classify these costs according to the various cost terms used in the chapter. *Carefully study the classification of each cost.* If you don't understand why a particular cost is classified the way it is, reread the section of the chapter discussing the particular cost term. The terms *variable cost* and *fixed cost* refer to how costs behave with respect to the number of tables produced in a year.

BRIEF EXERCISE 1–2 Classifying Manufacturing Costs [LO2]

The PC Works assembles custom computers from components supplied by various manufacturers. The company is very small and its assembly shop and retail sales store are housed in a single facility in a Redmond, Washington, industrial park. Listed below are some of the costs that are incurred at the company.

Required:

For each cost, indicate whether it would most likely be classified as direct labor, direct materials, manufacturing overhead, selling, or an administrative cost.

1. The cost of a hard drive installed in a computer.
2. The cost of advertising in the *Puget Sound Computer User* newspaper.
3. The wages of employees who assemble computers from components.
4. Sales commissions paid to the company's salespeople.
5. The wages of the assembly shop's supervisor.
6. The wages of the company's accountant.
7. Depreciation on equipment used to test assembled computers before release to customers.
8. Rent on the facility in the industrial park.

BRIEF EXERCISE 1–3 Classification of Costs as Period or Product Cost [LO3]

Suppose that you have been given a summer job as an intern at Issac Aircams, a company that manufactures sophisticated spy cameras for remote-controlled military reconnaissance aircraft. The company, which is privately owned, has approached a bank for a loan to help it finance its growth. The bank requires financial statements before approving such a loan. You have been asked to help prepare the financial statements and were given the following list of costs:

1. Depreciation on salespersons' cars.
2. Rent on equipment used in the factory.
3. Lubricants used for machine maintenance.
4. Salaries of personnel who work in the finished goods warehouse.
5. Soap and paper towels used by factory workers at the end of a shift.
6. Factory supervisors' salaries.
7. Heat, water, and power consumed in the factory.
8. Materials used for boxing products for shipment overseas. (Units are not normally boxed.)
9. Advertising costs.
10. Workers' compensation insurance for factory employees.
11. Depreciation on chairs and tables in the factory lunchroom.
12. The wages of the receptionist in the administrative offices.
13. Cost of leasing the corporate jet used by the company's executives.
14. The cost of renting rooms at a Florida resort for the annual sales conference.
15. The cost of packaging the company's product.

Required:

Classify the above costs as either product costs or period costs for the purpose of preparing the financial statements for the bank.

Illustration 1.1

Swadeshi Co. Ltd supplies the following cost data for the month ending 31st July 1992.

	Rs.
Direct materials	90,000
Direct wages	75,000
Selling and distribution overhead	52,500
Office and administrative overhead	42,000
Factory overhead	45,000
Profit	60,500

Prepare a cost sheet and calculate:

(i) Prime cost, (ii) Works cost, (iii) Cost of production, (iv) Cost of sales, and (v) Sales value

(B. Com Calicut Adapted)

Solution

Swadeshi Co. Ltd.

Cost Sheet

for the month ending 31st July 1992

		Rs.
Direct materials		90,000
Direct wages		75,000
	Prime cost	1,65,000
Factory overhead		45,000
	Works cost	2,10,000
Office and adm. overhead		42,000
	Cost of Production	2,52,000
Selling and dist. overhead		52,500
	Cost of Sales	3,04,500
Profit		60,500
	SALES	3,65,000

Illustration 1.2

The following figures have been extracted from the books of ABX Ltd. for the year ending 31st March, 1992.

	Rs.
Direct materials	70,000
Direct wages	75,000
Indirect wages	10,000
Other direct expenses	15,000
Factory rent and rates	5,000
Office rent and rates	500
Indirect materials	500
Depreciation of plant	1,500
Depreciation of office furniture	100
Managing Director's remuneration	12,000
General factory expenses	5,700
General office expenses	1,000
Generl selling expenses	1,000
Travelling expenses	1,100
Office salaries	4,500
Carriage outward	1,000
Advertisements	2,000
Sales	2,50,000

From the above figures, calculate the following:

(*a*) Prime cost

(*b*) Works cost

(*c*) Cost of production

(*d*) Cost of sales

(*e*) Net profit

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Exercise 1

The following figures have been provided for the year ended 30 June.

	£
Opening stock of raw materials	8,200
Purchases of raw materials	85,000
Closing stock of raw materials	6,100
Factory wages	25,600
Factory overheads	
Rent and rates	860
Indirect wages	4,200
Insurance	1,340
Light and heat	780

You are required to prepare a manufacturing account to show:

a) cost of raw materials consumed
b) direct wages
c) prime cost
d) total factory overheads
e) factory cost of production.

Exercise 2

JK Productions has provided the following figures for the year ended 30 September.

	£
Direct wages	120,000
Purchases of raw materials	240,000
Opening stock of raw materials	10,000
Closing stock of raw materials	9,000
Factory overheads	
Rent	20,000
Light and heat	1,300
Factory supervisor's wages	23,000
Maintenance of factory machinery	6,000
Insurance of factory machinery	860
Depreciation of factory machinery	5,000

You are required to prepare a manufacturing account to show:

a) cost of raw materials consumed
b) direct wages
c) prime cost
d) total factory overheads
e) factory cost of production.

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Chapter 1 1 Auditing and Internal control

This chapter introduces auditing and other assurance services provided by auditors, as well as auditors' role in society. These services provide value by offering assurance on financial statements, the effectiveness of internal control, and other information. There is also a discussion of the types of audits and auditors, including the requirements for becoming a certified public accountant (CPA).

NATURE OF AUDITING

Describe auditing.

We have introduced the role of auditors in society and how auditors' responsibilities have increased to include reporting on the effectiveness of internal control over financial reporting for larger public companies. We now examine auditing more specifically using the following definition:

> **Auditing** is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria. Auditing should be done by a competent, independent person.

The definition includes several key words and phrases. For ease of understanding, we'll discuss the terms in a different order than they occur in the description.

Information and Established Criteria

To do an audit, there must be information in a *verifiable form* and some standards (*criteria*) by which the auditor can evaluate the information. Information can and does take many forms. Auditors routinely perform audits of quantifiable information, including companies' financial statements and individuals' federal income tax returns. Auditors also audit more subjective information, such as the effectiveness of computer systems and the efficiency of manufacturing operations.

The criteria for evaluating information also vary depending on the information being audited. In the audit of historical financial statements by CPA firms, the criteria may be U.S. generally accepted accounting principles (GAAP) or International Financial Reporting Standards (IFRS). This means that in an audit of Boeing's financial statements, the CPA firm will determine whether Boeing's financial statements have been prepared in accordance with GAAP. For an audit of internal control over financial reporting, the criteria will be a recognized framework for establishing internal control, such as *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (widely known as COSO).

For the audit of tax returns by the Internal Revenue Service (IRS), the criteria are found in the Internal Revenue Code. In an IRS audit of Boeing's corporate tax return, the internal revenue agent uses the Internal Revenue Code as the criteria for correctness, rather than GAAP.

For more subjective information, it is more difficult to establish criteria. Typically, auditors and the entities being audited agree on the criteria well before the audit starts. For example, in an audit of the effectiveness of specific aspects of computer operations, the criteria might include the allowable level of input or output errors.

Accumulating and Evaluating Evidence

Evidence is any information used by the auditor to determine whether the information being audited is stated in accordance with the established criteria. Evidence takes many different forms, including:

- Electronic and documentary data about transactions
- Written and electronic communication with outsiders
- Observations by the auditor
- Oral testimony of the auditee (client)

To satisfy the purpose of the audit, auditors must obtain a sufficient quality and volume of evidence. Auditors must determine the types and amount of evidence necessary and evaluate whether the information corresponds to the established criteria. This is a critical part of every audit and the primary subject of this book.

Competent, Independent Person

The auditor must be qualified to understand the criteria used and must be *competent* to know the types and amount of evidence to accumulate in order to reach the proper conclusion after examining the evidence. The auditor must also have an *independent mental attitude.* The competence of those performing the audit is of little value if they are biased in the accumulation and evaluation of evidence.

Auditors strive to maintain a high level of independence to keep the confidence of users relying on their reports. Auditors reporting on company financial statements are often called **independent auditors**. Even though such auditors are paid fees by the company, they are normally sufficiently independent to conduct audits that can be relied on by users. Even internal auditors—those employed by the companies they audit—usually report directly to top management and the board of directors, keeping the auditors independent of the operating units they audit.

Reporting

The final stage in the auditing process is preparing the **audit report**, which communicates the auditor's findings to users. Reports differ in nature, but all must inform readers of the degree of correspondence between the information audited and established criteria. Reports also differ in form and can vary from the highly technical type usually associated with financial statement audits to a simple oral report in the case of an operational audit of a small department's effectiveness.

DISTINCTION BETWEEN AUDITING AND ACCOUNTING

OBJECTIVE 1-5

Distinguish between auditing and accounting.

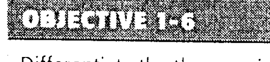
Many financial statement users and the general public confuse auditing with accounting. The confusion results because most auditing is usually concerned with accounting information, and many auditors have considerable expertise in accounting matters. The confusion is increased by giving the title "certified public accountant" to many individuals who perform audits.

Accounting is the recording, classifying, and summarizing of economic events in a logical manner for the purpose of providing financial information for decision making. To provide relevant information, accountants must have a thorough understanding of the principles and rules that provide the basis for preparing the accounting information. In addition, accountants must develop a system to make sure that the entity's economic events are properly recorded on a timely basis and at a reasonable cost.

When auditing accounting data, auditors focus on determining whether recorded information properly reflects the economic events that occurred during the accounting period. Because U.S. or international accounting standards provide the criteria for evaluating whether the accounting information is properly recorded, auditors must thoroughly understand those accounting standards.

In addition to understanding accounting, the auditor must possess expertise in the accumulation and interpretation of audit evidence. It is this expertise that distinguishes auditors from accountants. Determining the proper audit procedures, deciding the number and types of items to test, and evaluating the results are unique to the auditor.

TYPES OF AUDITS



Differentiate the three main types of audits.

CPAs perform three primary types of audits, as illustrated with examples in Table 1-2 (p. 13):

1. Operational audit
2. Compliance audit
3. Financial statement audit

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Operational Audits

An **operational audit** evaluates the *efficiency* and *effectiveness* of any part of an organization's operating procedures and methods. At the completion of an operational audit, management normally expects recommendations for improving operations. For example, auditors might evaluate the efficiency and accuracy of processing payroll transactions in a newly installed computer system. Another example, where most accountants feel less qualified, is evaluating the efficiency, accuracy, and customer satisfaction in processing the distribution of letters and packages by a company such as Federal Express.

In operational auditing, the reviews are not limited to accounting. They can include the evaluation of organizational structure, computer operations, production methods, marketing, and any other area in which the auditor is qualified. Because of the many different areas in which operational effectiveness can be evaluated, it is impossible to characterize the conduct of a typical operational audit. In one organization, the auditor might evaluate the relevancy and sufficiency of the information used by management in making decisions to acquire new fixed assets. In a different organization, the auditor might evaluate the efficiency of the information flow in processing sales.

It is more difficult to objectively evaluate whether the efficiency and effectiveness of operations meets established criteria than it is for compliance and financial statement audits. Also, establishing criteria for evaluating the information in an operational audit is extremely subjective. In this sense, operational auditing is more like management consulting than what is usually considered auditing. Operational auditing is discussed in greater depth in Chapter 26.

Compliance Audits

A **compliance audit** is conducted to determine whether the auditee is following specific procedures, rules, or regulations set by some higher authority. Following are examples of compliance audits for a private business.

- Determine whether accounting personnel are following the procedures prescribed by the company controller.
- Review wage rates for compliance with minimum wage laws.
- Examine contractual agreements with bankers and other lenders to be sure the company is complying with legal requirements.
- Determine whether a mortgage bank is in compliance with newly-enacted government regulations.

Governmental units, such as school districts, are subject to considerable compliance auditing because of extensive government regulation. Many private and not-for-profit organizations have prescribed policies, contractual agreements, and legal requirements that may require compliance auditing. Compliance audits for federally funded grant programs are often done by CPAs and are discussed in detail in Chapter 26.

Results of compliance audits are typically reported to management, rather than outside users, because management is the primary group concerned with the extent of compliance with prescribed procedures and regulations. Therefore, a significant portion of work of this type is often done by auditors employed by the organizational units. When an organization such as the IRS wants to determine whether individuals or organizations are complying with its requirements, the auditor is employed by the organization issuing the requirements.

Financial Statement Audits

A **financial statement audit** is conducted to determine whether the financial statements (the information being verified) are stated in accordance with specified criteria. Normally, the criteria are U.S. or international accounting standards, although auditors may conduct audits of financial statements prepared using the cash basis or some other basis of accounting appropriate for the organization. In determining whether financial statements are fairly stated in accordance with

accounting standards, the auditor gathers evidence to determine whether the statements contain material errors or other misstatements. The primary focus of this book is on financial statement audits.

As businesses increase in complexity, it is no longer sufficient for auditors to focus only on accounting transactions. An integrated approach to auditing considers both the risk of misstatements and operating controls intended to prevent misstatements. The auditor must also have a thorough understanding of the entity and its environment. This understanding includes knowledge of the client's industry and its regulatory and operating environment, including external relationships, such as with suppliers, customers, and creditors. The auditor also considers the client's business strategies and processes and critical success factors related to those strategies. This analysis helps the auditor identify business risks associated with the client's strategies that may affect whether the financial statements are fairly stated.

TYPES OF AUDITORS

OBJECTIVE 1-7

Identify the primary types of auditors.

Several types of auditors are in practice today. The most common are certified public accounting firms, government accountability office auditors, internal revenue agents, and internal auditors.

Certified Public Accounting Firms

Certified public accounting firms are responsible for auditing the published historical financial statements of all publicly traded companies, most other reasonably large companies, and many smaller companies and noncommercial organizations. Because of the widespread use of audited financial statements in the U.S. economy, as well as businesspersons' and other users' familiarity with these statements, it is common to use the terms *auditor* and *CPA firm* synonymously, even though several different types of auditors exist. The title *certified public accounting firm* reflects the fact that auditors who express audit opinions on financial statements must be licensed as CPAs. CPA firms are often called *external auditors* or *independent auditors* to distinguish them from internal auditors.

Government Accountability Office Auditors

A **government accountability office auditor** is an auditor working for the U.S. Government Accountability Office (GAO), a nonpartisan agency in the legislative branch of the federal government. Headed by the Comptroller General, the GAO reports to and is responsible solely to Congress.

The GAO's primary responsibility is to perform the audit function for Congress, and it has many of the same audit responsibilities as a CPA firm. The GAO audits much of the financial information prepared by various federal government agencies before it is submitted to Congress. Because the authority for expenditures and receipts of governmental agencies is defined by law, there is considerable emphasis on compliance in these audits.

An increasing portion of the GAO's audit efforts are devoted to evaluating the operational efficiency and effectiveness of various federal programs. Also, because of the immense size of many federal agencies and the similarity of their operations, the GAO has made significant advances in developing better methods of auditing through the widespread use of highly sophisticated statistical sampling and computer risk assessment techniques.

In many states, experience as a GAO auditor fulfills the experience requirement for becoming a CPA. In those states, if an individual passes the CPA examination and fulfills the experience stipulations by becoming a GAO auditor, he or she may then obtain a CPA certificate.

As a result of their great responsibility for auditing the expenditures of the federal government, their use of advanced auditing concepts, their eligibility to be CPAs,

and their opportunities for performing operational audits, GAO auditors are highly regarded in the auditing profession.

Internal Revenue Agents

The IRS, under the direction of the Commissioner of Internal Revenue, is responsible for enforcing the *federal tax laws* as they have been defined by Congress and interpreted by the courts. A major responsibility of the IRS is to audit taxpayers' returns to determine whether they have complied with the tax laws. These audits are solely compliance audits. The auditors who perform these examinations are called **internal revenue agents**.

It might seem that the audit of returns for compliance with the federal tax laws is a simple and straightforward problem, but nothing is farther from the truth. Tax laws are highly complicated, and there are hundreds of volumes of interpretations. The tax returns being audited vary from the simple returns of individuals who work for only one employer and take the standard tax deduction to the highly complex returns of multinational corporations. Taxation problems may involve individual income taxes, gift taxes, estate taxes, corporate taxes, trusts, and so on. An auditor involved in any of these areas must have considerable tax knowledge and auditing skills to conduct effective audits.

Internal Auditors

Internal auditors are employed by all types of organizations to audit for management, much as the GAO does for Congress. Internal auditors' responsibilities vary considerably, depending on the employer. Some internal audit staffs consist of only one or two employees doing routine compliance auditing. Other internal audit staffs may have more than 100 employees who have diverse responsibilities, including many outside the accounting area. Many internal auditors are involved in operational auditing or have expertise in evaluating computer systems.

To maintain independence from other business functions, the internal audit group typically reports directly to the president, another high executive officer, or the audit committee of the board of directors. However, internal auditors cannot be entirely independent of the entity as long as an employer–employee relationship exists. Users from outside the entity are unlikely to want to rely on information verified solely by internal auditors because of their lack of independence. This lack of independence is the major difference between internal auditors and CPA firms.

In many states, internal audit experience can be used to fulfill the experience requirement for becoming a CPA. Many internal auditors pursue certification as a certified internal auditor (CIA), and some internal auditors pursue both the CPA and CIA designations.

MULTIPLE CHOICE QUESTIONS FROM CPA EXAMINATIONS

1-14 (Objectives 1-1, 1-3, 1-5) The following questions deal with audits by CPA firms. Choose the best response.

a. Which of the following best describes why an independent auditor is asked to express an opinion on the fair presentation of financial statements?

(1) It is difficult to prepare financial statements that fairly present a company's financial position, operations, and cash flows without the expertise of an independent auditor.

(2) It is management's responsibility to seek available independent aid in the appraisal of the financial information shown in its financial statements.

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(3) The opinion of an independent party is needed because a company may not be objective with respect to its own financial statements.
(4) It is a customary courtesy that all stockholders of a company receive an independent report on management's stewardship of the affairs of the business.

b. Independent auditing can best be described as
(1) a branch of accounting.
(2) a discipline that attests to the results of accounting and other functional operations and data.
(3) a professional activity that measures and communicates financial and business data.
(4) a regulatory function that prevents the issuance of improper financial information.

c. Which of the following professional services is an attestation engagement?
(1) A consulting service engagement to provide computer-processing advice to a client.
(2) An engagement to report on compliance with statutory requirements.
(3) An income tax engagement to prepare federal and state tax returns.
(4) The preparation of financial statements from a client's financial records.

d. Which of the following attributes is likely to be unique to the audit work of CPAs as compared to the work performed by practitioners of other professions?
(1) Independence.
(2) Competence.
(3) Due professional care.
(4) Complex body of knowledge.

1-15 [illegible] The following questions deal with types of audits and auditors. Choose the best response.

a. Operational audits generally have been conducted by internal auditors and governmental audit agencies but may be performed by certified public accountants. A primary purpose of an operational audit is to provide
(1) a means of assurance that internal accounting controls are functioning as planned.
(2) a measure of management performance in meeting organizational goals.
(3) the results of internal examinations of financial and accounting matters to a company's top-level management.
(4) aid to the independent auditor, who is conducting the audit of the financial statements.

b. In comparison to the external auditor, an internal auditor is more likely to be concerned with
(1) internal administrative control.
(2) cost accounting procedures.
(3) operational auditing.
(4) internal control.

c. Which of the following best describes the operational audit?
(1) It requires the constant review by internal auditors of the administrative controls as they relate to the operations of the company.
(2) It concentrates on implementing financial and accounting control in a newly organized company.
(3) It attempts and is designed to verify the fair presentation of a company's results of operations.
(4) It concentrates on seeking aspects of operations in which waste could be reduced by the introduction of controls.

d. Compliance auditing often extends beyond audits leading to the expression of opinions on the fairness of financial presentation and includes audits of efficiency, economy, effectiveness, as well as
(1) accuracy.
(2) adherence to specific rules or procedures.
(3) evaluation.
(4) internal control.

0:0012[illegible]

ACCOUNT CLASSIFICATION AND PRESENTATION

Account Title	Classification	Financial Statement	Normal Balance
		A	
Accounts Payable	Current Liability	Balance Sheet	Credit
Accounts Receivable	Current Asset	Balance Sheet	Debit
Accumulated Depreciation—Buildings	Plant Asset—Contra	Balance Sheet	Credit
Accumulated Depreciation—Equipment	Plant Asset—Contra	Balance Sheet	Credit
Advertising Expense	Operating Expense	Income Statement	Debit
Allowance for Doubtful Accounts	Current Asset—Contra	Balance Sheet	Credit
Amortization Expense	Operating Expense	Income Statement	Debit
		B	
Bad Debt Expense	Operating Expense	Income Statement	Debit
Bonds Payable	Long-Term Liability	Balance Sheet	Credit
Buildings	Plant Assets	Balance Sheet	Debit
		C	
Cash	Current Asset	Balance Sheet	Debit
Common Stock	Stockholders' Equity	Balance Sheet	Credit
Copyrights	Intangible Asset	Balance Sheet	Debit
Cost of Goods Sold	Cost of Goods Sold	Income Statement	Debit
		D	
Debt Investments	Current Asset/Long-Term Investment	Balance Sheet	Debit
Depreciation Expense	Operating Expense	Income Statement	Debit
Discount on Bonds Payable	Long-Term Liability—Contra	Balance Sheet	Debit
Dividends	Temporary account closed to Retained Earnings	Retained Earnings Statement	Debit
Dividends Payable	Current Liability	Balance Sheet	Credit
		E	
Equipment	Plant Asset	Balance Sheet	Debit
		F	
Freight-Out	Operating Expense	Income Statement	Debit
		G	
Gain on Disposal of Plant Assets	Other Income	Income Statement	Credit
Goodwill	Intangible Asset	Balance Sheet	Debit
		I	
Income Summary	Temporary account closed to Retained Earnings	Not Applicable	(1)
Income Tax Expense	Income Tax Expense	Income Statement	Debit
Income Taxes Payable	Current Liability	Balance Sheet	Credit
Insurance Expense	Operating Expense	Income Statement	Debit
Interest Expense	Other Expense	Income Statement	Debit
Interest Payable	Current Liability	Balance Sheet	Credit
Interest Receivable	Current Asset	Balance Sheet	Debit
Interest Revenue	Other Income	Income Statement	Credit
Inventory	Current Asset	Balance Sheet (2)	Debit

Account Title	Classification	Financial Statement	Normal Balance
L			
Land	Plant Asset	Balance Sheet	Debit
Loss on Disposal of Plant Assets	Other Expense	Income Statement	Debit
M			
Maintenance and Repairs Expense	Operating Expense	Income Statement	Debit
Mortgage Payable	Long-Term Liability	Balance Sheet	Credit
N			
Notes Payable	Current Liability/ Long-Term Liability	Balance Sheet	Credit
O			
Owner's Capital	Owner's Equity	Owner's Equity and Balance Sheet	Credit
Owner's Drawings	Temporary account closed to Owner's Capital	Owner's Equity	Debit
P			
Patents	Intangible Asset	Balance Sheet	Debit
Paid-in Capital in Excess of Par—Common Stock	Stockholders' Equity	Balance Sheet	Credit
Paid-in Capital in Excess of Par—Preferred Stock	Stockholders' Equity	Balance Sheet	Credit
Preferred Stock	Stockholders' Equity	Balance Sheet	Credit
Premium on Bonds Payable	Long-Term Liability	Balance Sheet	Credit
Prepaid Insurance	Current Asset	Balance Sheet	Debit
Prepaid Rent	Current Asset	Balance Sheet	Debit
R			
Rent Expense	Operating Expense	Income Statement	Debit
Retained Earnings	Stockholders' Equity	Balance Sheet and Retained Earnings Statement	Credit
S			
Salaries and Wages Expense	Operating Expense	Income Statement	Debit
Salaries and Wages Payable	Current Liability	Balance Sheet	Credit
Sales Discounts	Revenue—Contra	Income Statement	Debit
Sales Returns and Allowances	Revenue—Contra	Income Statement	Debit
Sales Revenue	Revenue	Income Statement	Credit
Selling Expenses	Operating Expense	Income Statement	Debit
Service Revenue	Revenue	Income Statement	Credit
Stock Investments	Current Asset/Long-Term Investment	Balance Sheet	Debit
Supplies	Current Asset	Balance Sheet	Debit
Supplies Expense	Operating Expense	Income Statement	Debit
T			
Treasury Stock	Stockholders' Equity—Contra	Balance Sheet	Debit
U			
Unearned Service Revenue	Current Liability	Balance Sheet	Credit
Utilities Expense	Operating Expense	Income Statement	Debit

(1) The normal balance for Income Summary will be credit when there is a net income, debit when there is a net loss. The Income Summary account does not appear on any financial statement.

(2) If a periodic system is used, Inventory also appears on the income statement in the calculation of cost of goods sold.