

Financial Accounting – Theory – II Sem BCom CA AB 2025

1.1 Meaning and Definitions of Accounting

Accounting is the systematic process of recording, classifying, summarizing, and interpreting financial transactions of a business. It helps in determining the profit or loss of an organization and in understanding its financial position at a particular date. Accounting is often described as the “language of business” because it communicates financial information to various users such as owners, investors, creditors, management, and government authorities. Through accounting, financial data is presented in a meaningful manner to assist in decision-making.

According to the Institute of Chartered Accountants of India (ICAI), accounting is the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by users of the information. This definition highlights that accounting is not merely record-keeping but a process aimed at providing useful information for making economic decisions. It emphasizes identification of transactions, measurement in monetary terms, and communication through financial statements.

The American Institute of Certified Public Accountants (AICPA) defines accounting as the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof. This definition stresses the systematic procedure of accounting and the importance of interpretation of financial results.

1.2 Objectives of Accounting

1. Maintaining Systematic Records:

One of the primary objectives of accounting is to maintain complete and systematic records of all financial transactions. Proper recording helps in avoiding errors, detecting fraud, and ensuring that financial information is available whenever required. It provides a reliable database for future reference.

2. Determination of Profit or Loss:

Accounting aims to determine whether a business has earned profit or incurred loss during a specific accounting period. This is done by preparing the Trading and Profit and Loss Account. It helps management and owners evaluate business performance.

3. Ascertainment of Financial Position:

Another important objective is to know the financial position of the business at a particular date. The Balance Sheet shows assets, liabilities, and capital, helping stakeholders understand the solvency and stability of the organization.

4. Providing Information to Users:

Accounting provides useful financial information to various users such as owners, investors, creditors, management, and government authorities. This information helps them make informed economic decisions.

5. Assisting in Decision-Making and Control:

Accounting supports management in planning, controlling, and evaluating business activities. It provides data for budgeting, forecasting, and performance analysis.

6. Compliance with Legal Requirements:

Accounting ensures that the business meets legal obligations such as tax payment, audit requirements, and statutory reporting. Proper accounting helps in smooth functioning and legal compliance of the organization.

1.3 Functions of Accounting

1. Recording of Financial Transactions:

The primary function of accounting is to record all financial transactions in a systematic and chronological manner. These transactions are first entered in the journal to ensure that no transaction is omitted.

2. Classifying the Transactions:

After recording, transactions are classified into different accounts such as

assets, liabilities, capital, income, and expenses. This is done by posting entries into the ledger, which helps in organizing financial data.

3. Summarizing the Data:

Accounting summarizes the classified information by preparing financial statements such as Trial Balance, Trading Account, Profit and Loss Account, and Balance Sheet. This makes the data understandable and meaningful.

4. Analyzing and Interpreting:

Another important function is to analyze and interpret financial results. It helps management understand profitability, financial position, and overall performance of the business.

5. Communicating Information:

Accounting communicates financial information to various stakeholders like owners, investors, creditors, management, and government authorities through financial reports.

6. Assisting in Control and Decision-Making:

Accounting helps in controlling business operations by comparing actual performance with planned targets. It provides necessary information for planning and making sound business decisions.

1.4 Difference Between Bookkeeping and Accounting

Basis	Bookkeeping	Accounting
Meaning	Bookkeeping is the process of recording financial transactions in a systematic manner.	Accounting is the process of recording, classifying, summarizing, analyzing, and interpreting financial data.
Scope	It has a limited scope and is only concerned with recording transactions.	It has a wider scope and includes analysis and

Basis	Bookkeeping	Accounting
		interpretation of financial information.
Nature of Work	Clerical and mechanical in nature.	Analytical and interpretative in nature.
Objective	To maintain proper and systematic records of transactions.	To determine profit or loss and ascertain financial position.
Stage	It is the first stage of accounting.	It begins where bookkeeping ends.
Skill Required	Requires basic knowledge of recording transactions.	Requires professional knowledge and judgment.
Financial Statements	Does not prepare financial statements.	Prepares financial statements like Profit and Loss Account and Balance Sheet.

1.5 Branches of Accounting

1. Financial Accounting:

Financial accounting deals with the recording and reporting of financial transactions of a business. It focuses on preparing financial statements such as Trading Account, Profit and Loss Account, and Balance Sheet. The information generated is mainly useful to external users like investors, creditors, and government authorities.

2. Cost Accounting:

Cost accounting is concerned with recording, analyzing, and controlling the cost of production or services. It helps in determining the cost per unit,

controlling expenses, and improving efficiency. This branch is mainly useful for internal management.

3. Management Accounting:

Management accounting provides both financial and non-financial information to management for planning, controlling, and decision-making. It includes budgeting, forecasting, ratio analysis, and performance evaluation.

4. Tax Accounting:

Tax accounting deals with the computation of taxable income and preparation of tax returns in accordance with tax laws. It ensures that the business complies with legal and statutory requirements related to taxation.

5. Government Accounting:

Government accounting relates to the accounting system followed by government departments and public sector organizations. It focuses on proper utilization and control of public funds.

6. Auditing:

Auditing involves the examination and verification of books of accounts to ensure their accuracy and reliability. It helps in detecting errors and frauds and increases the credibility of financial statements.

1.6 Advantages and Limitations of Accounting

Advantages of Accounting

1. Systematic Record of Transactions:

Accounting maintains a complete and systematic record of all financial transactions. This helps in avoiding confusion and provides reliable data for future reference.

2. Determination of Profit or Loss:

Accounting helps in calculating the profit earned or loss incurred during a particular accounting period by preparing the Profit and Loss Account.

3. Knowledge of Financial Position:

Through the preparation of the Balance Sheet, accounting shows the financial position of the business in terms of assets, liabilities, and capital.

4. Assists in Decision-Making:

Accounting provides useful financial information to management, investors, and creditors, which helps them in making informed decisions.

5. Legal Evidence and Compliance:

Properly maintained books of accounts serve as legal evidence in case of disputes and help in fulfilling statutory requirements such as taxation and auditing.

6. Facilitates Control:

Accounting helps in comparing actual performance with planned performance, thereby assisting in effective control of business operations.

Limitations of Accounting

1. Records Only Monetary Transactions:

Accounting records only those transactions that can be expressed in terms of money. Non-monetary factors like employee efficiency or customer satisfaction are not recorded.

2. Based on Historical Data:

Accounting information is mainly based on past transactions and may not reflect current market conditions.

3. Possibility of Manipulation:

Financial statements can sometimes be influenced by personal judgment or different accounting methods.

4. Ignores Qualitative Aspects:

Accounting does not consider qualitative factors such as brand value, employee morale, or management efficiency.

5. Not an Exact Science:

Accounting involves estimates and assumptions; therefore, the results may not always be perfectly accurate.

1.7 GAAP (Generally Accepted Accounting Principles)

Meaning of GAAP:

Generally Accepted Accounting Principles (GAAP) refer to the basic rules, principles, concepts, and conventions that are followed in the preparation and presentation of financial statements. These principles ensure uniformity, consistency, and transparency in accounting practices. GAAP helps in presenting a true and fair view of the financial position and performance of a business.

GAAP aims to make financial statements reliable and comparable. When businesses follow common accounting principles, users such as investors, creditors, and government authorities can easily understand and compare financial information of different organizations. Thus, GAAP enhances the credibility of financial reports.

Objectives of GAAP:

The main objective of GAAP is to bring uniformity in accounting methods and practices. It ensures reliability of financial statements by following accepted standards. GAAP also promotes comparability of financial information between different accounting periods and different companies. It ensures proper disclosure of all material financial information.

Important Principles under GAAP:

GAAP includes principles such as the Business Entity Principle, which treats the business and owner as separate entities; the Money Measurement Principle, which records only transactions measurable in money; the Going Concern Principle, which assumes the business will continue for a long time; the Cost Principle, which records assets at original cost; the Accounting Period Principle, which divides business life into specific periods; and the Dual Aspect Principle, which states that every transaction has two aspects (Debit and Credit).

1.8 Accounting Concepts and Conventions

Accounting Concepts

Business Entity Concept:

According to this concept, the business and its owner are treated as separate entities. The personal transactions of the owner are not recorded in the business books. Only business transactions are considered in accounting.

Money Measurement Concept:

Only those transactions that can be expressed in monetary terms are recorded in the books of accounts. Non-monetary factors such as employee efficiency or goodwill reputation are not recorded.

Going Concern Concept:

This concept assumes that the business will continue its operations for a long period and will not be closed in the near future. Therefore, assets are recorded at cost and not at liquidation value.

Accounting Period Concept:

Although a business may continue indefinitely, its life is divided into specific periods (usually one year) to measure profit or loss for each period.

Cost Concept:

According to this concept, assets are recorded at their original purchase cost and not at their current market value.

Dual Aspect Concept:

Every business transaction has two aspects — debit and credit. This concept forms the basis of the accounting equation: $\text{Assets} = \text{Liabilities} + \text{Capital}$.

Accrual Concept:

Revenue and expenses are recorded in the period to which they relate, irrespective of actual receipt or payment of cash.

Realisation Concept:

Revenue is recognized when it is earned, not necessarily when cash is received.

Accounting Conventions**Convention of Consistency:**

Accounting methods should be applied consistently from one accounting period to another to ensure comparability.

Convention of Full Disclosure:

All material and important information must be fully disclosed in financial statements.

Convention of Conservatism (Prudence):

Accountants should anticipate no profits but provide for all possible losses.

Convention of Materiality:

Only significant information that may influence the decision of users should be disclosed.

1.9 Accounting Cycle

The accounting cycle refers to the step-by-step process followed in recording, classifying, summarizing, and reporting financial transactions of a business during an accounting period. It begins with identifying transactions and ends with the preparation of financial statements. The cycle is repeated every accounting year.

1. Identification of Transactions:

The first step in the accounting cycle is identifying financial transactions. Only those transactions which are measurable in monetary terms and relate to the business are recorded.

2. Recording in Journal:

After identification, transactions are recorded in the journal in chronological order. This process is known as journalizing.

3. Posting to Ledger:

The journal entries are then posted to the ledger accounts. Ledger helps in classifying transactions under different heads such as assets, liabilities, capital, income, and expenses.

4. Preparation of Trial Balance:

After posting, a Trial Balance is prepared to check the arithmetical accuracy of ledger accounts. It ensures that total debits are equal to total credits.

5. Passing Adjusting Entries:

At the end of the accounting period, necessary adjustments such as outstanding expenses, prepaid expenses, depreciation, and accrued income are recorded.

6. Preparation of Final Accounts:

After adjustments, final accounts are prepared. These include the Trading Account, Profit and Loss Account, and Balance Sheet to determine profit or loss and financial position.

7. Closing the Books:

Temporary accounts like income and expenses are closed, and the books are prepared for the next accounting period.

1.10 Double Entry Accounting System

The Double Entry Accounting System is a method of recording financial transactions in which every transaction has two aspects — debit and credit. This system is based on the principle that for every debit, there must be a corresponding and equal credit. It forms the foundation of modern accounting and ensures accuracy in maintaining books of accounts.

According to this system, every transaction affects at least two accounts. One account is debited, and another account is credited. The total amount debited must always be equal to the total amount credited. This principle is based on the accounting equation: **Assets = Liabilities + Capital.**

The double entry system helps in maintaining complete records of transactions and reduces the chances of errors and fraud. Since both aspects of a transaction are recorded, it becomes easier to detect mistakes through the preparation of a Trial Balance. If the debit and credit totals do not match, it indicates an error in recording.

For example, if goods are purchased for cash, the Purchases Account is debited and the Cash Account is credited. If goods are sold on credit, the Debtor's Account is debited and the Sales Account is credited. In each case, the total debit is equal to the total credit.

The advantages of the double entry system include accuracy, reliability, complete record of transactions, and easy preparation of financial statements. It provides a clear picture of the financial position and performance of the business.

1.11 Classification of Accounts

Traditional Classification of Accounts

Under the traditional approach, accounts are classified into three types:

1. Personal Accounts:

These accounts relate to persons, firms, companies, and institutions. They include Natural Persons (e.g., debtors, creditors), Artificial Persons (companies, banks), and Representative Personal Accounts (outstanding expenses, prepaid expenses).

Rule: Debit the receiver, Credit the giver.

2. Real Accounts:

These accounts relate to assets and properties of the business. They include tangible assets (cash, machinery, building) and intangible assets (goodwill, patents).

Rule: Debit what comes in, Credit what goes out.

3. Nominal Accounts:

These accounts relate to expenses, losses, incomes, and gains of the

business. Examples include salary, rent, interest, and commission.
Rule: Debit all expenses and losses, Credit all incomes and gains.

Modern Classification of Accounts

Under the modern approach, accounts are classified into five categories:

- 1. Assets**
- 2. Liabilities**
- 3. Capital**
- 4. Income**
- 5. Expenses**

This classification is based on the accounting equation:

$$\text{Assets} = \text{Liabilities} + \text{Capital}$$

1.12 Debit and Credit Rules

Rules under Traditional Classification

Under the traditional approach, accounts are classified into Personal, Real, and Nominal Accounts. Each type has specific debit and credit rules.

Personal Account Rule:

Debit the receiver and Credit the giver.

For example, if cash is paid to a creditor, the creditor's account is debited (receiver) and cash account is credited (giver).

Real Account Rule:

Debit what comes in and Credit what goes out.

For example, when machinery is purchased for cash, Machinery Account is debited (comes in) and Cash Account is credited (goes out).

Nominal Account Rule:

Debit all expenses and losses and Credit all incomes and gains.

For example, when salary is paid, Salary Account is debited (expense) and Cash Account is credited.

Rules under Modern Classification

Under the modern approach, accounts are classified into Assets, Liabilities, Capital, Income, and Expenses.

- Increase in Asset → Debit
- Decrease in Asset → Credit
- Increase in Liability → Credit
- Decrease in Liability → Debit
- Increase in Capital → Credit
- Decrease in Capital → Debit
- Increase in Income → Credit
- Increase in Expense → Debit

2.1 Journal and Ledger

Journal

A Journal is the book of original entry in which all financial transactions are recorded for the first time in chronological order. The process of recording transactions in the journal is known as journalizing. Each entry recorded in the journal is called a journal entry. It shows the date, accounts debited and credited, amount, and a brief narration explaining the transaction. Journal provides a complete record of transactions as and when they occur.

The main advantages of a journal are that it provides a systematic record of transactions, helps in preventing errors, and acts as a reference for posting entries into the ledger. It is the first step in the accounting process.

Date	Particulars	LF	Dr	Cr

Ledger

A Ledger is the principal book of accounts in which journal entries are classified and posted into individual accounts. The process of transferring entries from the journal to the ledger is known as posting. Each account in the ledger is prepared in “T” shape format, showing debit and credit sides separately.

Ledger helps in summarizing transactions relating to each account. It provides the balance of each account, which is used to prepare the Trial Balance. Without a ledger, it is not possible to know the position of individual accounts such as cash, capital, expenses, or creditors.

Dr		Name of the Account				Cr	
Date	Particulars	Folio	Amount	Date	Particulars	Folio	Amount

2.2 Subsidiary Books

Subsidiary Books, also known as Special Journals, are the books in which transactions of similar nature are recorded separately instead of recording all transactions in one journal. When the number of transactions increases, recording all entries in a single journal becomes difficult. Therefore, subsidiary books are maintained to save time, reduce errors, and divide work efficiently.

Each subsidiary book records a specific type of transaction. After recording, entries from these books are periodically posted to the ledger. This system makes accounting work systematic and convenient, especially in large businesses.

Types of Subsidiary Books

1. Purchases Book:

This book records all credit purchases of goods meant for resale. Cash purchases are not recorded here.

Date	Particulars	Invoice No (Inwards)	LF	Amount

2. Sales Book:

This book records all credit sales of goods. Cash sales are recorded in the Cash Book.

Date	Particulars	Invoice No (Outwards)	LF	Amount

3. Purchases Returns Book (Returns Outward Book):

This book records goods returned to suppliers that were previously purchased on credit.

Date	Particulars	Debit Note No	LF	Amount

4. Sales Returns Book (Returns Inward Book):

This book records goods returned by customers that were previously sold on credit.

Date	Particulars	Credit Note No	LF	Amount

5. Cash Book:

This book records all cash and bank transactions, including cash receipts and payments. This book is of four types namely Single Column, Double Column, Triple Column and Petty Cash Book.

6. Bills Receivable Book:

This book records all bills received from debtors.

Date	Bill No	Acceptor	From	Terms	Due Date	Amount

7. Bills Payable Book:

This book records all bills accepted in favor of creditors.

Date	Bill No	Drawee	Payee	Terms	Date of Maturity	Amount

8. Journal Proper:

This book records transactions that cannot be recorded in any other subsidiary book, such as opening entries, adjustment entries, and transfer entries.

2.3 Benefits of Subsidiary Books

1. Division of Work:

Subsidiary books help in dividing accounting work among different persons. Each clerk can handle a specific book, which increases efficiency and saves time.

2. Time Saving:

Recording similar types of transactions in separate books reduces

Sales A/c Dr 500
 To Purchases A/c 500

5. Wrong Amount Posted

Example: Goods sold to Mohan ₹3,200 was posted as ₹2,300. (Short credited by ₹900)

Entry to Rectify:

Mohan A/c Dr 900
 To Sales A/c 900

6. Posting to Wrong Side

Example: Discount received ₹400 debited instead of credited.

Correct entry should have been credited, so rectification requires double effect:

Discount Received A/c Dr 800
 To Suspense A/c 800

(If Trial Balance already prepared)

7. Rectification After Preparation of Trial Balance (Using Suspense A/c)

Example: Purchase Book undercast by ₹1,000.

Purchases A/c Dr 1,000
 To Suspense A/c 1,000

3.1 Meaning and Causes of Depreciation and Amortisation

Depreciation

Depreciation refers to the gradual and permanent decrease in the value of a tangible fixed asset due to use, wear and tear, passage of time, or

obsolescence. Assets such as machinery, buildings, furniture, and vehicles lose their value over time. Depreciation is charged as an expense in the Profit and Loss Account to ascertain the correct profit and to show the asset at its reduced value in the Balance Sheet.

Depreciation is not a loss caused by accident but a normal and continuous decline in the usefulness of an asset. It ensures proper allocation of the cost of an asset over its useful life.

Causes of Depreciation

1. Wear and Tear:

Continuous use of assets like machinery and vehicles results in physical deterioration.

2. Passage of Time:

Some assets lose value simply with the passage of time, even if not used, such as leasehold property.

3. Obsolescence:

Assets may become outdated due to technological advancements or changes in market demand.

4. Accidents:

Unexpected events like fire or damage may reduce the value of assets.

5. Depletion:

Natural resources such as mines and oil wells lose value as they are extracted.

Amortisation

Amortisation refers to the systematic write-off of the cost of intangible assets over their useful life. Intangible assets such as patents, copyrights, trademarks, and goodwill do not have physical form but provide long-term benefits to the business. The reduction in their value over time is known as amortisation.

Amortisation ensures that the cost of intangible assets is properly allocated to different accounting periods and helps in determining accurate profit.

3.2 Depreciation vs Amortisation

Meaning:

Depreciation refers to the gradual and permanent decrease in the value of tangible fixed assets due to use, wear and tear, passage of time, or obsolescence. It applies to physical assets such as machinery, buildings, furniture, and vehicles. Amortisation, on the other hand, refers to the systematic write-off of the cost of intangible assets over their useful life. It applies to non-physical assets such as patents, copyrights, trademarks, and goodwill.

Nature of Assets:

Depreciation is charged on tangible assets that have physical existence. Amortisation is charged on intangible assets that do not have physical form but provide long-term benefits.

Causes:

Depreciation is caused by wear and tear, usage, passage of time, or technological changes. Amortisation occurs due to expiry of legal rights or reduction in the economic value of intangible assets.

Method of Calculation:

Depreciation may be calculated using different methods such as Straight Line Method or Written Down Value Method. Amortisation is generally calculated using the Straight Line Method over the asset's useful or legal life.

Accounting Treatment:

Both depreciation and amortisation are treated as expenses and debited to the Profit and Loss Account. They reduce the value of the respective assets in the Balance Sheet.

3.3 Straight Line Method of Depreciation

The Straight Line Method (SLM) is one of the simplest methods of calculating depreciation. Under this method, depreciation is charged equally every year over the useful life of the asset. The amount of depreciation remains constant throughout the life of the asset. This method is also known as the **Original Cost Method** or **Fixed Installment Method**.

Under the Straight Line Method, depreciation is calculated on the original cost of the asset. The formula used is:

Depreciation = (Cost of Asset – Scrap Value) ÷ Useful Life of Asset.

The cost of the asset includes purchase price and installation expenses, while scrap value is the estimated residual value at the end of useful life.

This method is suitable for assets that give equal benefits every year such as buildings, furniture, and leasehold assets. It is easy to understand and simple to apply because depreciation amount remains the same every year. It also helps in easy calculation of asset value in the Balance Sheet.

However, this method has certain limitations. It does not consider the actual usage of assets, and it may not be suitable for assets like machinery where benefits decrease over time. Despite this, the Straight Line Method is widely used due to its simplicity and consistency in accounting records.

3.4 Written Down Value Method of Depreciation

The Written Down Value (WDV) Method is a method of calculating depreciation in which depreciation is charged at a fixed percentage on the book value (written down value) of the asset every year. Under this method, depreciation amount is higher in the initial years and gradually decreases in the later years. This method is also known as the **Reducing Balance Method**.

In this method, depreciation is calculated on the opening book value of the asset. The formula used is:

Depreciation = Book Value × Depreciation Rate. Since depreciation is

charged on the reduced value of the asset every year, the value of depreciation keeps decreasing over time. This method is commonly used for assets like machinery, vehicles, and equipment which give higher benefits in the early years of use.

The WDV method is suitable because it matches higher maintenance and repair costs with lower depreciation in later years. It also reflects a more realistic value of the asset in the Balance Sheet. However, the calculation is slightly more complex compared to the Straight Line Method.

In conclusion, the Written Down Value Method is widely used in business accounting because it provides a realistic charge of depreciation and is suitable for assets that lose value faster in the initial years.

3.5 Annuity and Depletion Method of Depreciation

Annuity Method

The Annuity Method is a method of charging depreciation where depreciation is calculated by considering interest on the amount invested in the asset. Under this method, the cost of the asset is treated as an investment, and interest is calculated on the outstanding balance of the asset value each year. This method helps in determining the true cost of using the asset because it includes both depreciation and interest cost.

The depreciation amount under the annuity method remains almost equal every year, but the interest component decreases over time. This method is suitable for assets that involve large investments such as buildings, leasehold properties, and long-term projects. However, this method is complex because it requires calculation of interest and annuity tables.

Annual Depreciation = Cost / Annuity Factor

Depletion Method

The Depletion Method is used for natural resources such as mines, oil wells, quarries, and forests. Under this method, depreciation is calculated based on the quantity of resources extracted rather than time or usage. As

natural resources are extracted, the value of the asset decreases proportionately.

Under this method, depreciation is calculated using the formula:
Depreciation = (Cost of Asset / Total Estimated Units of Resource) × Units Extracted During the Period. This method is suitable for industries dealing with natural resources because the asset value reduces as the resource is consumed.

In conclusion, the annuity method considers interest on investment, while the depletion method is based on extraction of natural resources. Both methods help in accurately allocating the cost of assets over their useful life.

4.1 Provisions and Reserves

Meaning of Provisions

Provisions are amounts set aside from profits to meet known liabilities or probable future losses whose exact amount or timing is uncertain. They are created to ensure that the business is prepared for expenses or losses that may arise in the future. Examples include provision for bad debts, provision for taxation, and provision for depreciation. Provisions reduce the profit of the business in the year they are created.

The purpose of provisions is to show a realistic financial position and to avoid overstating profit or assets. They are treated as liabilities in the Balance Sheet or as deductions from assets, depending on the type of provision.

Meaning of Reserves

Reserves are amounts retained from profits to strengthen the financial position of the business or to meet future expansion or contingencies. Unlike provisions, reserves are created from undistributed profits, not to cover specific liabilities. Examples include general reserve, capital reserve, and dividend equalization reserve.

Reserves are part of the owner's equity in the Balance Sheet and are not treated as liabilities. They serve multiple purposes such as providing funds for expansion, paying dividends, and improving the financial stability of the business.

4.2 Objectives of Provisions and Reserves

Objectives of Provisions

1. To Provide for Known Liabilities:

The primary objective of creating provisions is to meet known liabilities or expenses whose exact amount is uncertain. It ensures that expected obligations such as taxation or bad debts are properly accounted for.

2. To Cover Probable Future Losses:

Provisions are created to anticipate possible losses and avoid sudden financial burden in future periods. This helps in maintaining financial stability.

3. To Show True and Fair Profit:

By charging provisions to the Profit and Loss Account, the business avoids overstating profits. This ensures that profits are calculated accurately after considering all expected expenses.

4. To Present Correct Value of Assets:

Provisions like provision for doubtful debts help in showing assets at their realizable value in the Balance Sheet.

5. To Follow the Principle of Conservatism:

Provisions are created in accordance with the accounting principle of prudence, which states that expected losses should be provided for, but anticipated profits should not be recorded.

6. To Ensure Financial Discipline:

Creating provisions promotes careful financial planning and responsible management of business resources.

Objectives of Reserves

1. To Strengthen Financial Position:

One of the main objectives of creating reserves is to strengthen the financial stability of the business. Reserves increase the owner's equity and improve the overall financial soundness of the organization.

2. To Meet Future Contingencies:

Reserves are created to face unexpected losses or emergencies in the future. They act as a financial cushion during difficult periods.

3. To Provide for Business Expansion:

Reserves help in financing future growth and expansion activities such as purchasing new assets, opening new branches, or introducing new products.

4. To Maintain Stable Dividends:

Reserves can be used to maintain uniform dividend payments to shareholders even in years of low profits.

5. To Improve Creditworthiness:

A business with adequate reserves gains the confidence of investors, creditors, and financial institutions, thereby improving its borrowing capacity.

6. To Comply with Legal Requirements:

Certain reserves, such as statutory reserves, are created to meet legal and regulatory requirements.

4.3 Types of Provisions and Reserves

Types of Provisions

Provisions are created to meet known liabilities or probable losses. The main types include:

1. Provision for Bad Debts:

This is created to cover debts that may not be recovered from debtors. It ensures that assets are shown at their realizable value in the Balance Sheet.

2. Provision for Depreciation:

This provision is made to account for the gradual decrease in the value of fixed assets due to wear and tear, obsolescence, or usage.

3. Provision for Taxation:

This is created to meet income tax or other tax liabilities that may arise on the profits earned by the business.

4. Provision for Discount on Debtors or Creditors:

Sometimes, provisions are made for expected discounts to be allowed to debtors or received from creditors.

5. Other Provisions:

Other types include provision for warranties, contingencies, or legal liabilities that may arise in the future.

Types of Reserves

Reserves are amounts retained from profits to strengthen the financial position of the business or meet future contingencies. The main types include:

1. General Reserve:

This reserve is created from profits to strengthen the financial stability of the business. It is not meant for any specific purpose.

2. Specific Reserve:

Also called Special Reserve, it is created for a specific purpose, such as dividend equalization reserve or reserve for expansion.

3. Capital Reserve:

This reserve arises from capital profits like profit on the sale of fixed assets or issue of shares at premium. It cannot be distributed as dividends.

4. Revenue Reserve:

This reserve is created from revenue profits and can be used for business purposes or to pay dividends.

5. Statutory Reserve:

Some reserves are required by law, such as reserves under the Companies Act or for banks and financial institutions.

In conclusion, provisions are created to cover known liabilities or probable losses, while reserves are created from profits to strengthen the financial position or meet future contingencies of the business. Both play a crucial role in prudent financial management.

4.4 Differences between Provisions and Reserves

1. Meaning:

Provisions are amounts set aside from profits to meet known liabilities or probable future losses. Reserves are amounts set aside from profits to strengthen the financial position of the business and meet future uncertainties.

2. Purpose:

Provisions are created to cover specific liabilities or expected losses such as bad debts or taxation. Reserves are created for business expansion, financial stability, or future contingencies.

3. Impact on Profit:

Provisions are charged to the Profit and Loss Account and reduce the current year's profit. Reserves are created from profits after determining the net profit.

4. Nature:

Provisions are compulsory in many cases as per accounting principles. Reserves are generally created voluntarily by management, except statutory reserves.

5. Balance Sheet Treatment:

Provisions are shown as liabilities or deducted from the related asset value. Reserves are shown under the owner's equity or capital section in the Balance Sheet.

6. Dividend Distribution:

Provisions cannot be used for dividend distribution. Reserves may be used for dividend distribution depending on the type of reserve.

7. Certainty:

Provisions are created for known or probable losses. Reserves are created for unknown future contingencies and business expansion.

In conclusion, provisions help in covering expected losses, while reserves help in strengthening the financial position and supporting future business growth.

4.5 Accounting Treatment of Provisions and Reserves

Accounting Treatment of Provisions

Provisions are treated as expenses or liabilities depending on their nature. Provisions are usually charged to the Profit and Loss Account because they are created to meet expected losses or liabilities. For example, provision for bad debts is shown as an expense in the Profit and Loss Account and deducted from debtors in the Balance Sheet to show their realizable value. Provision for taxation is shown as a liability in the Balance Sheet until the tax amount is paid. Provision for depreciation is treated as an expense and is deducted from the value of fixed assets in the Balance Sheet. Thus, provisions help in presenting a true and fair view of financial statements.

Accounting Treatment of Reserves

Reserves are created from profits after determining net profit. Reserves are shown under the owner's equity or capital section in the Balance Sheet. Unlike provisions, reserves are not treated as expenses. General reserves

and revenue reserves are created from revenue profits, while capital reserves are created from capital profits such as profit on sale of assets. Reserves help in strengthening the financial position of the business and can be used for business expansion or future contingencies. Some reserves, such as statutory reserves, are created as per legal requirements.

Provisions and Reserves – Impact on Profit

Impact of Provisions on Profit

Provisions have a **direct impact on profit** because they are treated as a charge against revenue. They are created to meet known liabilities or expected losses and are debited to the Profit and Loss Account before arriving at net profit.

When a provision is created, the amount is deducted from the profit of the current year. Therefore, provisions **reduce net profit**. This ensures that profits are not overstated and that financial statements present a true and fair view. Since provisions are compulsory and based on prudence, they must be created even if it reduces distributable profit.

Impact of Reserves on Profit

Reserves do **not affect net profit directly** because they are an appropriation of profit. They are created only after calculating net profit and are transferred from the Profit and Loss Appropriation Account.

Creation of reserves does not reduce the net profit figure; instead, it reduces the amount available for dividend distribution. Reserves strengthen the financial position of the business but do not affect the calculation of operating profit.

5.1 Preparation of Trading Account with Adjustments

The **Trading Account** is prepared to ascertain the **Gross Profit or Gross Loss** of a business for a particular accounting period. It records only direct revenues and direct expenses related to purchase and sale of goods.

Items Debited to Trading Account

- Opening Stock
- Purchases (Less: Purchase Returns)
- Direct Expenses (Carriage Inwards, Wages, Freight, Customs Duty, etc.)

Items Credited to Trading Account

- Sales (Less: Sales Returns)
- Closing Stock

Important Adjustments in Trading Account

1. Closing Stock

Closing stock is shown on the credit side of Trading Account and also on the asset side of the Balance Sheet.

2. Outstanding Wages

If wages are unpaid, they are added to wages in Trading Account and shown as a liability in the Balance Sheet.

3. Prepaid Wages

If wages are paid in advance, they are deducted from wages and shown as a current asset.

4. Goods Withdrawn for Personal Use (Drawings)

Such goods are deducted from purchases.

5. Goods Distributed as Free Samples

The cost of free samples is deducted from purchases and transferred to Advertisement Account.

6. Abnormal Loss of Stock (Fire, Theft)

Abnormal loss is deducted from purchases and shown separately in Profit and Loss Account.

Format of Trading Account

Trading Account for the Year Ended ...

Dr.	Amount	Cr.	Amount
To Opening Stock	xxx	By Sales	xxx
To Purchases	xxx	By Closing Stock	xxx
Less: Purchase Returns	(xxx)		
To Wages	xxx		
Add: Outstanding Wages	xxx		
To Carriage Inwards	xxx		
To Gross Profit (c/d)	xxx		

Calculation

$$\text{Gross Profit} = \text{Net Sales} - \text{Cost of Goods Sold}$$

Where:

$$\text{Cost of Goods Sold} = \text{Opening Stock} + \text{Net Purchases} + \text{Direct Expenses} - \text{Closing Stock}$$

If the credit side exceeds the debit side, it is **Gross Profit**.

If the debit side exceeds the credit side, it is **Gross Loss**.

5.2 Preparation of Profit & Loss Account with Adjustments

The **Profit and Loss Account** is prepared to ascertain the **Net Profit or Net Loss** of a business for a particular accounting period. It includes all

indirect expenses and indirect incomes that are not recorded in the Trading Account.

Gross Profit (or Gross Loss) from the Trading Account is transferred to the Profit and Loss Account.

Items Debited to Profit & Loss Account (Indirect Expenses)

- Salaries
- Rent, Rates and Taxes
- Insurance
- Office Expenses
- Printing and Stationery
- Depreciation
- Bad Debts
- Provision for Doubtful Debts
- Interest Paid
- Advertisement Expenses

Items Credited to Profit & Loss Account (Indirect Incomes)

- Commission Received
- Interest Received
- Discount Received
- Rent Received
- Dividend Received

Important Adjustments in Profit & Loss Account

1. Outstanding Expenses

Outstanding expenses are added to the respective expense and shown as a liability in the Balance Sheet.

2. Prepaid Expenses

Prepaid expenses are deducted from the respective expense and shown as a current asset.

3. Accrued Income

Accrued income is added to the respective income and shown as an asset.

4. Income Received in Advance

Income received in advance is deducted from income and shown as a liability.

5. Depreciation

Depreciation on assets is debited to Profit and Loss Account and deducted from the asset value in the Balance Sheet.

6. Bad Debts and Provision for Doubtful Debts

Bad debts are written off and provision is created by debiting Profit and Loss Account.

7. Interest on Capital

It is treated as an expense and debited to Profit and Loss Account, while added to capital in Balance Sheet.

8. Interest on Drawings

It is treated as income and credited to Profit and Loss Account, while deducted from capital.

Format of Profit & Loss Account

Profit and Loss Account for the Year Ended ...

Dr.	Amount	Cr.	Amount
To Salaries	xxx	By Gross Profit (b/d)	xxx
To Rent	xxx	By Commission Received	xxx
To Insurance	xxx	By Interest Received	xxx
To Depreciation	xxx		
To Bad Debts	xxx		
To Net Profit (c/d)	xxx		

If the credit side exceeds the debit side, it is **Net Profit**.

If the debit side exceeds the credit side, it is **Net Loss**.

5.3 Preparation of Balance Sheet with Adjustments

The **Balance Sheet** is a statement showing the financial position of a business on a particular date. It is prepared after the Trading Account and Profit and Loss Account. It shows the assets, liabilities, and capital of the business.

The basic equation of the Balance Sheet is:

Assets = Capital + Liabilities

Structure of Balance Sheet

Liabilities Side

- Capital (Adjusted with Net Profit/Loss, Drawings, Interest)
- Long-term Liabilities (Loans, Debentures)
- Current Liabilities (Creditors, Bills Payable, Outstanding Expenses, Bank Overdraft)

Assets Side

- Fixed Assets (Land, Building, Machinery, Furniture)

- Investments
- Current Assets (Stock, Debtors, Bills Receivable, Cash, Bank, Prepaid Expenses, Accrued Income)

Important Adjustments in Balance Sheet

1. Closing Stock

Shown on the asset side of the Balance Sheet.

2. Outstanding Expenses

Shown as a current liability.

3. Prepaid Expenses

Shown as a current asset.

4. Accrued Income

Shown as a current asset.

5. Income Received in Advance

Shown as a current liability.

6. Depreciation

Deducted from the concerned asset value.

7. Provision for Doubtful Debts

Deducted from Debtors on the asset side.

8. Interest on Capital

Added to Capital.

9. Interest on Drawings

Deducted from Capital.

10. Drawings

Deducted from Capital.

Format of Balance Sheet

Balance Sheet as on ...

Liabilities	Amount	Assets	Amount
Capital	xxx	Land & Building	xxx
Add: Net Profit	xxx	Less: Depreciation	(xxx)
Less: Drawings	(xxx)	Debtors	xxx
		Less: Provision	(xxx)
Creditors	xxx	Closing Stock	xxx
Outstanding Expenses	xxx	Cash in Hand	xxx

5.4 Uses of Final Accounts

Final Accounts include the Trading Account, Profit and Loss Account, and Balance Sheet. They show the financial performance and financial position of a business at the end of the accounting period. The following are the important uses of final accounts:

1. To Determine Profit or Loss:

Final accounts help in finding out the gross profit and net profit or net loss of the business for a particular period. This shows whether the business is running successfully.

2. To Know Financial Position:

The Balance Sheet shows the assets, liabilities, and capital of the business. It helps in understanding the financial strength and solvency of the business.

3. To Assist in Decision Making:

Management uses final accounts to take important decisions regarding expansion, investment, cost control, and pricing policies.

4. To Provide Information to Owners:

Owners can evaluate the performance of the business and know the return on their investment.

5. To Help Creditors and Investors:

Creditors and investors examine final accounts to judge the creditworthiness and profitability of the business before lending money or investing.

6. For Taxation Purpose:

Final accounts form the basis for calculating income tax and other statutory payments.

7. For Comparison and Analysis:

Final accounts help in comparing the performance of the business over different years and with other similar businesses.