

# FUNDAMENTALS OF ACCOUNTING

## UNIT-1:

### **Need for Accounting:**

The main aim of a business is to earn profit. For earning profit, a businessman will either purchase the goods in one market at certain price and sell it in another market at higher price or will convert the raw materials into finished products and sell it to the different customers at a price which will give him some percentage of profit on cost of production. However, he will be anxious at the end of the year to find out whether his goods taken together have been sold at a profit or at a loss and what is the financial position on a particular date. Moreover in a big business information is required for planning, control, evaluation of performance and decision making. This information can be provided only when business transactions are recorded, classified and summarized properly. In order to achieve these purposes it would be necessary to record business transactions according to a well devised system. Book-keeping (in elementary stage) and Accounting (in advanced stage) is the name given to such a system.

### **Definition of Accounting:**

Important purposes of accounting are to ascertain profit or loss during a specified period, to show financial position of the business on a particular date and to have control over the firm's property. Such accounting records are required to be maintained to measure the income of the business and communicate the information so that it may be used by managers, owners and other parties. Accounting is a discipline which records, classifies, summarizes and interprets financial information about the activities of a concern so that intelligent decisions can be made about the concern.

#### **1. American Institute of Certified Public Accountants**

"Financial Accounting is" the art of recording, classifying and summarizing in a significant manner in terms of money transactions and events which are in part, at least of a financial character and interpreting the results thereof. "

#### **2. H. Bierman and AR Drebin**

Accounting may be defined "as the identifying, measuring, recording and communicating of financial information.

## Objectives of Accounting:

The objectives of accounting (as given by the American Accounting Association) are to provide information for the following purposes:

- 1) Making decisions concerning the use of limited resources including identification of crucial decision areas and determination of objectives and goals.
- 2) Effectively directing and controlling the organization's human and material resources.
- 3) Maintaining systematic records and reporting on the custodianship of resources.
- 4) Facilitating special functions and control.

From the objectives as given above three main objectives of accounting can be given as follows:

**1. To ascertain whether the business operations have been profitable or not.** Accounting helps us to know whether a business has earned profit or suffered loss during the accounting period. It will give us an idea of efficiency of the business. To determine profit or loss of the accounting period, a Trading and Profit and Loss Account or an Income Statement is prepared by matching revenues and expired costs (i.e., revenue expenditures) incurred for earning the revenues. In the process of determination of profit or loss, it is expense or cost that is matched with revenue and not vice versa. Thus, first of all revenue is determined and then expenses incurred for earning the revenue are matched with the revenue for calculating the difference known as net profit or net loss.

**2. To ascertain the financial position of the business.** Balance Sheet or Position Statement is prepared to give an idea of the financial position of the business on a particular date. The financial position of an enterprise is indicated by its assets on a given date and its liabilities on that date. Excess of assets over liabilities represent the capital and is indicative of the financial soundness of an enterprise. A properly drawn up balance sheet gives information relating to (i) the nature and value of assets, (ii) the nature and extent of liabilities, (iii) whether the enterprise is solvent, (iv) whether the business concern is over trading.

**3. To generate and communicate information to the users.** Accounting records generate and communicate information which may be helpful to various persons in planning, control, evaluation of performance and decision making. Functions of Accounting.

## **Functions of Accounting:**

Important functions of accounting are:

**1. Systematic record of business transactions.** To keep systematic record of business transactions, post them to the ledger and ultimately to prepare the final accounts is the first main function of accounting.

**2. Protecting the property of the business.** For performing this function the accountant is required to devise such a system of recording information so that assets of the business are not put to wrong use and a complete record of the assets of the concern is available without any difficulty.

**3. Communicating results to interested parties.** This function requires to supply the meaningful information about the financial activities of the business to the various parties i.e. owners, creditors, investors, employees, government, public, research scholars and the managers at the right time.

**4. Compliance with legal requirements.** The accounting system must be such which may be able to comply with the legal requirements. Under various enactments a businessman is required to file various statements e.g. income tax return, return for sale tax purposes etc.

**5. Stewardship.** In case of companies, the management is entrusted with the resources of the enterprise. The managers are expected to act as true trustee of the funds and accounting helps them to achieve the same.

**6. Assistance to Management.** Accounting assists the management in planning, evaluation of performance, control and decision making by providing required information.

**7. Fixing Responsibility.** Accounting helps in determination of the profitability of different departments of the enterprise and ultimately helps in fixing the responsibility of the departmental heads.

## **Distinction Between Book-keeping and Accounting:**

Book-keeping is recording of the financial transactions of a business in a methodical manner so that information on any point in relation to them may be quickly obtained. A book-keeper may be responsible for keeping all the financial records of a business or only a minor segment such as maintenance of the customers' accounts in a departmental store. Much of the work of a

book-keeper is clerical in nature and can be accomplished through the use of mechanical and electronic equipment.

On the other hand, Accounting is primarily concerned with the design of the system of records, the preparation of reports based on the recorded data, the interpretation of the reports and finally communicating the results of the interpretation to persons who are interested in such results. Accountants often direct and review the work of book-keepers. The work of accountants at the beginning may include some book-keeping but accountants must possess a much higher level of knowledge, conceptual understanding and analytical skill than is required of the book-keepers.

Main differences between Book-keeping and Accounting are as follows:

<b>Points of Distinction</b>	<b>Book-keeping</b>	<b>Accounting</b>
1. Object	The object of book-keeping is to prepare original books of accounts, trial balance and final accounts and to maintain systematic records of financial results.	The object of accounting is to record, classify, summarize, analyze and interpret the business transactions and to ascertain operating results & financial position and to communicate to various users.
2. Scope	It has limited scope and is concerned with recording, classifying, and summarizing of business transactions.	It has a wide scope and covers book keeping plus analysis and interpretation.
3. Level of Work	It is restricted to clerical work and is done by lower levels of management.	It is concerned with all levels of management. Lower level clerks prepare the accounts, medium level report it and top level interpret it.
4. Mutual Dependence	It has to depend on accounting for making the accounting records more useful.	It has to depend on book-keeping for getting the required information from accounting records and for making them useful for planning, control and decision making.
5. Results of the Business	It shows the net result and financial position of the business as the scope extends to the preparation of final accounts.	It analyzes the operating results and financial position of the business.
6. Stages	Bookkeeping is a primary	Accounting is the secondary

	stage.	stage. It begins where book-keeping ends.
7. Nature of Job	The job of book-keeper is often routine and clerical in nature.	The job of an accountant is analytical in nature.
8. Knowledge Required	The book-keeper is not required to have a higher level of knowledge than that of an accountant.	The accountant must be professional to have higher level of knowledge than that of bookkeeper.
9. Staff for Performing Work	Book keeping work is performed by junior staff.	Accounting work is performed by senior staff.

### **Advantages of Accounting:**

Following are main advantages of accounting :

**1. Replacement of memory.** In a large business it is very difficult for a business-man to remember all the transactions. Accounting provides records which will furnish information as and when desired and thus it replaces human memory.

**2. Evidence in court.** Properly maintained accounts are often treated as a good evidence in the court to settle a dispute.

**3. Settlement of taxation liability.** If accounts are properly maintained, it will be of great assistance to the businessman in settling the income tax and sale tax liability otherwise tax authorities may impose any amount of tax which the businessman will have to pay.

**4. Comparative study.** It provides the facility of comparative study of the various aspects of the business such as profits, sales, expenses etc. with that of previous year and helps the businessman to locate significant factor leading to the change, if any.

**5. Sale of business.** If accounts are properly maintained, it helps to ascertain the proper purchase price in case the businessman is interested to sell his business.

**6. Assistance to the insolvent person.** If a person is maintaining proper accounts and unfortunately he becomes insolvent (i.e. when he is unable to pay to his creditors), he can explain many things about the past with the help of accounts and can start a fresh life.

**7. Assistance to various parties.** It provides information to various parties, i.e. , owners, creditors, investors, government, managers, research scholars, public and employees and financial position of a business enterprise from their own point of view.

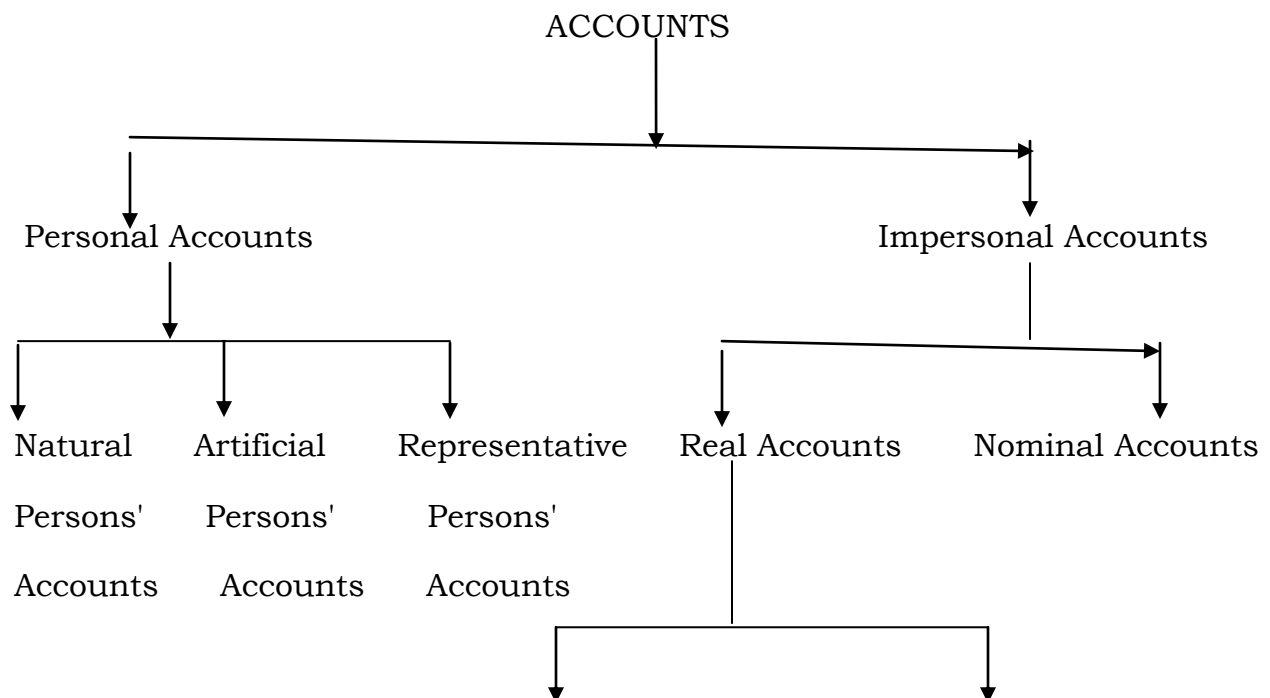
**8. Facilitate in raising loans.** Accounting facilitates raising loans from lenders by providing them the required financial information.

**9. Assistance to the management.** Accounting assists the management in taking managerial decisions. For example, Projected Cash Flow Statement facilitates the management to know the future receipts and payments and to take decisions regarding anticipated surplus or shortage of funds.

**10. Facilitate control over assets.** Accounting facilitates control over assets by providing information regarding Cash Balance, Bank Balance, Stock, Debtors, Fixed Assets, etc.

**Classification of accounts & its Rules:**

There are three types of accounts, namely, Personal Accounts, Real or Property Accounts and Nominal or Fictitious Accounts which are opened to keep a complete record of all the financial transactions of the business.



Tangible

Intangible

Real Accounts

Real Accounts

**Natural Person's Personal Account.** An account recording transactions with an individual human being is known as a natural person's personal account, e.g. , Vinod's Account.

**Artificial Person's Personal Account.** An account recording financial transactions with an artificial person created by law or otherwise is called an artificial person's personal account, e.g. , Arihant Industries Ltd. , Bank Account , Ramesh & Bros. Co. etc.

**Representative Personal Account.** An account indirectly representing a person or persons is known as a representative personal account. When accounts are of a similar nature and their number is large, it is better to group them under one head and open a representative personal account. Examples of such types of accounts can be: Salaries Outstanding Account, Interest Outstanding Account, Prepaid Insurance Account etc. Salaries Outstanding Account is a personal account representing salaries payable to the staff.

**Tangible Real Account.** Such type of accounts relates to an asset which can be touched, felt, seen and measured e.g. , Machinery Account , Cash Account , Furniture Account , Stock Account etc.

**Intangible Real Account.** Such type of accounts relates to assets which cannot be touched physically but can be measured in value. For example, Goodwill Account, Patents Account, Trade Marks Account, Copy Rights Account etc.

## **RULES OF THE DOUBLE ENTRY**

- a) **Personal Accounts:** Debit the Receiver: Credit the Giver
- b) **Real Account:** Debit What Comes In: Credit What Goes Out
- c) **Nominal Accounts:** Debit Expenses and Losses: Credit Incomes and Gains

**Accounting Cycle:** It refers to a complete sequence of accounting procedures which are required to be repeated in the same order during each accounting period. Accounting cycle includes:

**(a) Recording.** First, all transactions should be recorded in the Journal or Books of Original Entry known as subsidiary books as and when they take place.

**(b) Classifying.** All entries in the Journal or Books of Original Entry should be posted to the appropriate ledger accounts to find out at a glance the total effect of all such transactions in a particular account.

**(c) Summarizing.** Last stage is to prepare the trial balance and final accounts with a view to ascertaining the profit or loss made during a trading period and the financial position of the business on a particular date.



Thus sequential steps involved in an accounting cycle are:

- (i) Journalising,
- (ii) Posting,
- (iii) Balancing,
- (iv) Trial Balance,
- (v) Income Statement (i.e., Trading and Profit & Loss Account), and
- (vi) ) Position Statement (i.e., Balance Sheet).

## **Accounting concepts and conventions:**

### **ACCOUNTING CONCEPTS**

- 1) Business entity concept**
- 2) Money measurement concept**
- 3) Going concern concept**
- 4) Accounting period concept**
- 5) Accounting cost concept**
- 6) Dual aspect concept**
- 7) Matching concept**
- 8) Realisation concept**
- 9) Accrual concept**

### **ACCOUNTING CONCEPTS:**

Accounting concepts define the assumptions on the basis of which financial statements of a business entity are prepared. Concepts are those basic assumptions and condition which form the basis upon which the accountancy has been laid.

#### **Business entity concept:**

This concept assumes that, for accounting purposes, the business enterprise and its owners are two separate independent entities. Thus, the business and personal transactions of its owner are separate.

#### **Money measurement concept:**

This concept assumes that all business transactions must be in terms of money, that is in the currency of a country. In our country such transactions are in terms of rupees. Thus, as per the money measurement concept, transactions which can be expressed in terms of money are recorded in the books of accounts.

#### **Going concern concept:**

This concept states that a business firm will continue to carry on its activities for an indefinite period of time. Simply stated, it means that every business entity has continuity of life. Thus, it will not be dissolved in the near future. This is an important assumption of accounting, as it provides a basis for showing the value of assets in the balance sheet.

**Accounting period concept:**

All the transactions are recorded in the books of accounts on the assumption that profits on these transactions are to be ascertained for a specified period. This is known as accounting period concept. Thus, this concept requires that a balance sheet and profit and loss account should be prepared at regular intervals. This is necessary for different purposes like, calculation of profit, ascertaining financial position, tax computation etc.

The year that begins on January 1 and ends on January 31 is termed as calendar year whereas the year that begins on April 1 and ends on March 31 is termed as financial year.

**Accounting cost concept:**

It states that all assets are recorded in the books of accounts at their purchase price, which includes cost of acquisition, transportation and installation and not at its market price. It means that fixed assets like building, plant and machinery, furniture, etc are recorded in the books of accounts at a price paid for them.

**Dual aspect concept:**

Dual aspect is the foundation or basic principle of accounting. It provides the very basis of recording business transactions in the books of accounts. This concept assumes that every transaction has a dual effect, i.e. it affects two accounts in their respective opposite sides. Therefore, the transaction should be recorded at two places.

Assets = Liabilities + Capital

**Matching concept:**

The matching concept states that the revenue and the expenses incurred to earn the revenues must belong to the same accounting period. So once the revenue is realised, the next step is to allocate it to the relevant accounting period. This can be done with the help of accrual concept if the revenue is more than the expenses, it is called profit. If the expenses are more than revenue it is called loss. This is what exactly has been done by applying the matching concept. ..

## **Accounting Convention Methods**

There are four main accounting conventions designed to assist accountants:

**Conservatism:** Playing it safe is both an accounting principle and convention. It tells accountants to err on the side of caution when providing estimates for assets and liabilities. That means that when two values of a transaction are available, the lower one should be favored. The general concept is to factor in the worst-case scenario of a firm's financial future.

**Consistency:** A company should apply the same accounting principles across different accounting cycles. Once it chooses a method it is urged to stick with it in the future, unless it has a good reason to do otherwise. Without this convention, investors' ability to compare and assess how the company performs from one period to the next is made much more challenging.

**Full disclosure:** Information considered potentially important and relevant must be revealed, regardless of whether it is detrimental to the company.

**Materiality:** Like full disclosure, this convention urges companies to lay all their cards on the table. If an item or event is material, in other words important, it should be disclosed. The idea here is that any information that could influence the decision of a person looking at the financial statement must be included.

## **UNIT - II**

### **SUBSIDIARY BOOKS**

#### **1. Definition of Subsidiary Books:**

Subsidiary Books are the books that record the transactions which are similar in nature in an orderly manner. They are also known as special journals or Daybooks. In big business institutions, it is not easy to record all the transactions in one journal and post them into various accounts

#### **2. Types of Subsidiary Books:**

Subsidiary books are divided into eight types. They are given below.

**1. Purchases Book:** This book records all credit purchases only. Purchase of goods for cash and purchase of assets for cash or credit will not be recorded in this book.

**2. Sales Book:** This book is used to record credit sales only. Goods sold for cash, and sale of assets for cash or credit will not be recorded in this book.

**3. Purchase Returns Book:** This book is used to record the particulars of goods returned to the supplier.

**4. Sales Returns Book:** This book records the particulars of goods returned by the customers.

**5. Cash Book:** All cash transactions, receipts and payments are recorded in this book. Cash includes checks, money orders etc.

**6. Bills Receivable Book:** This book is used to record all the bills and promissory notes received.

**7. Bills Payable Book:** This is used to record all the bills or promissory notes accepted.

**8. Journal Proper:** This is used to record all the transactions that cannot be recorded in any of the above mentioned subsidiary books.

### **3. Advantages of subsidiary books (OR) Reasons for Maintaining the subsidiary books**

The following are the advantages of subsidiary books.

**1. Division of work:** As there are a number of subsidiary books, the work of recording business transactions may be given to a number of employees without any duplication of the same work.

**2. Increase in efficiency of staff:** Due to division of labor each employee will specialize in the work allotted to him. Naturally, he will become efficient in that part of the accounting work.

**3. Time Saving:** As the recording is done simultaneously in a number of books, the work will be completed quickly and independently.

**4. Ready made information:** Since a number of books are used for recording different types of transactions, the information relating to any class of transaction is available without any searching or delay.

**5. Minimization of frauds:** Checking the transactions for mistakes and errors can be done easily. Checking helps in tracing the errors and thus minimizes the frauds.

**6. Savings in stationery cost:** The use of subsidiary books results in economic and limited use of stationery materials.

**7. Helps in decision making:** Since the transactions of a similar nature are recorded at one place, the management can have the benefit of using them in planning and decision making.

**8. Ledger posting are made easier:** Posting from the subsidiary books are made at convenient intervals depending upon the nature of the business.

**4. Differences between Trade discount and Cash Discount:**

Trade discount and cash discount are not one. Trade discount is given on invoice price when buyer purchases goods on a large scale. Cash discount, on the other hand, is the incentive given for prompt or early payment of cash by the customer.

<b>Points of Difference</b>	<b>Trade discount</b>	<b>Cash discount</b>
1. Allowed by	Allowed by the manufacturer	Allowed by the creditor to his

Whom?	or the wholesaler to the retailer.	debtor.
2. Time	Trade discount is given at the time of purchase of goods.	Cash discount is given for early or prompt payment.
3. How it is given?	It is reduction in catalog price of an article.	It is reduction in the amount due by a debtor.
4. How it is shown?	It is shown as deduction in invoice. As such no entry is made in account books.	Cash discount must be entered in the books of accounts as an expense or income.
5. Objective	The objective of trade discount is to make the buyer to buy more.	The object here is to induce the debtors to pay the amount promptly or early.
6. Similarity	Trade discount may vary from trade to trade. And even in the same trade between different articles.	Cash discount is almost the same in all kinds of trade. But percentage of discount may vary according to the amount and the period of credit.

### 5. Differences between Debit Note and Credit Note:

Points of Difference	Debit Note	Credit Note
1. Meaning	It is a statement sent by the buyer to his supplier intimating that his account has been debited with the amount of goods returned to him.	It is a statement sent by the seller to his customer intimating that his account has been credited with the amount of goods returned by him or any other allowance granted to

		him.
2. Prepared by whom?	It is prepared by the buyer. It will be sent to the seller along with the goods returned.	It is prepared by the supplier on receipt of the goods from the customer. It will be sent to the customer.
3.Objective	The object of debit note is to inform the supplier that his account is debited with the value of goods returned to him	The objective of credit note is to inform the buyer customers that his account is credited with the value of goods returned by him.
4.Color of Paper	It is generally prepared in ordinary ink	It is generally prepared in red ink.
5.Basis for recording	Entry in the purchases returns book is made on the basis of debit note.	Entry in the sales returns book is made on the basis of credit note.

### **Contra Entry:**

The transactions relating to cash and bank balances are to be recorded in the cash book at the same time and hence contra entries are necessary. In Latin Contra means the other side. Contra entry means the recording of debit and credit of a transaction at a time in the cash book.

Circumstances of contra entry: In the following three circumstances only contra entries are necessary in cash book.

1. When cash is deposited in the bank (To Cash, By bank);
2. Cheque received is not sent to the bank for deposit on the same day, (To Cash; By Bank);
3. When cash is withdrawn for office purpose (To Bank; By Cash).

## UNIT - III

### TRIAL BALANCE & RECTIFICATION OF ERRORS

#### 1. Definitions:

Let us now go through some definitions given by experts in the field of Accounting.

**Spicer and Pegler:** A Trial balance is a list of all the balances standing on the Ledger accounts and cash book of a concern at any given date.

**J.R. Batliboi:** A Trial Balance is a statement of debit and credit balances extracted from the Ledger with a view to testing the arithmetical accuracy of the books.

Thus, a trial balance is a list of balances of the ledger accounts and cash book of a business entity at any given date.

#### 2. Advantages of Trial Balance

The following are the advantages of trial balance.

- 1. Proof of arithmetical accuracy:** It helps in checking the arithmetical accuracy of books of accounts.
- 2. Preparation of financial statements:** It helps in the preparation of financial statements.
- 3. Detection of errors:** It helps in detecting errors.
- 4. Rectification of errors:** It serves as an instrument for carrying out the job of rectification of errors.
- 5. Easy checking:** It is possible to find out the balances of various accounts at one place.

#### 3. Methods of Preparing Trial Balance

There are two methods of preparing trial balance:

- 1) **Total Method:** Under this method the total of debits and credits of all Ledgers accounts are shown in the debit and credit side of the trial balance. The trial balance prepared under this method is known as gross trial balance.
- 2) **Balance Method:** Under this method all the balances of each and every account will be shown against the debit or credit side in the Trial

Balance. If an account has no balance then it will not be shown in the trial balance. This method is more convenient and commonly used.

### **Meaning of errors**

Accounting Errors refer to the common mistakes made while recording or posting accounting entries. These discrepancies are not fraudulent and generally unintentional.

### **Types of Errors:**

#### **1. Errors of Principle:**

Errors involving violation of accounting principle are termed as 'errors of principle'.

For example, treating capital expenditure as revenue expenditure or vice versa.

1. A credit sale of old machinery recorded in the Sales Journal instead of Journal Proper This results in crediting the sales account instead of machinery account. This is an error of principle because it amounts to treating an expenditure of capital as revenue expenditure.

#### **2 Clerical Errors:**

The errors made by the clerical staff while recording the transactions are known as clerical errors. These are of three types.

- a) Errors of Omission
- b) Errors of Commission
- c) Compensating Errors.

##### **(a) Errors of Omission:**

When a transaction is wholly or partially omitted to be recorded in subsidiary books it is called an error of omission. If the transaction is not recorded in the subsidiary books or its posting is completely omitted, it is called an error of complete omission. However, if the posting is done in one account but omitted from the other, it is called 'error of partial omission'.

##### **(b) Errors of Commission:**

If a transaction is incorrectly recorded in the books of original entry or journal or it is incorrectly posted in the ledger, it is an error of commission.

Examples are:

- i. **Wrong Postings:** These include:
  - a) Posting to wrong account
  - b) Posting the amount wrongly
  - c) Recording in the wrong side of account

d) Recording the same item twice.

**(ii) Wrong Totalling:**

a) Wrong totaling of subsidiary books

b) Wrong totaling of accounts (undercasting or overcasting).

(iii) Wrong carry forward:

(iv) Wrong balancing:

(v) Wrong entry

(vi) Errors of Duplication

**(c) Compensatory Errors:**

When there is more than one error and they may counter the effect of each other. In other words, when one error compensates the other and this net effect may be nil. In other words, the errors of which cancel with each other are called compensating errors. For example, a sale of ₹ 500 to Ram was debited to his account as 50, while a sale of 50 to Syam was debited to his account as 500. It is a compensating error

## **SUSPENSE ACCOUNT**

When the Trial Balance does not agree, an effort is made to locate errors and rectify them. But if the errors cannot be located easily and quickly and, at the same time, if the final accounts are to be prepared urgently, the difference in the Trial Balance is rectified by writing it to the lesser side of the Trial Balance under the name of **Suspense account**. Such a temporarily opened suspense account is to be closed later on when the errors are located and rectified.

In case, the debit side of the Trial Balance exceeds the credit side, the difference is put on the credit side of the Trial Balance. In this case, the suspense account will show a credit balance. Similarly, if the credit side of the Trial Balance exceeds the debit side, the difference is put on the debit side of the Trial Balance. In this case, the suspense account will show a debit balance.

**Closing of Suspense Account:** When all the errors are located and rectified, the suspense account automatically stands closed i.e. , it does not show any balance. But if it still shows a balance, it indicates that certain errors are still to be discovered and rectified. Till then, if the suspense account shows a debit balance it will be shown at the assets side of the Balance Sheet. If it shows the credit balance it will be shown at the liabilities side of the Balance Sheet.

## UNIT -IV

### BANK RECONCILIATION STATEMENT

#### 1. Need for Preparing a Bank Reconciliation Statement

Among other reasons, enlisted below are some of the most important reasons why it is important to prepare a bank reconciliation statement:

##### **Accuracy**

Each month, the passbook of the bank and the cash book of a firm, display a particular amount, which is the balance in the bank as on that date. However, due to delay in the recording time and period of the same in the respective books, there is a high possibility that on the day of comparison the balances in the two books, would not match.

Hence, having prepared a bank reconciliation statement, one can determine the reasons and amounts by which the two balances differ. This analysis would further help the accountant in recording the missing amounts in each book. Hence, after the preparation of a bank reconciliation statement, the books of accounts would actually display a true and fair position of the firm.

##### **Check on the Entries**

In the process of preparing a bank reconciliation statement, an accountant will be able to point out all entries or amounts, recorded incorrectly in either of the books. Thus, it is quite useful to prepare a bank reconciliation statement, which would help in eliminating any entries recorded erroneously.

##### **Rectifying Incorrect Entries**

In case an amount or entry has been recorded incorrectly in both, the passbook and the cash book, the accountant will be able to rectify those entries, so as to arrive at the amount of correct bank balance in the passbook and the cash book.

## **Updated Cash Book**

Again, due to the irregularity in posting amount of entries in the cash book and due to the delays in the recording of such amounts, it is quite possible that the cash book would fail to show the updated balance of bank as on a particular date. When compared with the passbook, an accountant would be able to identify such entries and record them in the cash book instantly. This would help in reconciling the balances of both the cash book and the bank book instantly.

## **Detection of Delays**

Due to the preparation of bank reconciliation statement, it is possible to discover any amount of cheques that gets deposited in the bank but have aren't credited. This difference would be evident because the amount of such deposit would appear in the cash book but not in the bank book, hence giving rise to a difference in the bank balance of both. Thus, cheques deposited but not yet collected can come to notice quickly.

## **Check on the Dishonest Behavior of Employees**

Preparation of regular bank reconciliation statement has several benefits. It would act as a moral check on employees so that they do not indulge in the embezzlement of bank cheques, which would ultimately cause loss to the firm. This is so because even a low-value cheque can come in detection if it has been accepted but not deposited. In this way, a bank reconciliation statement serves a large purpose for a firm's accounting cycle and people.

## **2. What Are the Reasons for Differences between Cash Book Balance and Pass Books Balance?**

If all transactions entered in the cash book are also entered in the pass book, both books would show the same balance at any time. But, in practice it is not true. These two books may be showing two different balances on any particular date. The following are the reasons for such differences.

**1. Checks deposited but not collected:** Checks paid into bank but not collected and credited by the banker till the date of preparing the statement.

**2. Checks issued but not presented:** Checks issued but not presented for payment by creditors and hence not recorded in the pass book.

**3. Direct credits by banker:** Amounts collected and credited by the banker in the pass book as per standing instructions of the customer but no letter of intimation is received from the Bank till the date of preparing the statement.

**4. Direct debits by banker:** Amounts paid by the banker and debited in the pass book as per standing instruction but no letter of intimation is received from the banker till the date of preparing the statement.

**5. Interest, bank charges etc. credited / debited by banker directly :** Interest on the Bank balance credited in the pass book but not intimated to the customers

**6 . Direct Payment into the Customer's Bank Account :** Sometimes a third party may deposit money in the Bank account of the customer directly but the intimation of the same may not be received by the customer. As a result corresponding entry of the same may not be made in the Cash Book. As such these two balances will not agree.

**7. Standing Instructions:** A businessman may give standing instructions to the Bank for payment of insurance premium, shop rent, electricity charges etc. On making payment, the Bank passes a debit entry in the Pass Book, thereby reducing the customer's balance. The intimation of the same may not be received by the businessman. Therefore, it may not be recorded in the cash book. This will result in disagreement between the said balances.

**8. Dishonor of Cheques:** When the checks deposited in the Bank are dishonoured, the Bank passes a debit entry in the Pass Book. The corresponding entry is passed in the Cash Book after receiving advice from the Bank. If Bank Reconciliation Statement is prepared during this period, a difference will arise between the said balances.

**9. Errors:** The balance as shown by the Cash Book will not agree with the balance as shown by the Pass Book, if certain errors are committed either by the accountant or by the Bank clerk in recording the transactions.

**UNIT -V**  
**FINAL ACCOUNTS**

**1. Capital Expenditure:**

An expenditure intended to benefit future periods is known as capital expenditure. In other words, if the benefit of expenditure is not exhausted in one accounting period but is spread over future periods, the expenditure is known as capital expenditure. For instance, a computer bought during the current accounting period is intended to be used over and over again, so that the benefit of its usage is spread over a number of future accounting periods. The same is true of land, buildings, plant and machinery etc.

Accordingly, any expenditure incurred in the acquisition of an asset to be used over a number of years is capital expenditure. Similarly, an expenditure on an existing asset in the form of additions or improvements with a view to increasing its revenue earning capacity is also called capital expenditure. Thus, capital expenditure consists of the following.

- (1) Expenditure incurred to acquire fixed assets intended to be used in the business for a number of years, and not meant for resale.
- (2) Additions to assets, for example, an additional room for the existing building an additional item of furniture, additional plant or machinery etc.
- (3) Improvement effected to existing assets in such a way that it increases the capacity efficiency. life span or economy of operation, and increase the revenue earning capacity of such assets.
- (4) Expenditure incurred for acquiring benefit or right of an enduring nature, and for example, goodwill, copyright, trade mark, patent etc.
- (5) Expenditure incurred in the course of acquiring a fixed asset, and directly connected with it. For example, machinery erection and installation expenses, stamp duty and registration charges in the acquisition of land, traveling expenses for buying an asset etc.

**Treatment:** All the items relating to capital expenditure will be considered only in the preparation of Balance sheet. They will be shown in the asset side of the balance sheet.

**2 Revenue Expenditure:**

If the use of expenditure is limited to the accounting year, the expenditure is known as Revenue expenditure. Revenue expenditure consists of expenditure incurred in one accounting period and the full benefit of which is also consumed in the same period. Therefore, it is normally of recurring nature. Such an expenditure does not increase the earning capacity of the business nor does it bring into existence an asset of an enduring nature. Revenue expenditure thus consists of :

- 1) Expenditure on assets meant for resale at profit, e.g. , finished goods meant for resale.
- 2) Expenditure on assets meant for conversion into finished products, e.g. , raw materials and stores.
- 3) Expenditure on fixed assets for retaining their original efficiency, e.g. , repairs and renewal, depreciation, plant spares etc.

- 4) Day-to-day expenses in the conduct and administration of business, e.g. , rent, rates, taxes, insurance, wages, salaries, carriage etc.

Treatment: All the revenue expenses should be shown in the debit side of the Trading, Profit and loss account.

### 3. Deferred Revenue Expenditure:

It is that expenditure which seems to be revenue expenditure. But the utility of that expenditure will not expire during one year. The business will get it in future also. Then such expenditure is treated as deferred revenue expenditure. A part of it will be written off during the current period and the rest amount will be shown on the assets side of the balance sheet till it is completely written off. For example, heavy advertising of \* 75 lakhs expenditure incurred during one period may last long for 3 years. As such the amount of 75 lakhs is to be spread over 34 years i.e. , 25 lakhs each every year.

### Direct Expenses

As the phrase implies, "direct" expenses are directly tied to and assigned to a company's primary business operations. They are mostly concerned with the acquisition and production of commodities and services. Direct expenses are a component of a company's prime cost or the cost of products and services sold.

Direct expenses are directly tied to the manufacture of the product sold or the service performed, and they vary depending on the type of business, such as manufacturing, construction, or service. They are an element of a business's financial statement record used to maintain track of its spending. These expenses are continually used to determine the price of a product or service.

These expenses fluctuate with the pace of production, but they are consistent for each unit of output and are normally managed by the department manager. It is up to the business who produces its own goods and services to choose the rate for selling them as direct expenses. These expenses are used to calculate the company's gross profit. These costs are required to determine a product's significant cost. They are used to categorise and manage expenditures across departments.

**Conclusion** Direct expenses means all expenses directly connected with the manufacture, purchase of goods, and bringing them to the point of sale. Direct expenses include **carriage inwards, freight inwards, wages, factory lighting, coal, water and fuel, royalty on production**, etc.