Financial Accounting

Financial Accounting - Basics

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About the Tutorial

Accounting is a business language. We can use this language to communicate financial transactions and their results. Accounting is a comprehensive system to collect, analyze, and communicate financial information.

Audience

This tutorial has been designed to help beginners pursuing education in financial accounting or business management. Any enthusiastic reader with basic mathematics knowledge can comprehend this tutorial. After completing this tutorial, you will find yourself at a moderate level of expertise from where you can take yourself to next levels.

Prerequisites

Before you start proceeding with this tutorial, we assume that you have a basic understanding of commerce.

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1. Financial Accounting – Rectification of Errors

Financial accounting deals with recording and maintaining every monetary transaction of an organization. However, sometimes, a few entries might be either incorrect or used at the wrong place. In financial accounting, the process of correcting such mistakes is known as **Rectification of Errors**.

Types of Errors

Two most common types of errors, which are usually occurred at the time of preparation of Financial Statements are discussed below.

Error which Effect only One Account

- Omission of posting of balance in a Trial Balance.
- Error of carried forward of balance.
- Error of casting and posting.

Error which Effect Two or more Accounts

The nature of errors, which occur during the preparation of Financial Statements are:

- Error of posting in wrong account.
- Error of principle.
- Error of omission.

Methods of Rectification of Errors

There are three types of methods used in rectification of Errors:

Replacing Correct Figure by Striking Off the Wrong Figure

For example, cash payment of Rs. 989 on the account of stationery purchased written as Rs. 998, will be corrected as:

Cash Book

		By Stationery A/c	~~998~~ **989**

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Through Journal Entry

Normally, there are three types of errors, which can be rectified by passing Journal Entries:-

1. Short credited or debit in one account and excess debit or credit in another account. For example, purchase of stationery for Rs. 989 wrongly debited to purchase of raw material account will be corrected as follows:

Journal Entry

Stationery Account Dr.	989	
To Purchase Account		989
(Being Cash purchase of stationery wrongly debited to Purchase account, now rectified)		

2. If, **by *mistake one account is debited as well as credited with wrong amount simultaneously***. For example, Cash purchase of stationery of Rs. 989 booked with an amount of Rs. 489 will be corrected as follows:

Journal Entry

Stationery Account Dr.	500	
To Cash Account		500
(Being purchase of stationery for Rs. 989 wrongly written as Rs. 489 now rectified)		

3. If there is an omission of recording a transaction, it can be rectified by passing journal entry to book that omitted transaction. For example, omission of recording transaction of purchase of raw material for Rs. 5000 from Mr. X will be recorded and corrected by passing the following journal Entry:

Journal Entry

Purchase Account Dr.	5000	
To X Account		5000
(Being omitted entry of purchase of Rs. 5000 from Mr. X now recorded and rectified)		

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If there is a Mistake that Effects Trial Balance

- Before closing the books and transferring the difference in suspense account and
- After the agreed difference is transferred into the suspense account, following accounting treatment will be done:
    - Earlier entry debited or credited with fewer amount will be rectified by repeating that entry with difference amount to complete that amount. For example, entry done with Rs. 500 instead of Rs. 5000 will be rectified by doing same entry with an amount of Rs. 4500. In case, where entry wrongly debited or credited to other account may be rectified by doing reversal of old entry to nullify earlier effect.

If expense booked with less amount entry then:

Particular Expense Account	Dr	4,500
To Cash/Personal Account		4,500
(Being wrong amount of posting, rectified with		
Difference amount Rs. 4,500 (5000-500)		

If income is booked with less amount, it will be rectified as:

Cash/Personal account	Dr	4,500
To Income Account		4,500
(Being wrong amount of posting now		
Rectified. 4500 (5000-500)		

If posting done in wrong account that will be rectified as follows:

Stationery Account	Dr	**	
To Office Expenses Account			**
(Being wrongly debited earlier in office account, now			
Rectified and posted in stationery account)			

In case (ii) where difference has already been transferred to suspense account, further amount will be debited or credited to respective account and correspondingly suspense

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account will be debited or credited. Thus, these entries would reduce/nil the balance of suspense account.

Effect of Errors on Agreement of Trial Balance

The errors by which there is no change on both side of trial balance or wrong effect on trial balance with same amount will not lead to effect on agreement of Trial Balance. Errors of omission, error of posting with wrong amount on both side, or Error of principles are the example of such errors. To find out such errors is a challenging job for any book keeper or an accountant.

Effects of Errors on Financial Statements

Effect of error depends on the nature of effected accounts. If errors relate to nominal account, it will either increase or reduce the profit and rectification will reduce excess profit or Loss. Effect of error on Trading and Profit account ultimately effect the Balance-Sheet of a company too, because reduced profit or excess profit ultimately transferred to capital account, which is a part of the Balance Sheet.

There are some errors, which effect Trading or Profit and Loss account and Balance sheet simultaneously, like entry of depreciation will affect profit as well as value of the Fixed Assets.

Some entry may effect on Balance sheet only like, for instance omission of entry of cash paid to purchase fixed assets will affect Balance Sheet of a firm only.

Rectification of Errors after Preparation of Final Accounts

To remain unaffected Profit or Loss of the current financial year, the errors, which took place in last financial years are adjusted and rotated through a Profit & Loss adjustment account. Balance of this account directly transferred to capital account of firm without affecting the current year profit or loss.

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2. Financial Accounting – Capital and Revenue

One of the major aspects of preparing a correct financial statement is to distinguish revenue and capital in regard to revenue income, revenue expenditure, revenue payments, revenue profits, and revenue losses of the company with capital income, capital receipts, capital profit, or capital losses.

In fact, without differentiating, we cannot think of correctness of a financial statement. Ultimately, it will mislead the end results where no one can conclude anything. As per this principle, a revenue item should be recorded in the Trading and Profit & Loss account and a capital item should be recorded in the Balance-Sheet of respective firm.

Capital Expenditure

Capital expenditure is the expenditure incurred to acquire fixed assets, capital leases, office equipment, computer equipment, software development, purchase of tangible and intangible assets, and such kind of any value addition in business with the purpose to enhance the income. However, to decide nature of the capital expenditure, we need to pay attention on:

- The expenditure, which benefit cannot be consumed or utilized in the same accounting period, should be treated as **capital expenditure**.
- Expenditure incurred to acquire Fixed Assets for the company.
- Expenditure incurred to acquire fixed assets, erection and installation charges, transportation of assets charges, and travelling expenses directly relates to the purchase fixed assets, are covered under capital expenditure.
- Capital addition to any fixed assets, which increases the life or efficiency of those assets for example, an addition to building.

Revenue Expenditure

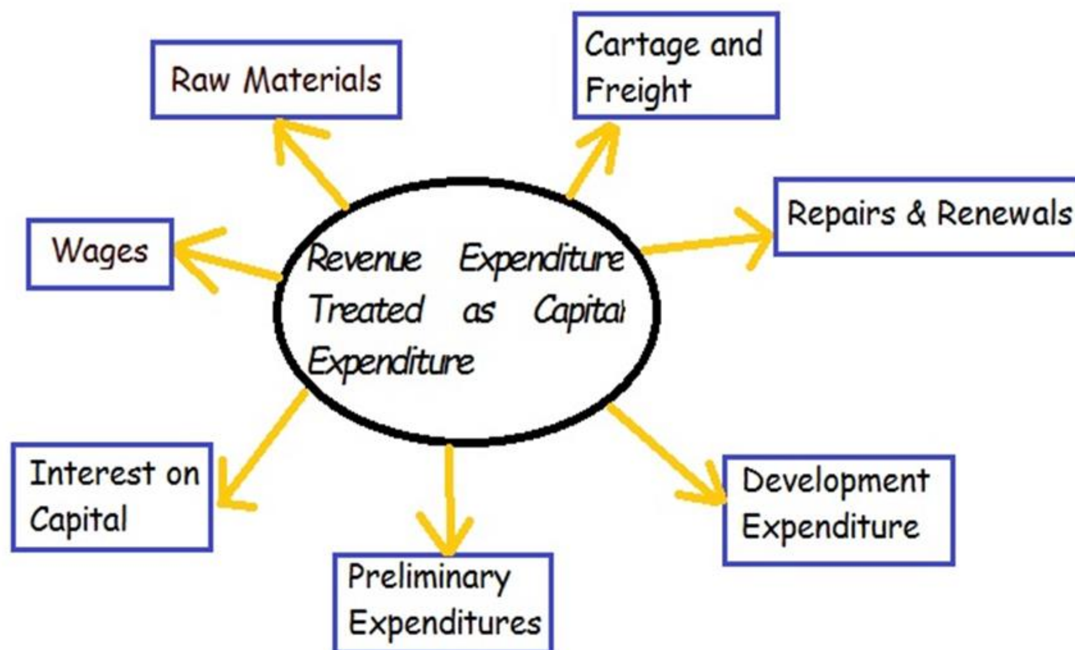
Revenue expenditure is the expenditure incurred on the fixed assets for the 'maintenance' instead of increasing the earning capacity of the assets. Examples of some of the important revenue expenditures are as follows:

- Wages/Salary
- Freight inward & outward
- Administrative Expenditure
- Selling and distribution Expenditure
- Assets purchased for resale purpose
- Repairs and renewal expenditure which are necessary to keep Fixed Assets in good running and efficient conditions

Revenue Expenditure Treated as Capital Expenditure

Following are the list of important revenue expenditures, but under certain circumstances, they are treated as a capital expenditure:

- **Raw Material and Consumables:** If those are used in making any fixed assets.
- **Cartage and Freight:** If those are incurred to bring Fixed Assets.
- **Repairs & Renewals:** If incurred to enhance life of the assets or efficiency of the assets.
- **Preliminary Expenditures:** Expenditure incurred during the formation of a business should be treated as capital expenditure.
- **Interest on Capital:** If paid for the construction work before the commencement of production or business.
- **Development Expenditure:** In some businesses, long period of development and heavy amount of investment are required before starting the production especially in a Tea or Rubber plantation. Usually, these expenditure should be treated as the capital expenditure.
- **Wages:** If paid to build up assets or for the erection and installation of Plant and Machinery.



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Deferred Revenue Expenditure

Some non-recurring and special nature of expenditure for which heavy amount incurred and benefit for the same will spread in up-coming years, to be treated as capital expenditure and will be shown as the assets of the firm. Part of the expenditure should be debited to Profit & Loss account every year. For example, if heavy amount paid for the advertisement of a product, which benefits are expected to be received in next four years, then it should be debited as ¼ of the part in Profit & Loss account as the revenue expenses and balance ¾ will be shown as the assets in the Balance-Sheet.

Capital and Revenue Profit

The premium received on issue of shares, and the profit on sale of fixed assets are the major examples of capital profit and should not be treated as revenue profit. Capital profit should be transferred to the capital reserve account, which is used to set off capital losses in future if any.

Capital and Revenue Receipts

Sale of fixed assets, capital employed or invested, and loans are the example of capital receipts. On the other hand, sale of stock, commission received, and interest on investment received are the main examples of revenue receipts. Revenue receipts will be credited to the profit and loss account and on the other hand, capital receipts will affect the Balance-sheet.

Capital and Revenue Losses

Discount on issue of shares and losses on sale of fixed assets are the capital loss and would be set off against the capital profits only. Revenue losses on normal business activity are part of the profit and loss account.

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3. Financial Accounting – Final Accounts

Final Accounts are the accounts, which are prepared at the end of a fiscal year. It gives a precise idea of the financial position of the business/organization to the owners, management, or other interested parties. Financial statements are primarily recorded in a journal; then transferred to a ledger; and thereafter, the final account is prepared (*as shown in the illustration*).

Usually, a final account includes the following components:

- Trading Account
- Manufacturing Account
- Profit and Loss Account
- Balance Sheet

Now, let us discuss each of them in detail:

Trading Account

Trading accounts represents the Gross Profit/Gross Loss of the concern out of sale and purchase for the particular accounting period.

Study of Debit side of Trading Account

- **Opening Stock**: Unsold closing stock of the last financial year is appeared in debit side of the Trading Account as "To Opening Stock" of the current financial year.

- **Purchases**: Total purchases (net of purchase return) including cash purchase and credit purchase of traded goods during the current financial year appeared as "To Purchases" in the debit side of Trading Account.

- **Direct Expenses**: Expenses incurred to bring traded goods at business premises/warehouse called direct expenses. Freight charges, cartage or carriage charges, custom and import duty in case of import, gas, electricity fuel, water, packing material, wages, and any other expenses incurred in this regards comes under the debit side of Trading Account and appeared as "To Particular Name of the Expenses".

- **Sales Account**: Total Sale of the traded goods including cash and credit sales will appear at outer column of the credit side of Trading Account as "By Sales." Sales should be on net releasable value excluding Central Sales Tax, Vat, Custom, and Excise Duty.

- **Closing Stock**: Total Value of unsold stock of the current financial year is called as closing stock and will appear at the credit side of Trading Account.

$$Closing\ Stock = Opening\ Stock + Net\ Purchases - Net\ Sale$$

- **Gross Profit**: Gross profit is the difference of revenue and the cost of providing services or making products. However, it is calculated **before** deducting payroll, taxation, overhead, and other interest payments. Gross Margin is used in the US English and carries same meaning as the Gross Profit.

$$Gross\ Profit = Sales - Cost\ of\ Goods\ Sold$$

- **Operating Profit**: Operating profit is the difference of revenue and the costs generated by ordinary operations. However, it is calculated **before** deducting taxes, interest payments, investment gains/losses, and many other non-recurring items.

$$Operating\ Profit = Gross\ Profit - Total\ Operating\ Expenses$$

- **Net Profit**: Net profit is the difference of total revenue and the total expenses of the company. It is also known as net income or net earnings.

$$Net\ Profit = Operating\ Profit - (Taxes + Interest)$$

Format of Trading Account

Trading Account of M/s ABC Limited (For the period ending 31-03-2014)			
Particulars	**Amount**	**Particulars**	**Amount**
To Opening Stock	XX	By Sales	XX
To Purchases	XX	By Closing Stock	XX
To Direct Expenses	XX	By Gross Loss c/d	XXX

To Gross Profit c/d	XXX		
Total	**XXXX**	**Total**	**XXXX**

Manufacturing Account

Manufacturing account prepared in a case where goods are manufactured by the firm itself. Manufacturing accounts represent cost of production. Cost of production then transferred to Trading account where other traded goods also treated in a same manner as Trading account.

Important Point Related to Manufacturing Account

Apart from the points discussed under the section of Trading account, there are a few additional important points that need to be discuss here:

- **Raw Material**: Raw material is used to produce products and there may be opening stock, purchases, and closing stock of Raw material. Raw material is the main and basic material to produce items.

- **Work-in-Progress**: Work-in-progress means the products, which are still partially finished, but they are important parts of the opening and closing stock. To know the correct value of the cost of production, it is necessary to calculate the correct cost of it.

- **Finished Product**: Finished product is the final product, which is manufactured by the concerned business and transferred to trading account for sale.

- **Raw Material Consumed (RMC)**: It is calculated as:

$$\boldsymbol{RMC = Opening\ Stock\ of\ Raw\ Material + Purchases - Closing\ Stock}$$

- **Cost of Production**: Cost of production is the balancing figure of Manufacturing account as per the format given below:

Manufacturing Account (For the year ending……….)			
Particulars	**Amount**	**Particulars**	**Amount**
To Opening Stock of Work-in-Progress	XX	By Closing Stock of Work-in-progress	XX

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To Raw Material Consumed	XX	By Scrap Sale	XX
To Wages	XX	By Cost of Production	XXX
To Factory overhead xx		(Balancing figure)	
Power or fuel xx			
Dep. Of Plant xx			
Rent- Factory xx			
Other Factory Exp. xx	xxx		
Total	**XXXX**	**Total**	**XXXX**

Profit & Loss Account

Profit & Loss account represents the Gross profit as transferred from Trading Account on the credit side of it along with any other income received by the firm like interest, Commission, etc.

Debit side of profit and loss account is a summary of all the indirect expenses as incurred by the firm during that particular accounting year. For example, Administrative Expenses, Personal Expenses, Financial Expenses, Selling, and Distribution Expenses, Depreciation, Bad Debts, Interest, Discount, etc. Balancing figure of profit and loss accounts represents the true and net profit as earned at the end of the accounting period and transferred to the Balance Sheet.

Profit & Loss Account of M/s .... **(For the period ending ....)**			
Particulars	**Amount**	**Particulars**	**Amount**
To Salaries	XX	By Gross Profit b/d	XXX
To Rent	XX		
To Office Expenses	XX	By Bank Interest received	XX

To Bank charges	XX	By Discount	XX
To Bank Interest	XX	By Commission Income	XX
To Electricity Expenses	XX	By Net Loss transfer to Balance sheet	XX
To Staff Welfare Expenses	XX		
To Audit Fees	XX		
To Repair & Renewal	XX		
To Commission	XX		
To Sundry Expenses	XX		
To Depreciation	XX		
To Net Profit transfer to Balance sheet	XX		
Total	XXXX	**Total**	XXXX

Balance Sheet

A balance sheet reflects the financial position of a business for the specific period of time. The balance sheet is prepared by tabulating the assets (fixed assets + current assets) and the liabilities (long term liability + current liability) on a specific date.

Assets

Assets are the economic resources for the businesses. It can be categorized as:

- **Fixed Assets**: Fixed assets are the purchased/constructed assets, used to earn profit not only in current year, but also in next coming years. However, it also depends upon the life and utility of the assets. Fixed assets may be tangible or intangible. Plant & machinery, land & building, furniture, and fixture are the examples of a few Fixed Assets.

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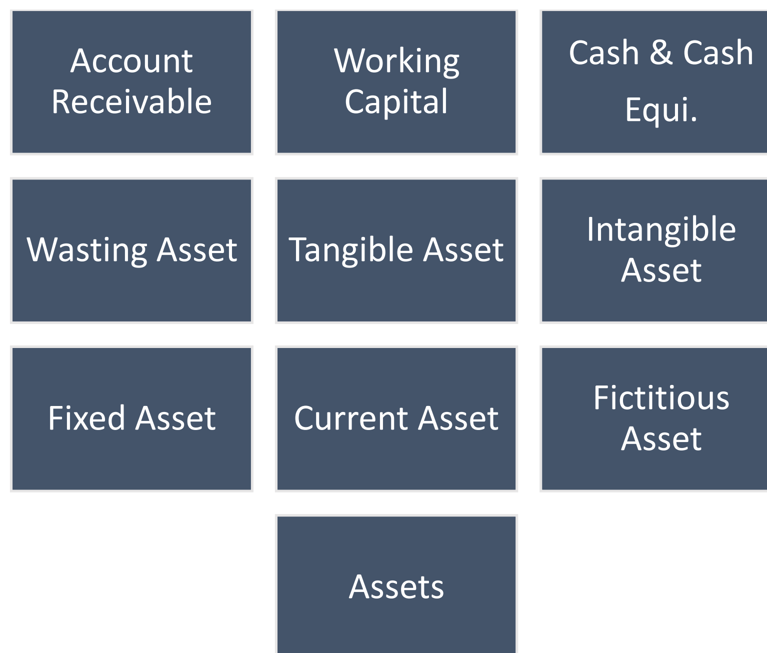
- **Current Assets**: The assets, which are easily available to discharge current liabilities of the firm called as Current Assets. Cash at bank, stock, and sundry debtors are the examples of current assets.

- **Fictitious Assets**: Accumulated losses and expenses, which are not actually any virtual assets called as Fictitious Assets. Discount on issue of shares, Profit & Loss account, and capitalized expenditure for time being are the main examples of fictitious assets.

- **Cash & Cash Equivalents**: Cash balance, cash at bank, and securities which are redeemable in next three months are called as Cash & Cash equivalents.

- **Wasting Assets**: The assets, which are reduce or exhausted in value because of their use are called as Wasting Assets. For example, mines, queries, etc.

- **Tangible Assets**: The assets, which can be touched, seen, and have volume such as cash, stock, building, etc. are called as Tangible Assets.



- **Intangible Assets**: The assets, which are valuable in nature, but cannot be seen, touched, and not have any volume such as patents, goodwill, and trademarks are the important examples of intangible assets.

- **Accounts Receivables**: The bills receivables and sundry debtors come under the category of Accounts Receivables.

- **Working Capital**: Difference between the Current Assets and the Current Liabilities are called as Working Capital.

Liability

A liability is the obligation of a business/firm/company arises because of the past transactions/events. Its settlement/repayments is expected to result in an outflow from the resources of respective firm.

There are two major types of Liability:

- **Current Liabilities**: The liabilities which are expected to be liquidated by the end of current year are called as Current Liabilities. For example, taxes, accounts payable, wages, partial payments of long term loans, etc.
- **Long-term Liabilities**: The liabilities which are expected to be liquidated in more than a year are called as Long-term Liabilities. For example, mortgages, long-term loan, long-term bonds, pension obligations, etc.

Grouping of Assets & Liabilities

There may be two types of Marshalling and grouping of the assets and liabilities:

- **In order of Liquidity**: In this case, assets and liabilities are arranged according to their liquidity.
- **In order of Permanence**: In this case, order of the arrangement of assets and liabilities are reversed as followed in order of liquidity.

Financial Statements with Adjustments Entries and their Accounting Treatment

In order to prepare a true and fair financial statement, there are some very important adjustments those have to be done before finalization of the accounts (*as shown in the following illustration*):

S. No.	Adjustments	Accounting Treatments
1	**Closing Stock:** Unsold stock at the end of Financial year called Closing stock and valued at " ***Cost or market value whichever is less"***	**First Treatment:** Where an opening and closing stock adjusted through a purchase account and the value of Closing Stock given in Trial Balance: Closing stock will be shown as adjusted purchase account on the debit side of Trading account and will appear in the Balance Sheet under current Assets.
2	**Outstanding Expenses:**	**Accounting Treatment:** Outstanding expenses will be added in Trading or Profit & Loss account in particular expense

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	Expenses which are due or not paid called as outstanding expenses.	account and will appear in liabilities side of the Balance Sheet under the current liabilities.
3	**Prepaid Expenses:** Expenses which are paid in advance are called as Prepaid Expenses.	**Accounting Treatment:** Prepaid Expenses will be deducted from the particular expenses as appear in Trading & Profit & Loss account and will be shown in the Balance Sheet under the current assets.
4	**Accrued Income:** The income, which is earned during the year, but not yet received at the end of the Financial Year is called as Accrued Income.	**Accounting Treatment:** Accrued income will be added to a particular income under the Profit & Loss account and will be shown in the Balance Sheet as current assets.
5	**Income Received in Advance:** An income received in advance, but not earned like advance rent etc.	**Accounting Treatment:** An income to be reduced by the amount of advance income in profit & loss account and will appear as current liabilities in the Balance Sheet.
6	**Interest on Capital:** Where an interest paid on the capital introduced by the proprietor or partner of the firm.	**Accounting Treatment:** • Debit Side of Profit & Loss account • Add to capital account (Credit side of Capital account).
7	**Interest on Drawing:** Where an interest paid on the capital introduced by the proprietor or partner of the firm	**Accounting Treatment:** • Credit Side of Profit & Loss account • Reduced from capital account (Debit side of Drawing account).
8	**Provision for Doubtful Debts:** If there is any doubt on the recovery from Sundry Debtors.	**Accounting Treatment:** • Debit Side of Profit & Loss Account • In a Balance Sheet, provision for the Doubtful will be deducted from the Sundry Debtors' Account.

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9	**Provision for Discount on Debtors:** If there is any offer of discount to pay the debtors within certain period.	**Accounting Treatment:** • Debit Side of Profit & Loss Account • In a Balance Sheet, provision for the Discount on Debtors will be deducted from the Sundry Debtors Account.
10	**Bad Debts:** Unrecovered debts or irrecoverable debts	**Accounting Treatment:** • Debit Side of Profit & Loss Account • In a Balance Sheet, Sundry debtors will be shown after deducting the Bad Debts.
11	**Reserve for Discount on Creditors:** If there is any chance to get discount on the payment of sundry creditors within certain period.	**Accounting Treatment:** • Credit Side of Profit & Loss Account • In a Balance Sheet, Sundry Creditors will be shown after deducting the Reserve for Discount.
12	**Loss of Stock by fire:** There may be three conditions in this case	**Accounting Treatment:** **1. If Stock is fully insured** • Credit Side of Trading Account • Assets side of Balance Sheet (With full value of loss) **2. If Stock is partially insured** • Credit side of Trading Account (With Total value of Loss) • Debit side of Profit & Loss a/c (With value of loss unrecoverable) • Asset Side of Balance Sheet (With value recoverable) 3. **If Stock is not insured**

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		• Credit Side of Trading Account • Debit side of Profit & Loss Account
13	**Reserve Fund:**	**Accounting Treatment:** • Debit side of Profit & Loss Account • Liabilities side of Balance Sheet
14	**Free Sample to Customers:**	**Accounting Treatment:** • Credit side of Trading Account • Debit Side of Profit & Loss Account
15	**Managerial Commission:**	**Accounting Treatment:** • Debit side of Profit & Loss Account • Liabilities side of Balance Sheet as commission payable
16	**Goods on Sale or Approval Basis:** If there is any un-approved stock lying with the customers at the end of financial year.	**Accounting Treatment:** • Sales Account Dr To Debtors A/c (With Sale Price) • Stock Account Dr To Trading Account (with cost price)

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4. Financial Accounting – Provision and Reserves

Meaning of Provisions

"*Any amount written off or retained by the way of providing depreciation or diminution in the value of assets or for providing any known liability of which the amount cannot be determined with substantial accuracy*."

- **The Institute of Chartered Accountants of India**

"*Liabilities which can be measured only by using a substantial degree of estimation*."

- **AS-29 issued by Institute of Chartered Accountants of India**

AS 29 also defines **liabilities** as "*a present obligation of the enterprises arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits*."

Debiting Profit and Loss account, provisions are created and shown either deducting assets side or on the liabilities side under relevant sub-head of Balance Sheet.

Provision for bad and doubtful debts, Provisions for Repair & Renewals, and Provision for discounts & depreciation are the most common examples.

Meaning of Reserves

"*That portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability*."

-**ICAI**

Reserve is an appropriation of profits; on the other hand, Provision is a charge against profit. Reserves are not meant to meet out contingencies or liabilities of a business. Reserve increases working capital of a company to strengthen the financial position.

There are two **types of reserves**:

1. Capital Reserve: Capital reserve is not readily available for distribution as the dividends among the shareholders of the company, and it creates only out of capital profit of the company. It is like Premium on issue of shares or debentures and Profit prior to incorporation.

2. Revenue Reserve: Revenue reserves are readily available for the distribution of profit as dividend to the shareholders of the company. Some of the examples of this are

general reserve, staff welfare fund, dividend equalization reserve, debenture redemption reserve, contingency reserve, and investment fluctuation reserves.

Distinction between Provisions and Reserves

- Reserve can be made only out of profit and provisions are the charge to profit.
- Reserves reduce divisible profits and provisions reduce the profit.
- Reserves, if remain un-utilized for some period can be distributed as dividends, but provisions cannot be transferred to General Reserve for the distribution.
- Purpose of provision is very specific, but reserve is created to meet out any probable future liabilities or losses.
- Creation of provisions is legally necessary, but reserves are created to save a concern from the future losses and liabilities.

Secret Reserves

Banking Company, Insurance Company, and Electricity Companies create secret reserves, where the public confidence is required. In this case, to create secret reserve, assets showed at lower cost or liabilities at higher value. Some of the examples of it are as follows:

- By undervaluing goodwill or stock
- By excessive depreciation
- By creating excessive provisions
- Showing free reserves as creditors
- By charging capital expenditure to profit and loss account

Advantages of Secret Reserves

Some of the important advantages are given below:

- Without disclosing to its shareholders, it increases working capital of a concern, which is a clear indication of the sound financial position.
- With the help of secret reserves, directors can maintain the rate of dividends during the unfavorable time.
- Non-disclosure of a big profit is useful to avoid an un-due competition.

Limitations of Secret Reserves

Major limitations or objections of secret reserves are as follows:

- Due to non-disclosure of actual profit, financial statements do not presents true and fair view of the state of affairs.

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- There are lots of chances of misuse of reserves by the directors for their personal benefits.
- Due to secret reserves, chances for the concealment of worst position of a company are very high.
- Company will get very lower amount of claim of insurance at the time of loss of stock or other assets, as valuation of the assets are done at very low value to create secret reserve.

General and Specific Reserves

Specific reserves are created and utilized for the purpose only for which they are created, like dividend equalization reserve and debenture redemption reserve.

General reserves are created for any future contingency or to utilize at the time of expansion of a business. Purpose of creation of General reserve is to strengthen the financial position of the company and to increase the working capital.

Sinking Fund

For the purpose to repay of any liabilities or to replace any fixed assets after particular period, sinking funds are created. For this, some amount are charged or appropriated from the profit and loss account every year and invested in any outside securities. Without any extra ordinary burden, replacement of an asset may be done in a systematic manner or pay any known liability on maturity of the sinking fund.

Investment of Reserves

It is a controversial issue, whether a reserve should be invested in outside securities or not. Thus, to decide anything, it is important to study the need and requirement of a firm according to the financial position of a firm. Therefore, investment in outside securities is justified only in a case where company has the extra fund to invest.

Nature of Reserve

In-spite of showing reserves on the liabilities side of a Balance Sheet, reserves are actually not at all any liabilities of a firm. Reserve represents as accumulated profits, which are available to disburse among the shareholders.

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5. Financial Accounting – Measurement of Business Income

One of the most significant accounting concepts is "**Concept of Income**". Similarly, measurement of a business income is also an important function of an accountant.

In General term, payment received in lieu of services or goods are called income, for example, salary received by any employee is his income. There may be different type of incomes like Gross income, Net income, National Income, and Personal income, but we are here more concerned for a business income. Surplus revenue over expenses incurred is called as "Business Income."

Objectives of Net Income

Following are the important objectives of a net income:

- Historical income figure is the base for future projections.
- Ascertainment of a net income is necessary to give portion of profit to employees.
- To evaluate the activities, which give higher return on scarce resources are preferred. It helps to increase the wealth of a firm.
- Ascertainment of a net income is helpful for paying dividends to the shareholders of any company.
- Return of income on capital employed, gives an idea of overall efficiency of a business.

Definition of Income

The most authentic definition is given by the American Accounting Association as:

"*The realized net income of an enterprise measures its effectiveness as an operative unit and is the change in its net assets arising out of a (a) the excess or deficiency of revenue compared with related expired cost, and (b) other gains or losses to the enterprise from sales, exchange or other conversion of assets*:".

According to the American Accounting Association, to be as business income, income should be realized. For example, to be a business income, only appreciation in value of assets of a company is not enough, for this, asset has really been disposed of.

Accounting Period

For the measurement of any income concerns, instead of a point of time, a span of time is required. Creditors, investors, owners, and government, all of them require systematic accounting reports at regular and proper intervals. The maximum interval between reports is one year, as it helps a businessman to take any corrective action.

An accounting period concept is directly related to matching concept and realization concept; in the absence of any of them, we could not measure income of the concerns. On the basis of matching concept, expenses should be determined in a particular accounting period (usually a year) and matched with the revenue (based on realization concept) and the result will be income or loss of the accounting period.

Accounting Concept and Income Measurement

The measurement of accounting income is the subject to several accounting concepts and conventions. Impact of accounting concepts and convention on measurement of the accounting income is given below:

Conservatism

Where an income of one period may be shifted to another period for the measurement of income is called as 'conservatism approach.'

According to the convention of conservatism, the policy of playing safe is followed while determining a business income and an accountant seeks to ensure that the reported profit is not over stated. Measurement of a stock at cost or market price, whichever is less is one of the important examples as applied to measurement of income. But it must be insured that providing excessive depreciation or excessive provisions for a doubt full debt or excessive reserve should not be there.

Consistency

According to this concept, the principle of consistency should be followed in accounting practice. For example, in the treatment of assets, liabilities, revenues, and expenses to insure the comparison of accounting results of one period with another period.

Therefore, the accounting profession and the corporate laws of most of the counties require that financial statement must be made out on the basis that the figures stated are consistent with those of the preceding year.

Entity Concept

Proprietor and business are the two separate and different entities according to the entity concept. For example, an interest on capital is business expenditure, but for a proprietor, it is an income. Thus, we cannot treat a business income as personal income or vice-versa.

Going Concern Concept

According to this concept, it is assumed that business will continue for a long time. Thus, charging depreciation on a Fixed Asset is based on this concept.

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Accrual Concept

According to this concept, an income must be recognized in the period in which it was realized and costs must be matched with the revenue of that period.

Accounting Period

It is desirable to adopt a calendar year or natural business year to know the results of business.

Computation of Business Income

To compute business income, following are the two methods:

Balance Sheet Approach

Comparison of the closing values (Assets minus outsider's liabilities) of a firm with the values at the beginning of that accounting period is called as Balance Sheet approach. In above value, an addition to capital will be subtracted and addition of drawings will be added while computing the business income of a firm. Since, income is calculated with the help of Balance Sheet hence called as Balance Sheet approach.

Transaction Approach

Transactions are mostly related to production or the purchase of goods and the sale of goods and all these transactions directly or indirectly related to the revenue or to the cost. Therefore, surplus collection of the revenue by selling goods, spent over for production or purchasing the goods is the measure of income. This system is widely followed by the enterprises where double entry system adopted.

Measurement of Business Income

There are following two factors which are helpful in the estimation of an income:

- **Revenues**: Sale of goods and rendering of services are the way to generate revenue. Therefore, it can be defined as consideration, recovered by the business for rendering services and goods to its customers.
- **Expenses**: An expense is an expired cost. We can say the cost that have been consumed in a process of producing revenue are the expired cost. Expenses tell us - how assets are decreased as a result of the services performed by a business.

Measurement of Revenue

Measurement of the revenue is based on an accrual concept. Accounting period, in which revenue earned, is the period of revenue accrues. Therefore, a receipt of cash and revenue

earned are the two different things. We can say that revenue is earned only when it is actually realized and not necessarily, when it is received.

Measurement of Expenses

- In case of delivery of goods to its customers is a direct identification with the revenue.
- Rent and office salaries are an indirect association with the revenue.

There are four types of events (*given below*) that need proper consideration about as an expense of a given period and expenditure and cash payment made in connection with those items:

- Expenditure, which are expenses of the current year.
- Some expenditure, which are made prior to this period and has become expense of the current year.
- Expenditure, which is made this year, becomes expense in the next accounting periods. For example, purchase of fixed assets and depreciation in next up-coming years.
- Expense of this year, which will be paid in next accounting years. For example, outstanding expenses.

Matching Concept

It is a problem of recognition of revenue during the year and allocation of expired cost to the period.

Recognition of Revenue

Most frequent criteria, which are used in recognition of the revenue are as follows:

- **Point of Sale**: Transfer of ownership title to a buyer is point of sale, in case of sale of commodity.
- **Receipt of Payment**: Criteria of cash basis is widely used by the attorneys, physicians, and other professionals in which revenue is considered to be earned at the time of collection of cash.
- **Instalment Method**: Instalment method is widely used in retail trading specially in consumer durables. In this system, revenue earned is treated in the same manner as is used in any other credit sale.
- **Gold Mines**: The accounting period in which gold is mined is the period of revenue earned.
- **Contracts**: Degree of contract completion, especially in long term construction contracts is based on percentage of completion of a contract in a single accounting year. It is based on total estimated life of the contract.

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Allocation of Costs

Matching of expired revenue and expired costs on a periodic time basis is the satisfactory basis of allocation of cost as stated earlier.

Measurement of Costs

Measurement of costs can be determined by:

- **Historical Costs**: To determine periodic net income and financial status, historical cost is important. Historical cost actually means - outflow of cash or cash equivalents for goods and services acquired.
- **Replacement Costs**: Replacing any asset at the current market price is called as replacement cost.

Basis of Measurement of Income

Following are the two significant basis of measurement of income:

- **Accrual Basis**: In an accrual basis accounting, incomes are recognized in a company's books at the time when revenue is actually earned (however, not essentially received) and expenses is recorded when liabilities are incurred (however, not essentially paid for). Further, expenses are compared with revenues on the income statement when the expenses expire or title has been transferred to the buyer, and not at the time when the expenses are paid.
- **Cash Basis**: In a cash basis accounting, revenues and expenses are recognized at the time of physical cash is actually received or paid out.

Change in the Basis of Accounting

We have to pass adjustment entries whenever accounting records change from cash basis to accrual basis or vice versa specially in respect of the prepaid expenses, outstanding expenses, accrued income, income received in advance, bad debts & provisions, depreciation, and stock in trade.

Features of Accounting Income

Followings are the main features of accounting income:

- Matching revenue with related cost or expenses is a matter of accounting income.
- Accounting income is based on an accounting period concept.
- Expenses are measured in terms of a historical cost and determination of expenses is based on a cost concept.
- It is based on a realization principal.

- Revenue items are considered to ascertain a correct accounting income.

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