FINANCIAL ACCOUNTING MGT101 – SHORT NOTES

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Chapter - 1

Basics of Financial Accounting

Definition of Accounting

Accounting is a language that is used to communicate and understand the financial ideas, financial expressions, financial thoughts and financial information.

Language

Language is a medium that is used to communicate and understand some ideas, feelings, expressions or information.

Financial information

Any information that is measurable in terms of money and causes a change in financial position of an entity is known as financial information. Or (Financial information means the information that can be measured in terms of money)

Sources of Financial Information

There are three sources of financial information, which are also known as accounting phenomena.

i) Transactions

Transactions are the outcome of dealings made.

ii) Events

Events are the outcome of incidents happened. There are two types of events, Monetary and Non-Monetary events

iii) Conditions

Conditions are the adjustments in recorded information.

Money measurement

Money measurement means to assign a value in reporting currency to the information, regardless the cash is still payable or receivable.

Financial position

Financial position means; an entity's status of Resources & Sources. Resources are the assets that an entity holds in its control and Sources are the means of finances through which the entity makes such assets. Means of finances include; liability and owners' equity. **Assets= liability + equity**

Elements of Financial Statements or Types of Account

Assets:

Assets are the resources in control of entity as a result of past event.

Liabilities:

Liabilities are the present obligations of entity arising from past events

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Income:
Incomes are earnings of the entity through Revenue or Gains.
Expense:
Expenses are the costs that expire during the reporting period of entity.
Owners' Equity:
Owners' equity is the source of finance that represents owners' stake in the entity.
Entity
It is an activity that is undertaken by individuals or group of people for some purpose (profit or non profit).

Users of Financial Information
Investor/Shareholders/owners 2 Trade contacts 3 Lenders 4 Taxation authorities 5 Manager and Employees 6 Financial consultants and advisers 7 Government 8 Public
Enhancing qualitative characteristics
1 Comparability 2 Verifiability 3Timeliness 4Understandability

Chapter – 2

Recording Financial Information
Double Entry Bookkeeping System – Accounting Equation

Sources of financial information
There are three sources of financial information:1. Transactions2. Events3. Conditions

Types of transactions
There are two types of transactions: 1. Cash Transactions 2.Credit Transactions.

Cash transaction means the transaction in which cash/cheque is either paid or received at the same time while entering into the transaction.

Credit transaction means a transaction in which payment or receipt in terms of cash or any other financial instrument is deferred for some future period.

Debtors (Accounts Receivables) – ASSETS
These are the customers to whom goods/services are sold on credit terms based on a commitment that they will pay money in future. They are treated as accounts receivables.

Creditors (Accounts Payable) – LIABILITIES
These are the suppliers from whom the goods/services are purchased on credit term based on a commitment that they will be paid in future, they are treated as accounts payables.

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ACCOUNTING EQUATION

In accounting the resources controlled by a business are assets and sources of such inputs are owner's equity and liabilities. So, we can amend the above equation as:

(Assets = Owner's Equity + Liabilities)

Incomes – Expenses = Profit or

Profit = Incomes – Expenses

Owner's Equity = Capital + Profit (– loss) – Drawings

It very interesting because of its mathematical wizard; that both sides of equation shall remain equal.

Chapter – 3

Rules of Debit and Credit

1. Debit – Debere in Latin – denoted by Dr. 2. Credit – Credere in Latin – denoted by Cr.
in the books of accounts. Dr. and Cr. Are also termed as tools of accounting
Debit Group consists of: 1. Assets 2. Expenses
Credit Group consists of: 1. Owner's Equity2. Liabilities3. Incomes
Conventionally accounts were divided into **three types**; **personal, real, nominal**.

Analyzing "Debit and Credit

Debit Group Increase Dr Decrease Cr
Credit Group Increase Cr Decrease Dr

Important Accounting equations

(i) Σ Dr = Σ Cr
(ii) Resources = Sources
(iii) Assets = Owners' Equity + Liabilities
(iv) Owners' Equity = Capital + Profit – Loss – Drawings
(v) Profit/Loss = Incomes – Expense
The core concept of **double entry bookkeeping** is that each transaction is recorded twice.

Concept of Voucher and Supporting Documents

Voucher is an internal document that is prepared to witness that the transaction is complete and verified, it is supported by needful documents and authorized by appropriate signatories.

Types of vouchers

1 Journal Vouchers 2 Cash Payment Voucher 3 Bank Receipt & Payment Voucher 4 Gift Voucher

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Source Documents

An **invoice** is a document that is prepared by seller and sent to the buyer

Credit note is a document that is prepared by a seller and sent to the buyer to correct mistake in the original Invoice

There are two types of books of accounts that are used to keep records of financial information of a business entity:

1. Books of original entries.
2. 2. Books of secondary entries.

Systems of Accounting/Reporting

There are two accounting systems being practiced:

 Cash Based Accounting/Reporting System

It is a system in which transactions are recorded only when cash is received or paid. The system which reports income when received and expenses when paid.

 Accrual Based Accounting/Reporting System

It is a system in which transactions are recorded on the basis of amount becoming due for payment or receipt, regardless the condition that settlement in terms of cash has happened or not.

 Entities using the double entry approach report financial results with an accrual accounting/reporting system.

 Entities using single entry approach are effectively limited to reporting on a cash basis only.

Chapter – 4

Journalizing – Books of Original Entries

Journal is the first book in accounting cycle, which is used primarily to record all financial information of the entity. Since the journal is first book of account, therefore, it is also known as book of primary entry or book of original entry

1. Assets (increase debit & decrease credit)
2. Expenses (increase debit & decrease credit)
3. Liabilities (increase credit & decrease debit)
4. Incomes (increase credit & decrease debit)
5. Owners' Equity (increase credit & decrease debit)

Compound Accounting Entry

The single journal entry, which combines multiple journal entries in which same accounting head is repeating, is known as compound entry.

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Complex Accounting Entries Accounting entries for "Discounts"

Types of discounts

A trader often allows its customers two types of discounts

1 Trade discount

It is the discount offered by a seller to its customers before entering into transaction with them.

2 Settlement discount

It is the discount offered by a seller to its customers based on cash settlement terms for early payment of the invoice.

Subdivision of Journal

For sales transactions there is a **sales journal** in which only and only credit transaction for sales are recorded. For purchases transactions there is a **purchase journal** in which only and only credit transactions for purchases are recorded.

If there are a large number of returns then separate **journals for sales return** and **purchases return** are also maintained.

For cash transactions there is a separate book in which only cash transactions are analyzed and recorded it is named as **cash book or cash journal or cash register**.

All remaining transactions and events like sale and purchase of fixed assets on credit, loss by fire etc. are recorded in **general journal**. General journal is also used to record rectifying entries, adjusting entries and closing entries.

Cash book is a book of original entries in which only cash transactions are recorded in a chronological sequence.

Types of Cash Book

1. Single column cash-book (with cash column only)
2. Two column cash-book (with cash and bank columns) OR (with cash and discount columns)
3. Three column cash-book (with cash, bank and discount columns)
4. Petty cash book (multi columnar cash book for recording insignificant nature of expenses)

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Chapter – 5

Main Ledger / General Ledger / Nominal Ledger
(Book of secondary entries)

Need for a Ledger

We need to prepare summary of each accounting head in a systematic way with the help of records maintained in journals. Such summaries are known as ledger accounts and the book in which these are prepared is knows as a Main Ledger or General Ledger or Nominal Ledger.

Chart of accounts is a list of the names of accounts that business accountant identifies from the journal and prepares for recording transactions in its general ledger.

Format of ledger accounts

A ledger account, in its simplest form, has three parts

- First, each account has a title, which is the name of accounting head.
- Second, each account has a debit side, which is its left-hand side.
- Third, each account has a credit side, which is its right-hand side.

Comprehensive format of a ledger account

A ledger account with full details is prepared in two styles:

a) T account style (traditional approach)

b) Running balance style (modern approach)

Posting from General Journal

The process of picking up amount from journal and placing into the debit or credit side of relevant ledger account in ledger is known as posting.

Identifying the Balance

A balancing figure appearing in the credit side of a ledger account is known as a Debit Balance and a balancing figure appearing in the debit side of a ledger account is known as Credit Balance.

Mechanism of Balancing Ledger Account

In order to balance a ledger account following steps should be followed precisely:

1. Identify "natural side" of the accounting head.
2. Make total of the "natural side" (being greater).
3. Place this sum at the bottom of both sides (Dr. and Cr.) of the ledger account.
4. Deduct, one by one, the amounts of lower side (opposite to the natural side) from the total of the "natural side" (that has already been placed at the bottom).

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5. Place the balancing figure in the lower side, so that the sum of both sides remains same.

Contra accounts are the accounting heads, which are presented in financial reports as deduction from the original accounting heads

Trial balance is merely a list of balances extracted from the ledger containing final balance of each ledger account.

Posting from sub-divided journals
Journals are sub-divided when a business enters into number of credit transactions relating to purchases & sales and also when a separate cash book is required to record large number of cash transactions.

Posting from sales journal into main ledger
The process of posting from sales journal is similar to the process we discussed for posting from purchase journal.

CHAPTER - 10

ACCOUNTING FOR FIXED ASSETS
AND DEPRECIATION

Property Plant and Equipment
1 Production of goods or services 2 Selling of goods or services3 Administrative purposes4 Rental to others

Recognition Criteria
1 Cost can be measured reliably 2 Probability of inflow of economic benefits in future

Measurement 1Purchased constructed/manufactured assets are initially measured at cost
2 Exchanged assets are initially measured at fair value, unless:

Cost components 1 Purchase price less trade discounts and rebates 2 Import duties 3 Non-refundable purchase taxes 4 Directly attributable cost 5 Estimated cost of dismantling, removal and site restoration

Depreciation
▪ Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life

Depreciable amount Cost of an asset, or other amount substituted for cost, less its residual value

Useful life 1Period over which an asset is expected to be used; or

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2Number of production units expected to be obtained from the asset some formulas are given

1. **Straight Line Method**

Depreciation=Depreciable amount / useful Life

2. Reducing Balance Method

Reducing Balance Method $= \frac{1-n\sqrt{Residual\ Value}}{Cost}$ x 100 = %

3. Service Hours Method/Usage method

Depreciation Rate Per hour = Depreciable amount / Total Estimated Hours

4. Units Output/Production Method

Depreciation Rate Per unit = Depreciable amount / Total Estimated output

Exchange of Asset

Exchange of Asset – Trade-in-Allowance

When an old asset is exchanged with a new asset the seller of new asset will offer an allowance while receiving payment for selling asset in consideration of the exchange of old asset. Such allowance is known as "trade in allowance". The buyer will subtract "trade in allowance" from the cost of new asset while making payment to the seller.

Cost of new asset = Cash consideration + Trade in allowance.

Cost of new asset – trade in allowance = Cash consideration

Exchange of Asset – Commercial Substance

When an asset is exchanged with another asset and commercial substance does not exist in such exchange, the cost of asset taken through exchange is carrying amount of asset given up.

But when the commercial substance does exist, then cost of asset taken through exchange would be fair value of asset given up.

When fair value of both assets is not determinable the carrying amount of asset given up would be considered as cost of asset taken through exchange.

Existence of commercial substance means; that the entity specific values (present value of future expected cash flows) of both assets are not equal.

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Important Tips to Remember (ITTRs)

1. Final balance of depreciation expense a/c is closed into the income statement as expense.
2. Carried forward balance of provision for depreciation is subtracted from carried forward balance of fixed asset to get net book value, which is shown in Statement of Financial Position.
3. While calculating depreciation charge for the year, following information must be gathered first.
   a. Depreciation rate 10% or 5% etc.
   b. Deprecation method SLM or RBM etc.
   c. Deprecation basis Time Proportionate or Full Year Basis etc.
4. Where date of purchase/disposal is given always use time proportionate basis if question is silent regarding the basis. But where the date of purchase and disposal are not given and the question is silent regarding the basis then charge full year's depreciation in the year of purchase and no deprecation in the year of disposal.
5. While calculating depreciation charge under straight line method subtract residual value from cost of the asset and then apply depreciation rate. This process will be followed in each year of useful life. In case the residual value is nil then depreciation rate will be applied on original cost in each year of its useful life. That is why straight line method is also named as original cost method.
6. While calculating depreciation charge under reducing balance method, in first year of useful life, depreciation rate is applied on cost, whereas in subsequent years depreciation rate is applied on opening balance of net book value of the asset for full year assuming there is no addition during the year.
7. In the year of disposal, depreciation charge will be calculated from opening date till the date of disposal and accounting entry will be:

Depreciation expense Dr.
Provision for depreciation Cr.

8. While recording accounting entries for disposal of fixed asset, follow the following steps:

a. Identify/calculate the amount of accumulated depreciation till the date of disposal in accordance with depreciation basis and then pass the accounting entry to transfer accumulated depreciation into asset disposal account.
b. Transfer cost of asset sold/disposed into asset disposal account.
c. Whether the asset is sold for cash credit or claim for insurance is lodged, the amount will be considered as disposal proceeds and will be credited in disposal account.

9. Single accounting entry for disposal of assets:

Provision for depreciation A/c. Dr.
Cash/Bank/Insurance claim A/c. Dr.

Income statement (for loss - if any) Dr. Fixed Asset A/c. Cr.
Income statement (For gain - if any) Cr.

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10. When an old asset is exchanged with a new asset the seller of new asset will offer an allowance while receiving payment for selling asset in consideration of the exchange of old asset. Such allowance is known as "trade in allowance". The buyer will subtract "trade in allowance" from the cost of new asset while making payment to the seller.

Cost of new asset = Cash consideration + Trade in allowance.
Cost of new asset – trade in allowance = Cash consideration

11. Asset account will be debited with the cost of new asset i.e., cash paid plus trade in allowance.
12. Trade in allowance is considered as disposal proceeds of the old asset.
13. Whenever the rate of deprecation, useful life of asset, depreciation method and/or residual value of asset is changed, accounting effects of such changes shall be recognized prospectively i.e. in the current year and subsequent years.
14. When an asset is exchanged with another asset and commercial substance does not exist in such exchange, the cost of asset taken through exchange is carrying amount of asset given up.
But when the commercial substance does exist, then cost of asset taken through exchange would be fair value of asset given up. When fair value of both assets is not determinable the carrying amount of asset given up would be considered as cost of asset taken through exchange.
15. Existence of commercial substance means; that the entity specific value (present value of future expected cash flows) of both assets are not equal.

CHAPTER – 11

CONTROL ACCOUNTS
Accounting for Receivables and Payables

Why Control Accounts are maintained
Control Account is a simple ledger account that represents numerous ledger accounts of similar nature. Entities that grow in size face difficulties in establishing control over multiple transactions under same head of account. This encounter is resolved through developing a system of maintaining control accounts.

Formats of Debtors and Creditors Control Accounts
While preparing Debtors Control Account, it must be noticed that its debit side should how the items that will cause increase in debtors' balance and items in credit side will cause a decrease in debtors' balance.
In the same way items that will cause increase in creditors balance are put in its credit side and items that will cause decrease in creditors balance are put in the debit side of Creditors Controls Account.

Important Tips to Remember (ITTRs)

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1. A control account is a ledger account that appears in the main/general ledger, it summarizes large volumes of transactions.
2. The debtors control account (sales ledger control account - total debtors account)
• is used to record all transactions with credit customers
• Balance shows the total amount currently owed by all credit customers, this balance should agree with the list of individual balances extracted from the Sales Ledger (a memorandum ledger containing ledger accounts of individual debtors).
3. The creditors control account (purchase ledger control account - total creditors account).
• is used to record all transactions with credit suppliers
• Balance shows the total amount currently owed to all credit suppliers, this balance should agree with list of individual balances extracted from the Purchase Ledger (a memorandum ledger containing ledger accounts of individual creditors)
4. Debtors Control a/c might produce two balances i.e. Dr. and Cr in this case the account will look like:

Debtors Control Account
Opening Dr Balance
Closing Cr Balance (unusual)
Opening Cr Balance (unusual)
Closing Dr Balance

5. Creditors Control a/c might produce two balances i.e. Dr. and Cr in this case the account will look like

Creditors Control Account
Opening Dr Balance (unusual)
Closing Cr Balance
Opening Cr Balance
Closing Dr Balance (unusual)

6. Regardless of the nature of ledger account, opening Dr balance would always appear in its debit side and opening Cr balance would always appear in its credit side.
7. Closing balances always appear in opposite side i.e. closing Dr balance will appear in credit side and closing Cr balance will appear in Dr side.
8. There might be a situation that a person who is Debtor (Customer) for the entity is also a Creditor (Supplier) of the same entity with different outstanding amounts.

For example; Mohsin is Debtor with Rs.700 and Mohsin is also Creditor with Rs.500. In this case contra entry would be required to set-off these two balances. Contra entry is always recorded with lower balance of outstanding amount, in this case Rs. 500.

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The contra entry would be:

Creditors Control A/c. (Mohsin) Dr. 500
Debtors Control A/c. (Mohsin) Cr 500

9. In case Mohsin is Debtor with Rs.700 and Mohsin is also a creditor with Rs 1,000, the contra entry would remain the same as above but the amount would then be Rs. 700 the lower one:

Creditors Control (Mohsin) Dr 700
Debtors Control (Mohsin) Cr 700

10. Balance as per sales ledger means the balance as per list of debtors in sales ledger, whereas balance as per sales ledger control account means the total debtors balance in the main ledger / nominal ledger.
11. Cr balance in Debtors account might arise because of cash received in advance.
12. Dr balance in Creditors account might arise because of cash paid in advance.
13. Names of Accounting Records that are often confused by the students.
a. Sales journal / day book is a Book of original entry (for credit sales)
b. Sales ledger is a Subsidiary ledger (a book for debtors)
c. Sales ledger control a/c is a Debtors control a/c in main/nominal ledger
d. Sales account is a Sales income in main/nominal ledger
a. Purchase journal / day book is a Book of original entry (for credit purchases)
b. Purchase ledger is a Subsidiary ledger (a book for creditors)
c. Purchase ledger control a/c is a Creditor control a/c in main/nominal ledger
d. Purchase account is a Purchase expense in main/nominal ledger
14. Closing balance of control account may not agree with total of the list of individual balances extracted from the subsidiary ledger
a) Any difference must be investigated and corrections made
b) This may involve adjustments:
▪ to the control account; and/or
▪ to the list of balances as per subsidiary ledgers

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CHAPTER- 12

RECTIFICATION OF ERRORS

Types of errors

These errors and omissions are widely split into two categories:

1. Those errors that do not cause a difference in trial balance agreement
2. Those errors that do cause a difference in trial balance agreement.

Important Tips to Remember (ITTR)

1. In certain circumstances, after rectifying all possible errors, there remains an unidentified balancing difference in the rectifying accounting entry; such effect (Dr./Cr.) shall be given to the suspense account.

2. In the questions of suspense account, sales book and purchases book are considered as Sales a/c and Purchases a/c respectively. Whereas, the correct concept is that sales book is a book of original entry and sales account is nominal ledger account representing revenue of the entity.

Casting error in a book of original entry would have two-fold effects whereas, casting error in a nominal ledger account would have single effect accompanying with suspense account as balancing effect.

3. If, in a rectifying entry, any nominal accounting head, relating to Income Statement (Expense and Income) is given debit effect, it would cause a decrease in the net profit. And if credit effect is given, then there would be an increase in net profit figure that was previously calculated in presence of errors.

Profit and Loss Adjustments

Profit before rectification of error * *

+ Nominal a/c credited in rectifying entry * *

- Nominal a/c debited in rectifying entry (* *)

Adjusted Net Profit ***

4. If in a rectifying entry an account relating to current assets or current liabilities is given debit effect it would cause an increase in working capital. And if credit effect is given to any current asset or current liability, it would cause a decrease in working capital.

Working Capital = Current Assets – Current Liabilities.

5. When Dr. side of Trial balance exceeds its Cr. Side the difference (named as suspense a/c) appearing in Cr. side is transferred to Cr. Side of Suspense A/c and vice versa.

6. Suspense a/c balance should be eliminated after rectification of all errors, but where some balance remains untraced in the Suspense A/c and it gives a closing balance, such balance whether Dr. or Cr. Should be closed in income statement and should never be carried forward in Statement of Financial Position (Balance Sheet) as asset or liability.

7. Concept of Capital and Revenue – Expenditure/Receipts should be taken care while recognizing accounting heads as Dr. or Cr.

o Capital expenditure – Asset

o Revenue expenditure – Expense

o Capital receipt – Liability or Owners' Equity

o Revenue receipt – Income

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CHAPTER – 13

FINAL ACCOUNTS WITH ADJUSTMENTS

Preparation of Final Accounts

Preparation of final accounts means to prepare certain financial statements at the end of reporting period in order to achieve certain objective from the perspective of user group.

According to International Accounting Standard (IAS) **1**, there are five components of financial statements; **1**) Statement of Financial Position **2**) Statement of Profit or Loss and Other Comprehensive Income **3**) Statement of Cash Flows **4**) Statement of Changes in equity and **5**) Notes to the Financial Statements.

Income statement (Statement of Profit or Loss and Other Comprehensive Income) is prepared to know the financial performance of an entity. Financial performance refers to the profitability (profit or loss) of entity during an accounting period i.e., a year.

Income statement is prepared for a specific period for which starting and ending dates are defined, normally a year of 12months, also known as **reporting period**

Remember this equation: Incomes – Expenses = Profit

Balance sheet (Statement of Financial Position) is prepared to know the financial position of an entity. Normally it is prepared at the end of reporting period, which is known as reporting date or balance sheet date.

Remember this equation: Assets = Owners equity + Liabilities

Important Tips To Remember (ITTRs)

Important tip to follow is to mark E/I/A/L/O while reading trial balance and then pass journal entries for adjustment. We shall practice these two techniques in the following section. important Tips To Remember (ITTRs)

1. While reading the trial balance mark each accounting head as A-E-I-L-O for Assets, Expense, Incomes, Liabilities and Owners equity items.
2. If both sides of a trial balance are equal then Expenses and Assets would always be appearing in the debit side whereas; Incomes, Liabilities and owners' equity would always be appearing in the credit side of trial balance.

Each accounting head appears in the side of its own nature.

3. Take care of the contra items like purchase return, sales return, drawing, provision for doubtful debts, provision for depreciation. Balances of these accounting heads would always appear in the side opposite to the nature of their main head.
4. Items appearing in trial balance would have single effect in the Income Statement or Statement of Financial

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Position (balance sheet) because its second effect has already been recorded e.g. a. prepaid salary account appearing in debit side of trial balance is recognized in balance sheet as asset only because its second effect has already been credited to the salaries expense.

b. accrued rent account appearing in credit side of trial balance is recognized in balance sheet as liability only because its second effect has already been debited to rent expense.

c. depreciation account appearing in debit side of trial balance is recognized in the income statement as expense only because its credit effect has already been credited to the provision for depreciation account

5. Trial balance is prepared on end of the reporting period (closing date), therefore each accounting head in trial balance would be revealing its closing balance except;

a. capital accounts that would always be giving opening balance because its closing balance would be ascertained after adjusting net profit or loss in it and subtracting drawings,

b. provision for depreciation account would be opening balance if and only if depreciation expense for the year has not yet been accounted for and its adjustment is required outside the trial balance,

c. provision for doubtful debts account would also be showing opening balance in the trial balance if and only if its adjustment is required outside the trial balance

6. Each adjustment appearing outside the trial balance would have two-fold effects debit and credit; in case of a difficult adjustment please be-careful that only two effects shall be recognized with equal amounts. For this purpose, always recall the rules of Dr & Cr.

7. If adjusted purchases or cost of goods sold is appearing in trial balance; it means that opening stock has already been added in it and closing stock has already been subtracted from it. In this case the stock appearing in trail balance shall be the closing stock and shall have single effect only i.e., it shall be shown as an item of current assets in the Statement of Financial Position (balance sheet).

8. Concept of direct and indirect expense does not exist in financial accounting language. Cost of goods sold expenses are wrongly termed as direct expenses whereas all operating expenses are wrongly termed as indirect expenses which is entirely baseless concept created and propagated by orthodox authors.

9. For classification purposes all expenses are categorized into five functions;

i. Cost of goods sold expense,

ii. Administrative expense,

iii. Selling and distribution expense

iv. Financial expense and

v. Income tax expenses.

10. Cost of goods sold includes all those expenses which are incidental to the purchase of goods for reselling purpose and also for bringing those goods into saleable condition.

11. For trading entities, wages should not be classified as an item of COGS, rather it should be taken as administrative or selling expense. Wages expense shall be included in COGS of manufacturing entities only.

12. Wages & salaries account or salaries & wages account appearing in trial balance of a trading entity often cause a confusion among the students that which account should be included in COGS and which should be included in operating expense; remember, arrangement (transposition) of these words have no impact on functional classification of expense, these shall be recognized as operating expenses.

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13. Administrative and selling expenses; together are known as operating expense. For the purpose of income statement of sole proprietorship and partnership; financial expense like bank charges and interest on loan may also be grouped in operating expense.

14. Accrued/Owing/Due/Outstanding/Payable Expenses: It means expenses incurred but not yet paid till the end of accounting period. If accrued expenses are found in adjustments then these should be added in particular expense given in trial balance to report expense in Income Statement. In balance sheet amount of accrued expenses also be shown as liability. Following adjusting entry is passed for accrued expense.

Particular Expense A/C
To Accrued Expense A/c

15. Accrued/Owing/Due/Outstanding/Receivable Income: It means income earned but not yet received till the end of accounting period. If accrued incomes are found in adjustments then these should be added in particular income given in trial balance to report income in Income Statement. In balance sheet amount of accrued incomes also be shown as asset. Following adjusting entry is passed for accrued income.

Accrued Income A/C
To Particular Income A/c

16. Prepaid/Advance/Unexpired/Paid in advance Expenses: If prepaid expenses are found in adjustments then these should be deducted from particular expense given in trial balance to report expense in Income Statement. In balance sheet amount of Prepaid expenses also be shown as asset. Following adjusting entry is passed for prepaid expense.

Prepaid Expense A/C
To Particular Expense A/c

17. Unearned/Prepaid/Advance Income: It means income received in advance but not yet earned till the end of accounting period. If unearned incomes are found in adjustments then these should be deducted from particular income given in trial balance to report income in Income Statement. In balance sheet amount of Unearned income also be shown as liability. Following adjusting entry is passed for unearned income.

Particular Income A/C
To Unearned Income A/c

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CHAPTER - 14

MANUFACTURING ACCOUNT

Reporting requirements of Manufacturing Entities

Manufacturing entities are always concerned about reporting of cost incurred for production of goods. This cost in incurred during the process of converting raw material into finished goods.

Trading entities purchase goods in finished form, make those goods available in the showroom, do marketing to sell those goods to the customers. Examples include; importers, exporters, wholesalers and retailers. Accountants of trading entities split income statement into two main parts i.e., "trading account" and "profit and loss account". Whereas, accountants of manufacturing entities prepare "manufacturing account" in addition to trading and profit & loss account. Manufacturing account consolidates all the production costs that are incurred to bring a product into saleable condition. These costs are categorized as; "direct cost" and "indirect cost". Direct cost includes; direct material, direct labor and other direct costs that can be independently traced as product cost. Indirect cost includes; factory overhead cost also known as product overhead cost. It is also a product cost but cannot be independently traced or identified in the cost of the product e.g., electricity bill of workshop, depreciation of production plant, rent of factory building.

Manufacturing account is prepared to produce "cost of goods manufactured" that is then transferred to the trading account as a substitute of purchases expense – in the case of trading entities. In the trading account of manufacturing entity, cost of goods manufactured is adjusted with opening and closing balances of finished goods inventory, just like in case of a trading entity; purchases expense is adjusted with opening and closing inventories.

Manufacturing entities carry three types of inventories i.e., material inventory, work in process inventory, and finished goods inventory. Material and work in process inventories are treated in manufacturing account, whereas, finished goods inventories are treated in trading account.

Classification and Analysis of Cost of production

Material cost = Direct material cost + Indirect material cost
+ + +
Labour cost = Direct labour cost + Indirect labour cost
+ + +
Other costs = other Direct costs + other Indirect cost
Total cost of = Prime cost + Factory overhead cost production

Other direct costs are those costs (other than direct material and direct labour) that have been incurred in full as a direct consequence of making a product or providing a service and can be identified independently in the cost of product. Examples include; the cost of specific tools, maintenance of specific jigs, and royalty at production level etc.

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Difference between cost and expense Cost that expires is expense. Here question arises that why “direct material consumed” “direct labour” “factory overhead” “total Manufacturing” etc. are termed as “cost” whereas, these have already been incurred. Remember; these are incurred not expired. The cost that is incurred and also has expired during the accounting period is expense.

The cost of goods manufactured is transferred to finished goods inventory, unless it is sold it remains in the category of cost. The sooner these finished goods are sold, these become expense and the unsold finished goods are asset. This is because the entity obtains economic benefit upon expiry of the cost of produced goods by selling those to the customers. That’s why any component of the cost of production is not termed as expense. Whereas, “cost of goods sold” is expense (despite the fact that word “cost” is used in it)

Types of inventories

There are three types of inventories that can be identified in a manufacturing entity.

1. Material and supplies inventory: This is the inventory for raw materials, store items, spare parts and indirect materials that are used in production. It is the cost that represents un-consumed materials and supplies laying in the stores at the end of the reporting period.
2. Work in process inventory: This is the inventory of semi-finished goods. It is the cost that represents work in process, which remained semi-finished at the end of the reporting period; a further cost is still required to be incurred on this type of inventory in order to convert it into finished goods.
3. Finished goods inventory: This is the inventory of completed products, which are ready for sale. Finished goods

Inventory is the value of those fully manufactured products, which remained unsold at the end of the reporting period.

Important Tips to Remember (ITTRs)

1. The “wages account” appearing in trial balance of a manufacturing entity shall be considered as a component of cost of production, direct labour cost, unlike for a trading entity where it was considered as an operating expense.

Because without incurring direct labour cost raw material cannot be converted into finished product.

2. Direct cost means the cost that can be identified in a product (that is incurred in full as a direct consequence of producing the product). Whereas, the indirect costs are those production costs that are incurred in a reporting period for overall production process and cannot be identified in a product e.g. electricity bill that is not paid for a single product but for a period in which so many units of product are manufactured.
3. Cost of loose tools purchased, spare parts purchased, fuel purchased and indirect material purchased are adjusted with opening and closing inventory to calculate their consumption cost, which is then included in factory overhead cost. Their closing inventory, like other closing inventories, is shown in current assets

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CHAPTER - 15

ACCOUNTING FOR INVENTORIES

Important Definitions as per IAS 2

Inventories are assets, held:

(a) for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make such sale.

Valuation of Inventories

Inventories shall be valued at lower of cost and net realizable value, on item-by-item basis or group basis.

One of the important characteristics of financial information is that it should be 'reliable'. For financial information to be reliable, a prudent view must be taken where there is certainty to ensure that assets and gains are not overstated and that liabilities and losses are not understated.

If net realizable value is lower than the cost of inventory, then it is anticipated that the entity is going to make a loss in future. To be prudent in valuing the inventory and to ensure reliability we should measure inventory at the lower figure, i.e. the net realizable value. Value of inventory is not overstated and the anticipated loss is recognized immediately in the Income Statement.

If cost of inventory is lower than the net realizable value, then it is anticipated that the entity is going to make a profit in future. In this case, inventory will be measured at its cost, which will ensure that the asset is not overstated and that the anticipated profit is not recognized.

Important Tips To Remember (ITTRs)

1. If NRV of finished goods is less than its cost then the inventory of Raw material (which is used in production of
such finished goods) shall be valued at lower of its cost and NRV (Replacement cost).

2. Whereas, if NRV of finished goods is greater than its cost then the inventory of Raw material (which is used in
production of such finished goods) shall be valued at its cost regardless of the fact that its NRV (replacement cost) is lower than its cost.

3. The amount of any reversal of any write-down of inventories, arising from an increase in net realizable value shall
be recognized as a reduction in expenses in the period in which the reversal occurs.

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Components of Cost of inventory

Cost of inventories comprises of:

i. costs of purchase,

ii. cost of conversion and

iii. other costs incurred in bringing the inventories to their present location and condition.

Cost of purchase

Cost of purchase comprise of

i. purchase price, less trade discount if any;

ii. import duties and other non-refundable taxes;

iii. transport and handling; and

iv. other cost directly attributable to acquisition of finished goods, materials and services

Allocation of fixed and variable production overhead costs to the cost of inventory

(a) Allocation of fixed production overheads to the costs of inventories is based on normal capacity of the production facilities. Normal capacity is the production expected to be achieved on average, over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance;

(b) The actual level of production may be used if it approximates normal capacity;

(c) The amount of fixed overhead allocated to each unit of inventory is not increased as a consequence of low production or idle plant;

(d) In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased so that inventories are not measured above cost; and

(e) Variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities.

Inventory costing methods

If the entire inventory represents individually identifiable unit then the cost of inventory will be determined through the "Specific Cost Method", i.e. Price per unit of individually identifiable inventory

However, if the inventory is mutually interchangeable and bought or produced at different prices then following methods are used to determine cost of inventory:

(i) First in First out (FIFO) an assumption is made for costing purposes that the first items of inventory received are the first items to be sold / issued. The closing inventory comprises the items purchased most recently.

(ii) Weighted Average Cost (W-AV-CO) under this system the inventory is valued at the weighted average price of the inventory on hand. This is achieved by dividing the total cost by the total units. The average cost will be computed every time additional inventory is purchased or produced.

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Accounting systems to record inventories

There are two known methods that are used to account for inventories in the books of accounts;

1. Perpetual Inventory System:
2. Periodic Inventory System:

Perpetual Inventory System

Under this system, a complete and continuous record of movement in each inventory item is maintained.

Advantages:

1) It protects materials from theft or loss.
2) It helps in reducing wastage and spoilage.
3) Inventory levels can be determined and observed.
4) It serves as a moral check.
5) It helps in highlighting slow moving and obsolete inventory.
6) It helps in frequent physical counting.

Disadvantages:

1) It is very complex.
2) It is costly.
3) Complex calculations are required.
4) Sufficient technical knowledge is required

Periodic inventory System or Physical system

Under this system, value of inventory is determined at the end of a reporting period through a physical count of inventory in store/warehouse.

Advantages:

2) It is very simple.
3) It is very cheap.
4) No calculations required.
5) No technical knowledge required.

Disadvantages:

1) It does not protect materials from theft or loss.
2) No help in reducing wastage and spoilage.
3) Inventory levels cannot be fixed and observed.
4) It does not help in highlighting slow moving and obsolete inventory.
5) It does not help in frequent physical counting.

Circumstances in which inventory (asset) is recognized as expense?

Following are the circumstances when inventory (asset) is recognized as expense:

(a) The inventories have been sold to customers, carrying amount of those inventories shall be recognized as cost of goods sold expense in the period in which the related revenue is recognized.

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(b) The amount of any write-down of inventories to net realizable value and all losses of inventories due to theft or fire etc. shall be recognized as an expense in the period in which such write-down or loss occurs.

Problems of Stock taking under periodic system

Under periodic inventory system, closing stock is physically counted, verified and valued at the end of each reporting period. In case of big organizations, it may not be possible to verify entire closing stock exactly on the last date of accounting period. In such a case, stock-count takes place either few days earlier or later from the end of reporting period, as permitted by the circumstances.

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