

The Basics of Business Accounting

Accounting:

“Accounting is an art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events of a financial character and interpreting the results thereof”.

Or

Accounting is the art of

- Interpreting
- Measuring
- And communicating the results of economic activities

Art of ACCOUNTING

Economic Activities:

- Paying your cellular bill
- Balancing your check book
- Preparing your wealth tax return
- Managing a MNC

Communication in the form of

- Balance Sheet
- Income Statement
- Cash flow Statement

Measuring:

- Earnings per share

Interpreting:

- Ratio analysis

Explanation:

Accountancy or accounting is the measurement, disclosure or provision of assurance about information that helps managers and other decision makers make resource allocation decisions. Financial accounting is one branch of accounting and historically has involved processes by which financial information about a business is recorded, classified, summarized, interpreted, and communicated.

Accountancy attempts to create accurate financial reports that are useful to managers, regulators, and other stakeholders such as shareholders, creditors, or owners. The day-to-day record-keeping involved in this process is known as bookkeeping.

At the heart of modern financial accounting is the double-entry book-keeping system. This system involves making at least two entries for every transaction: a debit in one account, and credit in another account. The sum of all debits should always equal the sum of all credits. This provides an easy way to check for errors. This system was first used in medieval Europe, although claims have been made that the system dates back to Ancient Greece.

Business Entity and Legal Entity

A **business entity** is any concern, whatever the form, the purpose of which is to do business for profit.

A **legal entity**, on the other hand, is a legal construct through which the law allows a group of natural persons to act as if it were an individual for certain purposes. The most common purposes are lawsuits, property ownership, and contracts. This allows for easy conduct of business by having ownership, lawsuits, and agreements under the name of the legal entity instead of the several names of the people making up the entity.

Basic Bookkeeping

To succeed in business, one of your most important tools is financial analysis, based on your business records. Accurate financial records will help you answer some very important questions. Are you making money, or losing it? How much? Is your business on sound financial ground, or are troubles lurking ahead? A sound bookkeeping system is the foundation on which all of this valuable financial information can be built.

In the following sections, we'll discuss:

- The importance of good records
- The accounting system and accounting basics
- How to record daily transactions
- Closing the books at the end of an accounting period
- Preparing financial statements

Difference Between Bookkeeping and Accounting

<u>Bookkeeping</u>	<u>Accounting</u>
1. It is the recording phase of an accounting system.	1. It is the summarizing phase of an accounting system.
2. It is the basis of accounting.	2. It is the basis for business language.
3. Persons responsible for bookkeeping are called book-keepers.	3. Persons responsible for accounting are called accountants.
4. It does not require any special skill or knowledge.	4. It requires special skill and knowledge.
5. Personal judgment of book-keeper is not required.	5. Personal judgment for accountant is essential.
6. Financial statements are not prepared from bookkeeping records.	6. Financial statements are prepared from accounting records.
7. It does not give the complete picture of the financial condition of the business unit.	7. It gives the complete picture of the financial condition of the business unit.
8. It does not help in complying with legal formalities.	8. It helps in complying with legal formalities.
9. It does not provide any information for taking managerial decisions.	9. It provides any information for taking managerial decisions.
10. It has no branch.	10. It has several branches, e.g., financial accounting, cost accounting, management accounting, etc.

Divisions into Financial and Management Accounting

Financial Accounting

Accounting is a service activity. Its function is to provide financial information i.e. financial statements to external groups.

Management Accounting

Accounting also helps management in planning and controlling. Accounting data is provided to managers to help them in taking decisions and managing the affairs of the enterprise.

“This division between Financial Accounting and Management Accounting is done to cater the information needs of book”.

Functions of Accounting

According to Moonitz, the functions of accounting are:

- i. To manage the resources held by specific entities;
- ii. To reflect the claims against and the interests in those entities;
- iii. To measure the changes in those resources, claims and interests;
- iv. To assign the changes to specifiable periods of time; and,
- v. To express the above in terms of money as a common denominator.

Characteristics of Accounting

Modern accounting possesses the following basic characteristics:

- i. Accounting involves recording of economic activities which accompany the complexity and uncertainty of business. Therefore, while preparing timely accounting statements, estimates and professional judgments must be made.
- ii. Accounting statements are prepared on **(a) cash basis of accounting**, which recognizes an event as a transaction only when cash is received or paid, or **(b) accrual basis of accounting**, which recognizes revenues earned and expenses incurred as transactions.
- iii. Accounting is historical in nature ---- it is the recording of past happenings.

Objectives of Accounting

These include providing reliable information about:

- i. Changes in financial position resulting from the income-producing efforts of an enterprise;
- ii. Earnings of an enterprise, presented in a manner that emphasizes sources and trends of earnings;
- iii. Economic resources and obligations of an enterprise;
- iv. Changes in net financial resources which result from the financial and investment activities of an enterprise; and,
- v. Any additional information, in the form of disclosures, which is relevant to statement users in assessing a particular enterprise's prospects.

Advantages of Accounting

- i. It provides information useful for making economic decisions.
- ii. It serves primarily those users who have limited authority, ability or resources to obtain information and who rely on financial statements as their principal sources of information about an enterprise's economic activities.
- iii. It provides information useful to investors and creditors for predicting, comparing and evaluating potential cash flows in terms of amount, timing and related uncertainty.
- iv. It supplies information useful in judging the management's ability to utilize enterprise resources effectively in achieving primary enterprise goals.

- v. It provides factual and interpretative information about transactions and other events which are useful for predicting, comparing and evaluating the enterprise's earning power.

Limitations of Accounting

- i. Accounting is historical in nature; it does not reflect the current financial position or worth of a business.
- ii. The Profit and Loss Account tends to match current revenues with historical costs (expenses) rather than current costs.
- iii. Accounting statements do not show the impact of inflation.
- iv. The Profit and Loss Account does not reflect those increases in net asset values which are not considered to be realized.
- v. Accounting principles are not static or unchanging--- alternative accounting procedures are often equally acceptable. Therefore, accounting statements do not always present comparable data.

Basic Concepts

If you want to succeed in business, you need to know about financial management. No matter how skilled you are at creating a product, providing a service, or marketing your wares, the money you earn will slip between your fingers if you don't know how to efficiently collect it, keep track of it, save it, and spend or invest it wisely. Therefore one should understand the basic principles of accounting as if these are being applied to one's own business.

Poor financial management is one of the leading reasons that businesses fail. In many cases, failure could have been avoided if the owners had applied sound financial principles to all their dealings and decisions. You need to understand the basic principles and use them on a daily basis, even if you plan to leave the more complicated work to professionals.

In this module we'll outline the basic concepts of financial management, as they apply to small business owners, starting with simplest, everyday bookkeeping tasks and moving on to more sophisticated concepts:

- Your basic bookkeeping explains how to record daily transactions, work with your accountant, and, for the do-it-yourselfers, how to close the books and draw up financial statements.
- Managing your cash flow describes the professional way to manage your cash flow to reduce the lag between cash outflows, and tells how to invest the surplus cash you'll soon have on hand!
- Analyzing current financial position delves into some of the more sophisticated ways of examining financial statements and other aspects of business, to identify trends, spot problems before they become too large, and compare business to others in the same industry.

Double-Entry Accounting

“The double entry system divides each page into two halves. The left hand side is called the DEBIT while the right hand is CREDIT side. The title of each account is written across the top of account at the center”.

<u>Account</u>	
Left Hand side DEBIT Debit Entry Debiting	Right Hand side CREDIT Credit Entry Crediting

Account

An account is a place where all the information in terms of increase and decrease relating to assets, capital, liabilities, incomes and expenses is summarized

Explanation

In double-entry accounting, every transaction has two journal entries: a debit and a credit. Debits must always equal credits. Because debits equal credits, double-entry accounting prevents some common bookkeeping errors. Errors that do occur are easier to find. Double-entry accounting is the basis of a true accounting system.

In double-entry accounting, every transaction in your business affects at least two accounts, since there is at least one debit and one credit for each transaction. Usually, at least one of the accounts is a balance sheet account. Entries that are not made to a balance sheet account are made to an income or expense account. Income and expenses affect the net profit of the business, which ultimately affects owner's equity. Each transaction (journal entry) is a real-life example of the accounting equation (**Assets = Liabilities + Owner's Equity**)

Some simple accounting systems do not use the double-entry system. You will have to choose between double-entry and single-entry accounting. Because of the benefits described above, we recommend double-entry accounting. Many accounting programs for the computer are based on a double-entry system, but are designed so that you enter each transaction once, and the computer makes the corresponding second entry for you. The double-entry part goes on **“Behind the scenes,”** so to speak.

You also need to decide whether you will be using the cash or accrual accounting method. We recommend the accrual method because it provides a more accurate picture of your financial situation.

Double Entry Concept

(OR)

Dual Aspect Concept

Every transaction has minimum two effects.

- | | | | | |
|-----------------------|---|----------|---|----------|
| 1. Assets | ➡ | Increase | ➡ | Decrease |
| 2. Liabilities | ➡ | Increase | ➡ | Decrease |
| 3. Incomes | ➡ | Increase | ➡ | Decrease |
| 4. Expenses | ➡ | Increase | ➡ | Decrease |

Rules of Double Entry

Heads of Accounts	Effects of Transactions	Recording
Assets	Increase	Debit
	Decrease	Credit
Liabilities	Increase	Credit
	Decrease	Debit
Incomes	Increase	Credit
	Decrease	Debit
Expenses	Increase	Debit
	Decrease	Credit

Heads Of Accounts	Increase	Decrease
Assets	Debit	Credit
Liabilities	Credit	Debit
Incomes	Credit	Debit
Expenses	Debit	Credit

Heads of Accounts	Debited	Credited
Assets & Expenses	Increased	Decreased
Liabilities & Incomes	Decreased	Increased

The essentials of double-entry bookkeeping in sequential order are:

- Analysis of transactions into debit entries and credit entries.
- Posting of journal entries into ledger accounts.
- Taking out a trial balance.
- Making appropriate adjusting entries.

e) Drawing up a Trading, Profit and Loss Account and Balance Sheet.

Accounting Basics/The definitions of Accounting Terms

Now you are ready to learn the following accounting concepts and definitions.

Debits:

At least one component of every accounting transaction (journal entry) is a debit amount. Debits increase assets and decrease liabilities and equity. For this reason, you will sometimes see debits entered on the left-hand side (the asset side of the accounting equation) of a two-column journal or ledger.

Credits:

At least one component of every accounting transaction (journal entry) is a credit amount. Credits increase liabilities and equity and decrease assets. For this reason, you will sometimes see credits entered on the right-hand side (the liability and equity side of the accounting equation) of a two-column journal or ledger.

Assets:

Things of value held by the business, assets are balance sheet accounts, Examples of assets are Cash, Accounts Receivable, and Furniture and Fixtures.

Any Asset Account

Debit	Credit
Increase	Decrease
+	-

Current Assets:

An asset should be classified as a current asset when it:

- a) is expected to be realised in, or is held for sale or consumption, in the normal course of the enterprise's operating cycle; or
- b) it is held primarily for the purpose of being traded;
- c) it is expected to be realized within twelve months after the balance sheet date; or
- d) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the balance sheet date.

All other assets shall be classified as non-current.

Liabilities:

What your business owes creditors. Liabilities are balance sheet accounts. Examples are Accounts Payable, Payroll taxes payable, and Loans payable.

Any Liability Account	
Decrease Debit -	Increase Credit +

Current Liabilities:

A liability should be classified as a current liability when it:

- a) is expected to be settled in the normal course of the enterprise's operating cycle; or
- b) it is held primarily for the purpose of being traded;
- c) it is due to be settled within twelve months after the balance sheet date; or
- d) the entity does not have an unconditional right to defer settlement or the liability for at least twelve months after the balance sheet date.

All other liabilities shall be classified as non-current.

Operating Cycle:

Operating Cycle is the average time between purchases of merchandise and conversion of this merchandise back into cash.

CAPITAL

“Capital in a business represents the resources invested by the owner”.

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

Increases in Capital:

- Investment by the Owner
- Earnings from the profitable operation of the Business.

Decreases in Capital:

- With draws / Drawings
- Losses

Capital Account	
Decrease Dr. -	Increase Cr. +

EXPENSES

” Expenses are the cost of goods and services used up in the process of earning revenue”.

Some Facts:

- Expenses are the cost of doing business.
- Expenses always cause a decrease in Capital

Expenses either be

- Decrease in Assets
- Increase in Liabilities
- Expenses decrease Capital therefore expenses are recorded by debits.

Any Expense Account	
Increase Debit +	Decrease Credit -

INCOME

” Income is an increase in Capital from the profitable operation of the business”.

- **Increase** in capital is accompanied by an increase in total assets.
- **Increase** in capital is accompanied by decrease in total liabilities.

$$\text{Net Income} = \text{Revenue} - \text{Expenses}$$

- Income must be related to a specified time i.e. accounting period.

EXAMPLE:

12 month accounting period used by an entity is called its fiscal year that usually ends on 31 December.

Any Income Account	
Decreases Dr. -	Increases Cr. +

The Accounting Equation:

“The financial statement called the balance sheet is based on the “Accounting Equation.”

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity.}$$

Note:

Assets are on the left-hand side of the equation, and liabilities and equities are on the right-hand side of the equation. Similarly, some balance sheets are presented so that assets are on the left, liabilities and owner's equity is on the right.

Chart of Accounts:

The list of account titles you use to keep your accounting records.

Credit Note:

Credit note is writing off all or part of a customer's account balance. A credit note would be required, for example, when a customer who bought merchandise on account returned some merchandise, or overpaid on their account.

Debit Note:

Debit note is billing a customer again. A debit note would be required, for example, when a customer has made a payment on their account by check, but the check bounced.

Foot:

Foot is to total the amounts in a column, such as a column in a journal or a ledger.

Depreciation:

Depreciation is an annual write-off of a portion of the cost of fixed assets, such as vehicles and equipment. Depreciation is listed among the expenses on the income statement.

(Or)

“It is systematic allocation of a depreciable asset over its useful life”.

Allowance for Bad Debts:

It is also called Reserve for Bad Debts; it is an estimate of uncollectible customer accounts. It is known as a “Contra” account because it is listed with the assets, but it will have a credit balance instead of a debit balance. For balance sheet purposes, it is reduction of accounts receivable.

Inventory:

Goods you hold for sale to customers. Inventory can be merchandise you buy for resale, or it can be merchandise you manufacture or process, selling the end product to the customer.

Accounting Equation

“The whole of the Financial Accounting is based upon a very simple idea. This is called the accounting equation”.

As the word equation means equal so the basic objective of accounting equation is that transactions should enter in accounting equation in such a manner that assets always remain equal to capital and liabilities.

In order to achieve this balance a rule has been devised that every transaction should be entered in two effects. When it will be done so this will keep the equation balanced which is required.

The entire accounting system rests on one basic concept, known as Accounting Equation and which is as follows:

Resources in the Business = Resources supplied by the owner

Usually people other than the owner have supplied some of the Assets. Liabilities are the name given to the amounts owing to these people.

Assets	=	Capital + Liabilities
Resources of Business		Owner's Investment Obligations of business

Increases on the left hand side are called Debit and increases on the right hand side are called Credits. Similarly, decreases on the left hand side are called Credits and decreases on the right hand side are called Debit.

Further rules and principles have been developed on this core concept, which are applied when preparing, and maintaining business records known as **“Bookkeeping”**.

A complete set of business records that is maintained by every business is referred as Accounting Cycle. So it can be concluded that accounting equation is not the term in which business records are being maintained however, type of records maintained (as covered by accounting cycle) and the way they are maintained is based on this concept.

Solved Accounting Equation with transactions

Transaction: 1

New business was begun on Feb 1, when Robert Deposited \$ 180,000 Cash in a bank account in the name of the business

Assets	=	Liabilities	+	Capital
Cash				Capital
180,000				180,000

Purchase of an Asset for Cash

Transaction: 2

Purchase of Land for Office, price was \$141,000; payment was made in cash on Feb 3.

Assets	=	Liabilities	+	Capital
Cash + Land	=			Capital
180,000				
(141,000)		141,000		
39,000 + 141,000	=			180,000

Purchase of an Asset and incurring of a Liability

Transaction: 3

On Feb 5 office building purchased paying \$ 36,000. The term provided immediate cash payment of \$ 15,000 and balance of \$ 21,000 within 90 days.

Assets	=	Liabilities	+	Capital
Cash + Land + Building	=	Accounts payable	+	Capital
39,000				
141,000				
36,000				
(15,000)		21,000		
24,000 + 141,000 + 36,000	=	21,000	+	180,000

Sale of an Asset

Transaction: 4

Parking area sold from land \$11,000 on credit.

Assets				=	Liabilities	+	Capital
Cash +	Land +	Building +	A/c Receivable	=	Account payable	+	Capital
24,000	141,000	36,000					180,000
			11,000				11,000
24,000+	141,000+	36,000+	11,000	=	21,000	+	191,000

Practical Questions

Question 1

Furqan Haider started business on 1 January, 20x7 and decides to set up a book shop. She decides to invest all her personal savings Rs. 2,000 to start his business. During the first month of her business following transactions took place:

1. Invested cash Rs. 2,000 in business.
2. Purchased building for business use for Rs. 500 paying by cash.
3. Purchased furniture on credit from Wood shop for Rs. 200.
4. Opened a business bank account and deposited Rs. 500 cash.
5. Repaid the amount due to Wood shop by cheque Rs. 200.
6. Withdrew cash Rs. 100 from business for her personal use.

Required:

*Enter the above transaction in an **accounting equation**.*

Question 2

*Enter the following transactions in an **accounting equation**.*

1. Hassan started business with Rs. 5,000 in the bank.
2. Bought Office Furniture by cheque Rs. 1,000.
3. Bought machinery Rs. 800 on credit from Haq Ltd.
4. Purchased a Van paying by cheque Rs. 700.
5. Sold some of the Office Furniture – net suitable for the firm – for Rs. 200 on credit to P Shadab & Sons.
6. Paid the amount owing to Haq Ltd Rs. 800 by cheque.
7. Purchased more machinery by cheque Rs. 600.

Question 3

*Enter the following transactions in an **accounting equation**.*

1. Muraad started business with Rs. 4,000 in cash.
2. Paid Rs. 2,000 of the Opening cash into a bank account for the business.
3. Purchased Office Furniture on credit from BS Ltd for Rs. 1,200.
4. Bought a Van paying by cheque Rs. 800.
5. Purchased works Machinery from Ahmed & Sons on credit Rs. 500.
6. Returned fault Office Furniture costing Rs. 200 to BS Ltd.
7. Sold some of the works machinery for Rs. 100 cash.
8. Paid amount owing to BS Ltd Rs. 1,000 by cheque.
9. Took Rs. 200 out of the bank.
10. S Nadeem lent us Rs. 1,500 – giving us the money by cheque.

Question 4

*Enter the following transactions in an **accounting equation**.*

1. Amjed started business with Rs. 5,000 in the bank.
2. Bought Vehicle paying by cheque Rs. 1,500.
3. Purchased Building Rs. 500 on credit from P Ltd.
4. Purchased Motor Car on credit from Suzuki Motors Rs. 1,000.
5. Took Rs. 500 out of the bank and put it into the Cash till.
6. Bought Office Fixtures paying by cash Rs. 200.
7. Paid Suzuki Motors a cheque for Rs. 1,000.
8. A loan of Rs. 1,000 cash is received from KH Bashir.

Traditional Classification of Accounts

This is a very old system of classifying accounts. Now a day, in advanced countries this system of classification of accounts is hardly used. Under this system, accounts are classified into four types.

1. Personal Accounts

These accounts show the transactions with the customers, suppliers, money lenders, the bank and the owner. A business may have many credit transactions with the above persons or organisations. A separate account is to be prepared for each of them. Persons or organizations with whom the business has credit transactions are either debtors or creditors. If they have to give some money to the firm, they are called **Debtors**. Conversely, if the firm is to pay them some money they are known as **Creditors**.

2. Real Accounts

These accounts are accounts of assets and properties such as land, building, plant, machinery, patent, cash, investment, inventory, etc. When machinery is purchased for cash, the two accounts involved are machinery and cash --- both are Real Accounts. But if the same machine is purchased from Z & Co on credit, the two accounts involved will be those of Machinery and Z & Co., the former being a Real Account and the latter being a Personal Account.

3. Nominal Accounts

These are the accounts of incomes, expenses, gains and losses. **Examples are:** Wages paid, discount allowed or received purchases, sales, etc. These accounts generally accumulate the data required for the preparation of income statement, i.e., the Trading and Profit and Loss Account.

4. Valuation Accounts

These are the accounts of provision for depreciation and provision for doubtful debts. Where fixed assets are, maintained in the books of accounts at original cost, to reflect the actual book value of the assets, a provision for depreciation account on the credit is maintained. In the Balance Sheet, it is shown as deduction from the original cost of the asset. Similarly, if the Debtors' personal accounts are retained at total amount due, a valuation account on the credit --- provision for doubtful debts is required. In the Balance Sheet, it is shown as reduction from Sundry Debtors Account to reflect estimated realisable value.

Illustration # 1

Classify the following into Real, Nominal, Personal and Valuation Accounts:

- i. Plant & Machinery ----- **Real Account;**
- ii. Purchases ----- **Nominal Account;**
- iii. Investment ----- **Real Account;**
- iv. Bank ----- **Personal Account;**
- v. Provision for Bad Doubtful Debts ----- **Valuation Account;**
- vi. Tata Iron & Steel Co. Ltd ----- **Personal Account;**
- vii. Rent ----- **Nominal Account;**
- viii. Land & Building ----- **Real Account;**
- ix. Carriage Outward ----- **Nominal Account;**
- x. Capital ----- **Personal Account;**
- xi. Leasehold ----- **Real Account;**
- xii. Trade Mark ----- **Real Account;**
- xiii. Return Outward ----- **Nominal Account;**
- xiv. Import Duty ----- **Nominal Account;**
- xv. Provision for Depreciation ----- **Valuation Account.**

It has already been stated that each transaction involves two or more accounts. After ascertaining the accounts involved, our next problem is to decide which account should be debited and which account should be credited.

Rules for Debit and Credit (Traditional)

1. Personal Accounts

Debit the account of the person who receives something and credit the account of the person who gives something.

2. Real Accounts

Debit the account of the asset/property which comes into the business or addition to an asset, and credit the account which goes out of the business. When furniture is purchased for cash, furniture account is debited (which comes into the business) and cash account is credited (which goes out of the business).

3. Nominal Accounts

Debit the accounts of expenses and losses, and credit the accounts of incomes and gains. When wages are paid, wages account is debited (expenses) and cash account is credited (asset goes out).

4. Valuation Accounts

Debit the account when the account is to be reduced and credit the account when the account is to be increased.

Rules for Debit and Credit at a Glance

Types of Accounts	Account to be Debited	Account to be Credited
i. Personal Account	Receiver	Giver
ii. Real Account	What comes in	What goes out
iii. Nominal Account	Expenses and Loss	Income and gain
iv. Valuation Account	When account to be decreased	When account to be increased

Illustration # 2

From the following transactions, state the nature of accounts and state which account will be debited and which account will be credited.

1. Mr. A started business with Rs 50,000
2. Purchased goods for cash Rs 10,000
3. Sold goods for cash Rs 15,000
4. Purchased goods from X for cash Rs 5,000
5. Sold goods to B for Rs 6,000
6. Purchased furniture for Rs 4,000
7. Purchased plant for Rs 10,000
8. Paid wages Rs 400

Solution

1. Mr. A started business with Rs 50,000

- (i) Cash Account ----- Real ----- Debit (Incomings)
- (ii) Capital Account -----Personal ----- Credit (Giver)

2. Purchased goods for cash Rs 10,000

- (i) Purchases Account ----- Nominal ----- Debit (Expenses)
- (ii) Cash Account ----- Real ----- Credit (Outgoings)

3. Sold goods for cash Rs 15,000

- (i) Cash Account ----- Real ----- Debit (Incomings)
- (ii) Sales Account ----- Nominal ----- Credit (Income)

4. Purchased goods from X for cash Rs 5,000

- (i) Purchases Account ----- Nominal ----- Debit (Expenses)
- (ii) Cash Account ----- Real ----- Credit (Outgoing)

5. Sold goods to B for Rs 6,000

- (i) B Account ----- Personal ----- Debit (Receiver)
- (ii) Sales Account ----- Nominal ----- Credit (Income)

6. Purchased furniture for Rs 4,000

- (i) Furniture Account ----- Real ----- Debit (Incomings)
- (ii) Cash Account ----- Real ----- Credit (Outgoings)

7. Purchased Plant for Rs 10,000

- (i) Plant Account ----- Real ----- Debit (Incomings)
- (ii) Cash Account ----- Real ----- Credit (Outgoings)

8. Paid wages Rs 400

- (i) Wages Account ----- Nominal ----- Debit (Expenses)
- (ii) Cash Account ----- Real ----- Credit (Outgoings)

Illustration # 3

From the following transactions, state the nature of accounts and state which account will be debited and which account will be credited.

1. Mr. A started business with Rs 50,000
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5. Sold goods to B for Rs 6,000
6. Purchased furniture for Rs 4,000
7. Purchased plant for Rs 10,000
8. Paid wages Rs 400

Solution

Transactions	Accounts Involved	Nature of Account	Debit (Rs)	Credit (Rs)	Reasons
1. Mr. A started business with Rs 50,000	Cash	Asset	50,000		Increased
	Capital	Liability		50,000	Increased
2. Purchased goods for cash Rs 10,000	Purchases	Expenses	10,000		Increased
	Cash	Asset		10,000	Decreased
3. Sold goods for cash Rs 15,000	Cash	Asset	15,000		Increased
	Sales	Income		15,000	Increased
4. Purchased goods from X for cash Rs 5,000	Purchases	Expenses	5,000		Increased
	Cash	Asset		5,000	Decreased
5. Sold goods to B for Rs 6,000	B	Asset	6,000		Increased
	Sales	Income		6,000	Increased

6. Purchased furniture for Rs 4,000	Furniture	Asset	4,000		Increased
	Cash	Asset		4,000	Decreased
7. Purchased plant for Rs 10,000	Plant	Asset	10,000		Increased
	Cash	Asset		10,000	Decreased
8. Paid wages Rs 400	Wages	Expenses	400		Increased
	Cash	Asset		400	Decreased

Practical Questions

Question # 1

From the following transactions, state the nature of accounts and state which account will be debited and which account will be credited.

1. Muraad started business with Rs. 4,000 in cash.
2. Paid Rs. 2,000 of the Opening cash into a bank account for the business.
3. Purchased Office Furniture on credit from BS Ltd for Rs. 1,200.
4. Bought a Van paying by cheque Rs. 800.
5. Purchased works Machinery from Ahmed & Sons on credit Rs. 500.
6. Returned fault Office Furniture costing Rs. 200 to BS Ltd.
7. Sold some of the works machinery for Rs. 100 cash.
8. Paid amount owing to BS Ltd Rs. 1,000 by cheque.
9. Took Rs. 200 out of the bank.
10. S Nadeem lent us Rs. 1,500 – giving us the money by cheque.

Question # 2

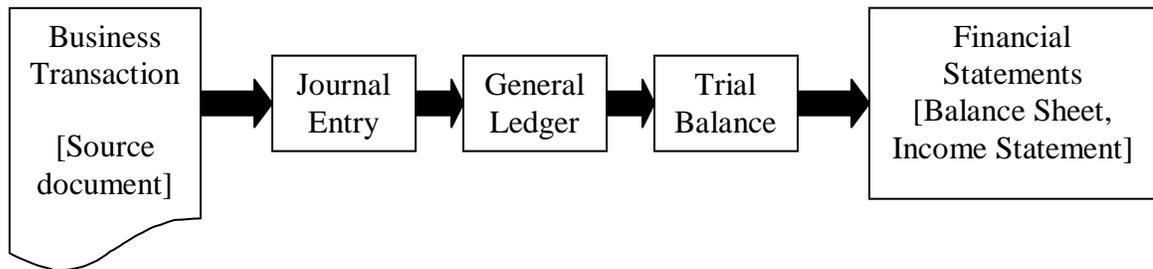
From the following transactions, state the nature of accounts and state which account will be debited and which account will be credited.

1. Amjed started business with Rs. 5,000 in the bank.
2. Bought Vehicle paying by cheque Rs. 1,500.
3. Purchased Building Rs. 500 on credit from P Ltd.
4. Purchased Motor Car on credit from Suzuki Motors Rs. 1,000.
5. Took Rs. 500 out of the bank and put it into the Cash till.
6. Bought Office Fixtures paying by cash Rs. 200.
7. Paid Suzuki Motors a cheque for Rs. 1,000.
8. A loan of Rs. 1,000 cash is received from KH Bashir.

The Accounting System

Before you can set up your accounting records, dive into your day-to-day transactions, and get your books ready for end-of month or end-of-year reporting, you must gain an understanding of basic accounting concepts.

Accounting is the method in which financial information is gathered, processed, and summarized into financial statements and reports. An accounting system can be represented by the following diagram, which is explained below.



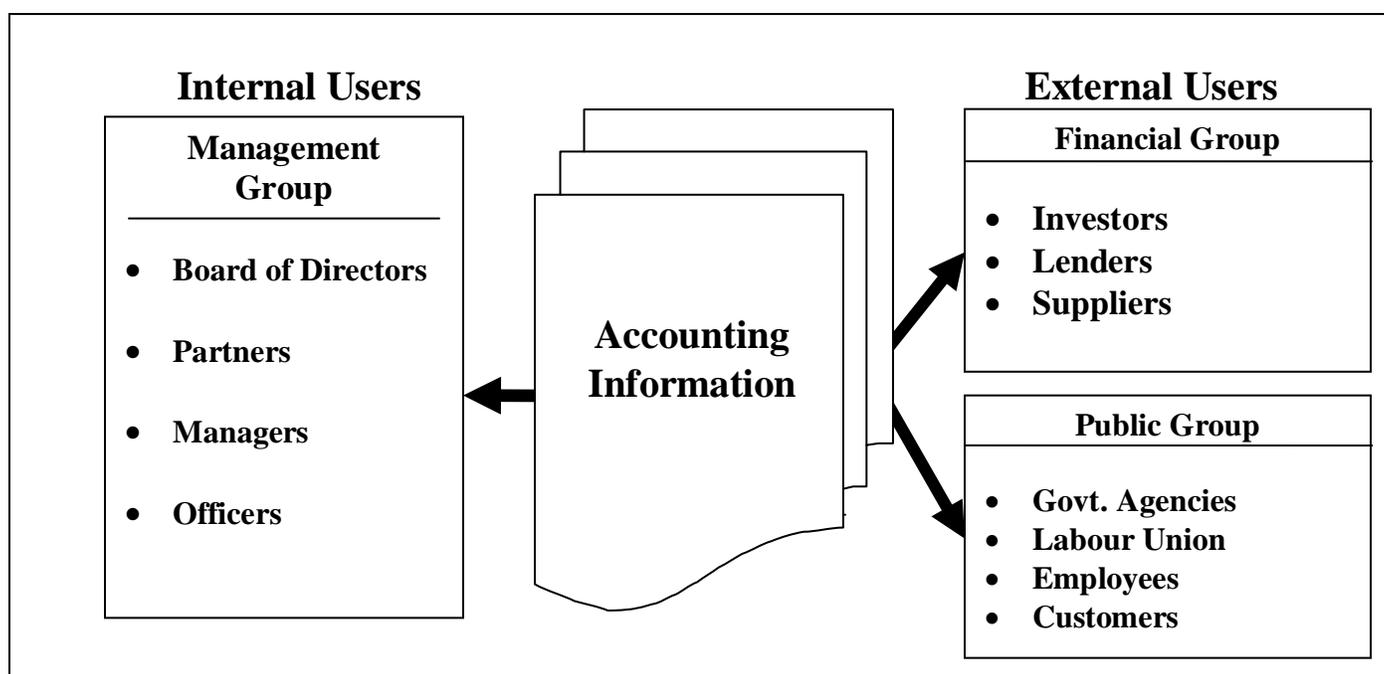
1. Every accounting entry is based on a business transaction, which is usually evidenced by a business document, such as a check or a sales invoice.
2. A journal is a place to record the transactions of a business. The typical journals used to record the chronological, day-to-day transactions are sales and cash receipts journals and a cash disbursements journal. A general journal is used to record special entries at the end of an accounting period.
3. While a journal records transactions as they happen, a ledger groups transactions according to their type, based on the accounts they affect. The general ledger is a collection of all balance sheets, income, and expense accounts used to keep a business's accounting records. At the end of an accounting period, all journal entries are summarized and transferred to the general ledger accounts. This procedure is called "Posting".
4. A trial balance is prepared at the end of an accounting period by adding up all the account balances in your general ledger. The sum of the debit balances should equal the sum of the credit balances. If total debits don't equal total credits, you must track down the errors.

5. Finally, financial statements are prepared from the information in your trial balance. Your accounting records are important because the resulting financial and reports help you plan and make decisions. They may be used by some third parties (Bankers, Investors, or Creditors) and are needed to provide information to government agencies.

For a more in-depth explanation of the accounting system, take a look at the following:

- Accounting Basics
- Definitions of accounting terms
- Cash vs. Accruals accounting
- Single or double-entry accounting

Users of Accounting Information



Users of Financial Statements

Investors

They are interested to know that how profitable the business operations have been.

Employees

Employees are interested in good running of the business. Their bread and butter depend upon the earnings of the concern.

Lenders

They evaluate the liquidity position of the enterprise that whether she will be able to repay the loans or not.

Suppliers and other creditors

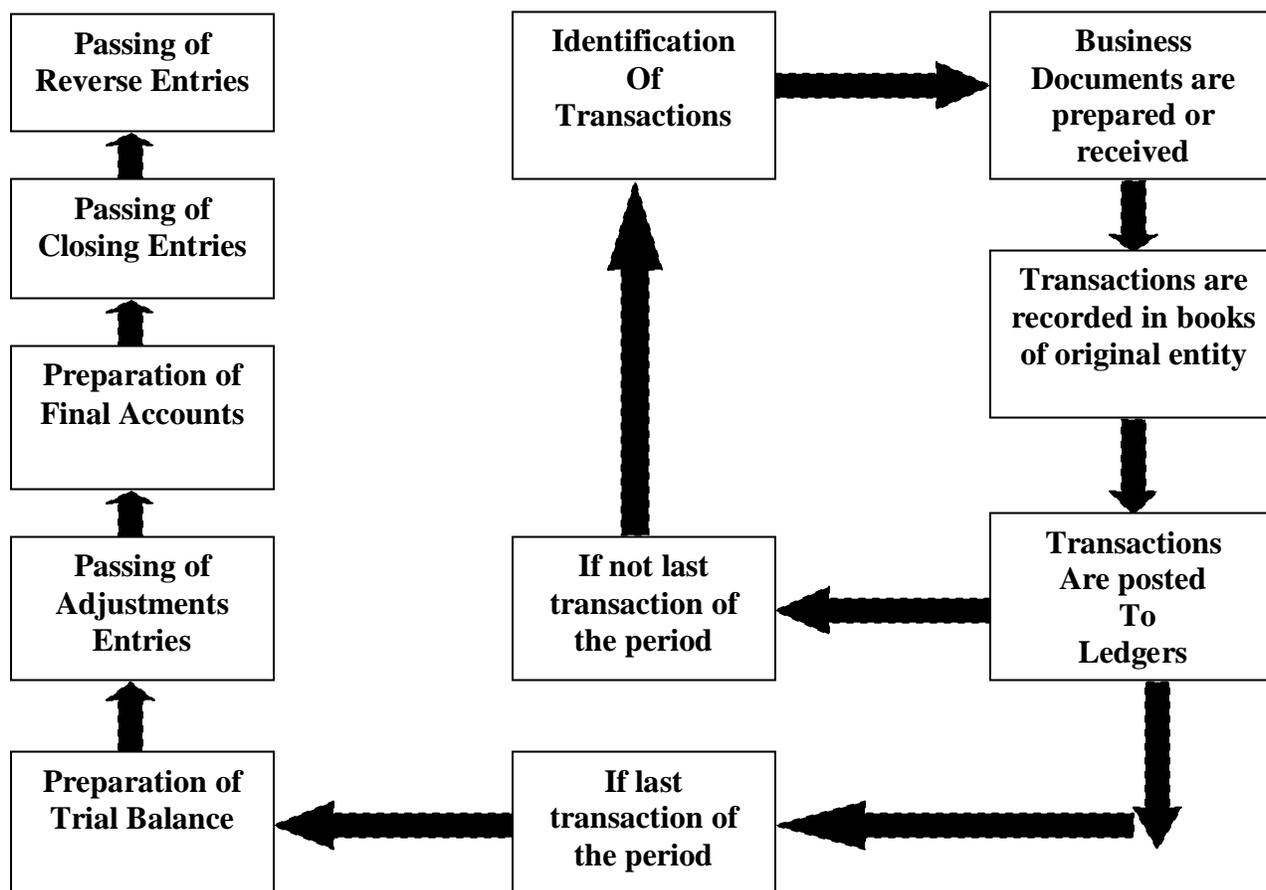
They are interested in immediate liquidity position of the enterprise that whether their balances will be paid in time.

Customers

They are interested in efficiency of the business that goods are delivered to them in time.

Accounting Cycle

Diagram of Accounting Cycle



1. The General Journal

“The first book in which the transactions of a business unit are recorded chronologically (in the order in which they occur or date wise) is called a Journal”.

Each record in a Journal is called an **“Entry”**. As a Journal is the first book in which entries are recorded, a Journal is also known as a **“Book of Original Entry”**.

A Journal Entry is an analysis of the effects of a transaction on the accounts, usually accompanied by an explanation (properly called as a **Narration**).

Therefore;

“A Journal is a tool for analysing and describing the impact of various transactions upon a business unit”.

Before a Journal entry is passed, it is necessary to decide for each transaction, what are the accounts involved. It is also necessary that the accounts to be debited or credited are identified.

In its usual form, a Journal is divided by vertical lines into five columns in which to enter, in respect of each transaction:

- (a) Date;
- (b) Particulars;
- (c) Ledger Folio;
- (d) Debit (Rs);
- (e) Credit (Rs).

Specimen

Date	Particulars	L.F	Debit (Rs)	Credit (Rs)

Example of a Journal Entry

This can be illustrated by means of an example. We suppose, on 1.1.x7, a trader sells goods for cash Rs 1,000. Here, the accounts involved are ----- Cash Account and Sales Account. Cash Account is to be debited and the Sales Account is to be credited.

Again, we suppose that on 2.1.x7 goods worth Rs 500 were purchased for cash. Here, Purchases Account is to be debited and Cash Account is to be credited. The entries in the Journal will be as under:

General Journal

	Date	Particulars	L.F	Debit (Rs)	Credit (Rs)
Debit Account _____ Credit Account _____ Narration _____	20x7 Jan,1	Cash Account Dr. Sales Account		1,000	1,000
		(Being goods sold for cash)			
Month and Year _____ Not repeated	2	Purchases Account Dr. Cash Account		500	500
		(Being goods purchased for cash)			

In connection with the Journal, the following points are to be remembered:

1. For each transaction, the exact accounts should be debited and credited. For that, the two accounts involved must be indentified to pass a proper Journal Entry.
2. Sometimes, a Journal entry may have more than one debit or more than one credit. This type of Journal entry is called "**Compound Journal Entry**". Regardless of how many debits or credits are contained in a Compound Journal Entry, all the debits are entered before any credits are entered. The aggregate amount of debits should be equal to the aggregate amount of credits.
3. For a business, Journal Entries generally extend to several pages. Therefore, the total are cast at the end of each page, against the debit and credit columns, the following words are written in the particular column, which indicates carried forward (of the amount on the next page) "**Total c/f**".
4. The debits and credits totals of the page are then written on the next page in the amount columns; and opposite to that on the left, the following words are written in the particulars column to indicate brought forward (of the amount of the previous page) "**Total b/f**". This process is repeated on every page and on the last page, "**Grand Total**" is cast

Illustration # 1

20x7

- January 1 Mr. Ali commences business as a computer merchant, trading under the name of “Computer Center” with a capital of Rs 400,000 brought in cash.
- 3 He buys on credit from Azeem Computers Ltd., 10 computers @ Rs 30,000 each.
- 15 He receives an invoice from Suzuki Transport Corporation for Rs 5,000 in respect of carriage of computers from Lahore.
- 20 He opens a bank account by depositing Rs 350,000.
- 25 He sells 6 computers on credit to ABC Computers # Rs 35,000 each.
- 29 He pays by cheque the amount for carriage.
- 31 He receives cash Rs 200,000 from ABC Computers.
- 31 He issues a cheque to Azeem Computers Ltd., for Rs 300,000.

You are required to pass Journal Entries in the books of Computer Center.

**In the Books of Computer Center
General Journal**

Date	Particulars/Heads of Accounts/Details	L.F	Debit (Rs)	Credit (Rs)
20x7 Jan. 1	Cash Account Capital Account (Being business started with capital brought in cash)		400,000	400,000
3	Purchases Account Azeem Computers Ltd. Account (Being the purchase of 10 computers @ Rs 30,000 each on credit)		300,000	300,000
15	Carriage Inward Account Suzuki Transport Corporation Account (Being carriage charges payable)		5,000	5,000
20	Bank Account Cash Account (Being the opening of bank account)		350,000	350,000
25	ABC Computers Account Sales Account (Being the sale of 6 computers @ Rs 35,000 each on credit)		210,000	210,000
29	Suzuki Transport Corporation Account Bank Account (Being paid by cheque)		5,000	5,000
31	Cash Account ABC Computers Account (Being cash received from ABC Computers)		200,000	200,000
31	Azeem Computers Account Bank Account (Being paid by cheque)		300,000	300,000
	Grand Total		1,770,000	1,770,000

Subdivision of Journal

The Journal is inadequate as the sole book of the original entry when the transactions are numerous. The nature of operations and the volume of transactions in the particular business determine the number and type of Journal needed.

A medium size business generally maintains the following types of Journal.

1. Cash Book ----- to record cash transactions;
2. Sales Day Book ----- to record credit sales;
3. Purchases Day Book ----- to record credit purchases;
4. Sales Return Day Book ----- to record sales return;
5. Purchases Return Day Book ----- to record purchases return;
6. Bills Receivable Book ----- to record bills receivable;
7. Bills Payable Book ----- to record bills payable;
8. Petty Cash Book ----- to record petty cash payments; and
9. Journal Proper ----- to record residuary transactions. It is also used for rectifying errors.

Recording ----- Journal

Classifying ----- Ledger

Summarizing ----- Income Statement and Balance Sheet.

2. The General Ledger

“It is the second book of accounts where transactions are posted from Journal and are classified according to their nature that is assets, capital, liabilities and expenses”.

Accounts

“An account is a place where all the information in terms of increase and decrease relating to assets, capital, liabilities, incomes and expenses is summarized.”

Chart of Accounts

“Chart of Accounts is an index to all accounts contained in a double entry system. It allocates to each account a number and arranges accounts in logical subdivisions”.

For example

If an owner wants to know the total purchases for an accounting period, he will only see the “Purchases Account”. It is not possible to ascertain from the Journal the total amount of purchases made. In the Journal, record of Purchases made at different dates can also be against cash or credit. Therefore, similar transactions should be sorted out and consolidated at one place to ascertain their net effect. This kind of processing is possible where different accounts are prepared in the ledger.

Therefore,

“An account represents a detailed record of changes that have occurred in a particular asset, liability, expense, loss, gain or capital during an accounting period”.

Subdivision of Ledger

When the size of the organization is very large and numbers of accounts are numerous, it is found necessary to maintain a separate ledger for customers’ accounts, suppliers’ accounts and for other accounts.

Generally, the following three kinds of ledgers are maintained by such organizations:

- a) Debtors’ Ledger;
- b) Creditors’ Ledger; and
- c) General Ledger.

Debtors’ Ledger

It may contain the accounts of all the customers to whom goods have been sold on credit. Entries in this ledger are made mostly from **Sales Day Books, Sales Returns Book and Cash Book**. This ledger is also called “**Customers’ Ledger or Sales Ledger**”.

Creditors’ Ledger

It may contain the accounts of all the suppliers from whom goods have been purchased on credit. Entries in this ledger are made mostly from **Purchase Day Books, Purchase Returns Book and Cash Book**. This ledger is also known as “**Suppliers’ Ledger or Purchase Ledger**”.

General Ledger

It may contain all residual accounts, mainly real and nominal accounts. This ledger is also called “**Nominal Ledger**”.

Standard Form of Ledger Account

A ‘T’ account is simplified representation of ledger accounts and is widely used. A ‘T’ account is divided into two sides, the left hand side represents the debit side and the right hand side represents the credit side. Each side of the ledger has columns of varying sizes for the following:

- a) Date;
- b) Particulars;
- c) Journal Folio; and
- d) Amount.

Specimen
Title of Account

Dr. Side				Cr. Side			
Date	Particulars/Details	J.F	Amount	Date	Particulars/Details	J.F	Amount

Running Balance Form of Ledger Account

An alternative ruling of a ledger, which is generally adopted by commercial banks and some other business houses, is that the entire ledger is divided into six columns as under:

- a) Date;
- b) Particulars;
- c) Journal Folio;
- d) Debit Amount;
- e) Credit Amount; and
- f) Balance.

Specimen
Bank Account

Date	Particulars/Details	J.F	Dr. Amount (Rs)	Cr. Amount (Rs)	Balance
20x7 June 1	Balance b/d		-----	-----	5,000 (Dr.)
	Sales Account		10,000	-----	15,000 (Dr.)
5	Salary Account		-----	4,000	11,000 (Dr.)

Posting

“The process of transferring of the debits and credits from the Journal to the Ledger accounts is called Posting”.

Each amount entered in the column of the debit column of the Journal is posted by entering it on the debit side/column of an account in the ledger, and each amount entered in the credit column of the Journal is posted by entering it on the credit side/column of an account in the ledger. Posting from Journal to the ledger accounts are necessary in order to know how transactions have changed the account balances.

Mechanics of Posting

The following procedures are followed for posting:

1. Locate in the ledger the 1st account named in the Journal.
2. Enter on the debit side of the ledger in particulars column.
3. Enter the date of the transaction in the date column.
4. Enter in the debit column of the ledger account, the amount of debit as shown in the Journal.
5. Enter in the folio column of the Ledger, the number of the Journal page from which the entry is being posted.
6. Enter in the folio column of the Journal, the number of the Ledger page in which the posting has been done.
7. Locate in the Ledger the second account named in the Journal.
8. Enter in the credit side of the Ledger in particulars column.
9. Enter the date of the transaction in the date column.
10. Enter in the credit column of the Ledger account the amount of credit as shown in the Journal.
11. Enter in the folio column of the Ledger, the number of the Journal page which the entry is being posted.

12. Enter in the folio column of the Journal, the number of the Ledger page in which posting has been done

Illustration # 3

Date	Particulars/Details/Heads of Accounts	L.F	Dr. (Rs)	Cr. (Rs)
20x7 July 9	Cash Account Capital Account (Being new capital introduced)	9 20	10,000	10,000

General Ledger
Cash Account

Date	Particulars/Details	J.F	Amount	Date	Particulars/Details	J.F	Amount
20x7 July 9	Capital Account	5	10,000				

Capital Account

Date	Particulars/Details	J.F	Amount	Date	Particulars/Details	J.F	Amount
				20x7 July 9	Cash Account	5	10,000

Balancing Ledger Accounts

Balancing is the sum necessary to equalise the debit and credit totals of an account. Periodically, all the accounts in a Ledger are balanced to ascertain the cumulative effect of entries on the accounts.

Balance

“The Balance is an accounting term which means the difference between the two sides of an account, or the total of an account containing only debits and credits”.

The computerized accounting system will usually print the balance of the account after each transaction, but in a manual system we must calculate the balance.

Important Note

*Where the total of the debit side exceeds the total of the credit side, the account is said to have a **Debit Balance**.*

*Where the total of the credit side exceeds the total of the debit side, the account is said to have a **Credit Balance**.*

The following steps are followed for balancing the accounts:

1. Add up both sides of find out their totals.
2. Deduct the smaller total from the bigger total to find the difference known as “Balance”.
3. Enter the “Balance” on the shorter side.
4. Enter the bigger total at the end of the amount of the amount column known as foot of the account at equal level on both sides.
5. Identify the name of the balance as Dr and Cr.
6. Transfer the balance to next year.

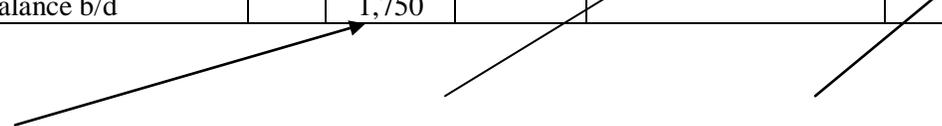
Note

Step # 6 will be in case of Asset, Capital and Liability accounts only.

Illustration # 4

Cash Account

Date	Particulars/Details	J.F	Amount	Date	Particulars/Details	J.F	Amount
2005 Jan 1	Capital Account		2,000	2005 Jan 2	Building Account		500
4	Sales Account		250	Dec 31	Balance c/d		1,750
			2,250				2,250
2006	Balance b/d		1,750				



Jan 1							
-------	--	--	--	--	--	--	--

Step # 6

Transfer the balance to
Next year and show on
Dr side as it was named
As Dr. Balance.

Step # 4

Enter the bigger totals
to level both sides.

Step # 3

Enter the difference.

Step # 1

Dr. Side total
Cr. Side total (before entering
Balancing figure)

(RS)

2,250

(500)

Step # 2

Bigger total
Smaller total
Difference

+/Dr	2,250
-/Cr	(500)
+/Dr	<u>1,750</u>

Step # 5

Bigger side is Dr so
Balance will be called as
Cash Dr balance **1,750.**



Same 6 steps repeated for capital and liability accounts. As far as income and expenses accounts are concerned step # 6 is not to be done. Therefore, instead of writing balance c/d with balancing figure of these accounts we write “Income Statement”.

The balances of income and expenses are required to determine profit and loss for a particular year and these amounts are not required for next year’s profit calculation. Therefore, the balances of these accounts are not transferred to next year as a result we do not write balance c/d with their balancing figures instead “Income statement” is used as these balances are taken there for profit loss calculation.

Practical Questions

Question # 1

Pass necessary Journal Entries and post them in the appropriate Ledger Accounts of Ali Hussain for the month of January 20x0:

- 1 Stated business with Rs 200,000 in the bank and Rs 40,000 cash;
- 1 Bought shop fittings Rs 40,000 and a van Rs 60,000 both paid by cheque;
- 2 Paid rent by cheque Rs 5,000; bought goods for resale on credit from Zakir & Co Rs 50,000;
- 3 Cash sales Rs 5,000;
- 5 Paid wages of assistant in cash Rs 1,000;
- 8 Paid insurance by cheque Rs 500;
- 10 Cash sales Rs 8,000;
- 12 Paid wages of assistant in cash Rs 1,000; Goods returned to Zakir & Co Rs 6,000;
- 15 Paid Zakir & Co Rs 30,000 by cheque;
- 17 Bought goods for resale on credit from Fazal & Co Rs 25,000;
- 19 Cash sales Rs 7,000;
- 19 Paid wages of assistant in cash Rs 1,000
- 22 Bought stationery paid in cash Rs 500;
- 24 Cash sales Rs 15,000
- 25 Paid Fazal & Co Rs 14,000 by cheque;
- 27 Paid wages of assistant in cash Rs 1,000
- 29 Paid Rs 20,000 into the bank.

Question # 2

Prepare the Stationery Account of a firm for the year ended 31.12.20x7 duly balanced off, from the following details:

			<u>Rs.</u>
20x7			
Jan.	1	Stock in hand	480
Apr.	5	Purchase of stationery by cheque	800
Nov.	15	Purchase of stationery on credit from Five Star Stationery Mart	1,280
Dec.	20	Purchase of stationery from petty cash	80
Dec.	31	Stock in hand	240

Question # 3

The following data is given by Mr. Amjad, the owner, with a request to compile only the two personal accounts of Mr. Asghar and Mr. Ahmed, in his ledger, for the month of April 20x6.

- 1 Mr. Amjad owes Mr. Ahmed Rs 15,000; Mr. Asghar owes Mr. Amjad Rs 20,000.
- 4 Mr. Ahmed sold goods worth Rs 60,000 @ 10% trade discount to Mr. Amjad.
- 5 Mr. Amjad sold to Mr. Asghar goods prices at Rs 30,000.
- 17 Record a purchase of Rs 25,000 net from Ahmed, which were sold to Asghar at a profit of Rs 15,000.
- 18 Mr. Amjad rejected 10% of Mr. Ahmed's goods of 4th April.
- 19 Mr. Amjad issued a cash memo for Rs 10,000 to Mr. Asghar who came personally for this consignment of goods, urgently needed by him.

- 22 Mr. Asghar cleared half his total dues to Mr. Amjad, enjoying a ½% cash discount (of the payment received, Rs 20,000 was by cheque).
- 26 Ahmed's total dues (less Rs 10,000 held back) were cleared by cheque, enjoying a cash discount of Rs 1,000 on the payment made.
- 29 Close Asghar's Account to record the fact that all but Rs 5,000 was cleared by him, by a cheque, because he was declared bankrupt.
- 30 Balance Ahmed's Account.

Question # 4

Write up the following transactions in the ledger of Mr. Faisal for the month of July, 20x7.

- 1 Started business with Rs 80,000 in bank and Rs 30,000 in cash.
- 2 Paid rent by cheque Rs 3,000; bought goods on credit from: Ali & Co Rs 15,000.
- 3 Sold goods for cash Rs 3,000 and on credit to Asif & Co Rs 5,000.
- 4 Paid insurance by cheque Rs 250 and bought stationery for Rs 100 in cash.
- 5 Paid wages in cash Rs 500; sold goods for cash Rs 700.
- 8 Paid cash into bank Rs 1,000 and returned goods to Ali & Co Rs 3,000.
- 9 Paid by cheque to Ali & Co Rs 10,000.
- 11 Sold goods on credit to Ahmed Ali Rs 8,000.
- 12 Paid wages in cash Rs 500 and sold goods for cash Rs 2,000.
- 15 Cash paid into bank Rs 1,500; goods returned by Asif & Co Rs 1,000; bought shop furniture, paid by cheque Rs 500.
- 17 Cheque received from Asif & Co Rs 4,000.
- 19 Paid wages in cash Rs 500 and cash sales Rs 2,000.
- 21 Bought goods on credit from Ali & Co Rs 6,000.
- 22 Goods sold for cash Rs 5,000 and on credit to Asif & Co Rs 10,000.
- 26 Cash paid into bank Rs 4,000 and bought postage stamps for Rs 50.
- 27 Paid telephone bill Rs 500 and electricity Rs 400 by cheque.
- 30 Paid wages in cash Rs 500.

3. Trial Balance

“Trial Balance is a list of balances of Assets, Liabilities, Capital, Incomes and Expenses with the help of which Financial Statements are prepared”.

Or

“A Trial Balance is simply a list of the names and balances of all the accounts in the ledger and cash book and listed in the order in which they appear in the ledger”.

Explanation

For every transaction in the double entry system, equal rupee amounts of debits and credits are recorded in the books of account. If all the transactions have been recorded perfectly, we can say that the total of the debits should be equal to the total to the credits. Similarly, if all the accounts have been correctly balanced, the total of the accounts with debit balances must be equal to the total of the accounts with credit balances.

Balance of Account

Balance of account is the difference between the total of debit side and that of the credit side of the same account. If the debit side total is higher, it is called a ‘**Debit**’ balance and similarly, if the credit side total is greater, it is called a ‘**Credit**’ balance.

For Instance

Bank Account

Date	Particulars	Amount	Date	Particulars	Amount
	Capital account	50000		Purchases account	30000
	Sales account	60000		Wages account	5000
				Electricity account	1000
				Rent account	2000

If we add up both sides, we get:

Debit side total	Rs. 110000
Credit side total	Rs. 38000
Difference	<u>Rs. 72000</u>

*This difference of the bank account will be called a ‘**Debit**’ balance because the debit side total is more. At the time of balancing an account the ‘**Balance**’ is first entered on the side whose total is less, then it is **brought down** on the proper side to show the actual nature of the ‘**Balance**’. After balancing, the above Bank Account will read as follows:*

Bank Account

Date	Particulars	Amount	Date	Particulars	Amount
------	-------------	--------	------	-------------	--------

	Capital account	50000		Purchases account	30000
	Sales account	60000		Wages account	5000
				Electricity account	1000
				Rent account	2000
				Balance c/d	72000
		110000			110000
	Balance b/d	72000			

Standard Form of Trial Balance

A Trial Balance contains mainly **five** columns:

- Serial Number;
- Heads of Accounts;
- Ledger Folio (L.F) number;
- Debit Column; and
- Credit Column.

Note

The debit balances are listed in the left-hand column and the credit balances are in the right hand column and the total of the two columns should agree. Since a Trial Balance is prepared on a particular date by taking the balances of the various accounts as on that date, the heading should show the date on which the Trial Balance is extracted.

A Trial Balance is prepared at regular intervals, such as **monthly, half-yearly or yearly**.

Specimen

Trial Balance of Arshad as at 31.6.2000

S.NO	Heads of Accounts	L.F	Debit Balance (Rs)	Credit Balance (Rs)
1.	Cash in hand		10000	
2.	Cash at bank		30000	
3.	Purchases account		100000	
4.	Wages account		15000	
5.	Rent account		5000	
6.	Sales account			120000
7.	Capital account			30000

8.	Loan from bank account		10000
TOTAL		160000	160000

Features of Trial Balance

1. It is a list of balances of all ledger accounts and cash book.
2. It is not a part of the double-entry system of bookkeeping; it is just a working paper.
3. It can be prepared any time during the accounting period.
4. It serves as an instrument for carrying out the job of checking and testing.
5. Arithmetical accuracy of posting of entries from journal to ledger can be ensured.
6. Some errors are not revealed by the Trial Balance, **e.g.**, errors of principle.

Objectives of Trial Balance

1. It ensures that all transactions have been recorded with identical debit and credit amounts and the balance of each account has been computed correctly.
2. It facilitates the preparation of the Trading, Profit and Loss Accounts and the Balance Sheet by making available the balances of all the accounts at one place.
3. It also ensures that the balance of each account, whether debit or credit has been transferred properly to the respective columns of the Trial Balance has been correctly added.
4. Some of the errors in the books of account can be detected by the Trial Balance and they can be rectified before the preparation of the **Final Accounts**.

Some Defects of a Trial Balance

An agreed Trial Balance does not prove that:

1. *All transactions have been correctly analyzed and recorded in the proper accounts. If;*

For Instance

The wages paid for the installation of Plant had been erroneously recorded by **debiting** the **wages account** in place of the **Plant account**, the Trial Balance would still agree.

2. *All transactions have been recorded in the books of original entry. If;*

For Instance

A sales invoice were to be completely omitted from being recorded in the sales day book, the error would not be disclosed in the Trial Balance.

Conclusion

As a conclusion, we can say that a **Trial Balance** should not, therefore, be regarded as a conclusive proof for the correctness of the **Books of Accounts**.

Construction of a Trial Balance

The Trial Balance can be prepared on a loose sheet that may have **five** columns:

- Serial Number;
- Heads of Accounts;
- Ledger Folio (L.F.);
- Debit Balance; and
- Credit Balance.

For the preparation of a Trial Balance, the following steps are followed:

Step 1 Calculate the balances of the cash book and all ledger accounts.

Step 2 Write down the heading ----- '**Trial Balance of as at ...**' at the top of the loose sheet.

Step 3 Write down:

- Serial Numbers of the accounts in the 1st column;
- Names of the accounts in the 2nd column;
- L.F. number in the 3rd column; and
- The balances in the respective columns.

Step 4 Add both the debit and credit columns to see whether they agree or not.

Just consider the comprehensive example of Journal, Ledger and Trial Balance:

Illustration 1

Enter the following transactions in the '**Books of Accounts**' of Mr. Rasheed in the month of January, 2005

	<u>Rs</u>
Jan 1 Started business with cash	60000
4 Goods purchased for resale	5000
7 Stationery purchased	500
10 Goods purchased for resale	7500
12 Wages paid to workers	1000
15 Sold goods for cash	3500
16 Sold goods for cash	3000
17 Electricity bill paid	700
19 Sold goods for cash	3500
20 Stationery purchased	800
21 Wages paid	1000
23 Goods purchased for resale	2000
24 Goods sold for cash	6000
25 Postage paid	800
26 Cash paid for advertisement	300
31 Sold goods for cash	7000
31 Wages paid	1500

Solution

**In the Books of Mr. Rasheed
General Journal**

Date	Particulars	L.F	Debit (Rs)	Credit (Rs)
2005	Cash Account		60,000	
Jan 1	Capital Account (Being Business started with Cash)			60,000
Jan 4	Purchases Account		5,000	
	Cash Account (Being goods purchased for resale)			5,000
Jan 7	Stationery Account		500	
	Cash Account (Being Stationery purchased on cash)			500
Jan 10	Purchases Account		7,500	
	Cash Account (Being goods purchased for resale)			7,500
Jan 12	Wages Account		1,000	
	Cash Account (Being Wages paid on cash)			1,000
Jan 15	Cash Account		3,500	
	Sales Account (Being goods sale on cash)			3,500
Jan 16	Cash Account		3,000	
	Sales Account (Being goods sale on cash)			3,000
Jan 17	Electricity Expense Account		700	
	Cash Account (Being Electricity expense paid on cash)			700
Jan 19	Cash Account		3,500	
	Sales Account (Being goods sale on cash)			3,500
Jan 20	Stationery Account		800	
	Cash Account (Being Stationery purchased on cash)			800
Jan 21	Wages Account		1,000	
	Cash Account (Being Wages paid on cash)			1,000
Jan 23	Purchases Account		2,000	
	Cash Account (Being Purchases made on cash)			2,000
Jan 24	Cash Account		6,000	
	Sales Account (Being Sales made on cash)			6,000
Jan 25	Postage Expenses Account		800	
	Cash Account (Being Postage expenses paid on cash)			800
Jan 26	Advertisement Expenses Account		300	
	Cash Account			300

	(Being Advertisement expense paid on cash)		
Jan 31	Cash Account	7,000	
	Sales Account		7,000
	(Being goods sale on cash)		
Jan 31	Wages Account	1,500	
	Cash Account		1,500
	(Being Wages paid on cash)		

**In the Books of Mr. Rasheed
General Ledger**

Cash Account

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
2005	Capital Account		60,000	2005	Purchases Account		5,000
Jan 1				Jan 4			
Jan 15	Sales Account		3,500	Jan 7	Stationery Account		500
Jan 16	Sales Account		3,000	Jan 10	Purchases Account		7,500
Jan 19	Sales Account		3,500	Jan 12	Wages Account		1,000
Jan 24	Sales Account		6,000	Jan 17	Electricity Account		700
Jan 31	Sales Account		7,000	Jan 20	Stationery Account		800
				Jan 21	Wages Account		1,000
				Jan 23	Purchases Account		2,000
				Jan 25	Postage Account		800
				Jan 26	Advertisement Account		300

	Jan 31	Wages Account	1,500
	Jan 31	Balance c/d	61,900
		<u>83,000</u>	<u>21,100</u>

Capital Account

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
				2005	Cash Account		60,000
				Jan 1			
Jan 31	Balance c/d		60,000				
			<u>60,000</u>				<u>60,000</u>

Purchases Account

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
2005	Cash Account		5,000				
Jan 4							
Jan 10	Cash Account		7,500	Jan 31	Balance c/d		14,500
Jan 23	Cash Account		2,000				
			<u>14,500</u>				<u>14,500</u>

Stationery Account

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
2005	Cash Account		500				
Jan 7							
Jan 20	Cash Account		800	Jan 31	Balance c/d		1,300
			<u>1,300</u>				<u>1,300</u>

Wages Account

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
2005	Cash Account		1,000				
Jan 12							
Jan 21	Cash Account		1,000	Jan 31	Balance c/d		3,500
Jan 31	Cash Account		1,500				
			<u>3,500</u>				<u>3,500</u>

Sales Account

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
				2005	Cash Account		3,500
				Jan 15			
				Jan 16	Cash Account		3,000
				Jan 19	Cash Account		3,500
				Jan 24	Cash Account		6,000
				Jan 31	Cash Account		7,000
Jan 31	Balance c/d		23,000				
			<u>23,000</u>				<u>23,000</u>

Electricity Account

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
2005	Cash Account		700				
Jan 17							
				Jan 31	Balance c/d		700
			<u>700</u>				<u>700</u>

Postage Account

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
2005	Cash Account		800				
Jan 25							
				Jan 31	Balance c/d		800
			<u>800</u>				<u>800</u>

Advertisement Account

Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
2005	Cash Account		300				
Jan 26							
				Jan 31	Balance c/d		300
			<u>300</u>				<u>300</u>

Mr. Rasheed

Trial Balance As on 31 Jan, 2005

S.no	Heads Of Accounts	L.F	Debit (Rs)	Credit (Rs)
1.	Cash Account		61,900	
2.	Capital Account			60,000
3.	Purchases Account		14,500	
4.	Wages Account		3,500	
5.	Sales Account			23,000
6.	Stationery Account		1,300	
7.	Postage Expenses Account		800	
8.	Electricity Expenses Account		700	
9.	Advertisement Expenses Account		300	
	Grand Total		83,000	83,000

Errors not Disclosed by the Trial Balance

1. Errors of Omission

If a particular transaction is omitted altogether from the books of original entry, it will not disturb the agreement of the Trial Balance.

For Example

If a sum of Rs 100 paid to X, is not recorded either in the Cash Book or in the account of X, only the total of the Trial Balance will fall short by Rs 100, but the debit and credit columns will show no difference.

2. Errors of Principle

These errors arise because of an incorrect application of the principles of accounting, **for instance**, failure to differentiate between capital and revenue expenditure. The existence of this type of error is not disclosed by the Trial Balance.

For Example

- a) Wages paid for installation of machinery being debited to Wages Account; and,
- b) Repairs of the building debited to Building Account and the like.

3. Compensating Errors

These are a group of errors, the total effect of which is not reflected in the Trial Balance. These errors are of a neutralizing nature, i.e., one error is compensated by another error or by errors of an opposite nature.

For Example

An extra debit in Salary Account for Rs 100 may be compensated by an extra credit of Rs 100 in Sales Account.

4. Recording Wrong Amount in the Books of Original Entry

If a transaction is wrongly recorded in the books of original entry and is subsequently carried through the ledgers, it will not cause disagreement in the Trial Balance.

For Example

If stationery purchased for cash Rs 175 is recorded in the cash book as Rs 751 and posted to Stationery Account in the ledger as Rs 751, the Trial Balance will still agree.

5. Recording Both Aspects of a Transaction more than once in the Books of Account

The Trial Balance will agree if both aspects of a transaction are recorded twice in the books of original entry.

For Example

If Ali makes a credit purchase of Rs 4000 from Tata Chemicals Ltd is entered in the purchase day book twice, the error will not cause a disagreement in the totals of the Trial Balance.

6. Errors in Recording a Transaction on the Correct Side of a Wrong Account

If a transaction is recorded on the correct side of a wrong account, it will not cause a disagreement in the Trial Balance.

For Example

If Rs 500 cash paid to Asad is wrongly debited to Ashraf Account, it will not affect the agreement of the Trial Balance.

Locating Errors

The following steps should be taken to locate the error or combination of errors that is causing a Trial Balance to disagree:

Step 1 Check whether the debit and credit columns have been added correctly by adding these columns in opposite directions, i.e. from bottom to top or from top to bottom.

Step 2 If the errors remain undetected; divide the exact difference between the totals of two columns by 9. If it is totally divisible by 9, this will mean that there is either a transposition error or a slide error.

Transposition Error

A transposition error is committed when a digit of an amount is placed wrongly,

For example,

If Plant Account has a balance of Rs 5760, but has been written as Rs 5760 in the Trial Balance, the resulting error is Rs 90, which is divisible by 9.

Slide Error

A slide error is committed when the decimal point is placed incorrectly, **for example**, Rs 6250 is copied as Rs 62.50. The resulting error is Rs 6187.50 which is also divisible by 9.

Step 3 Divide the difference by 2, and scan the columns for an identical amount. If a debit balance has been entered in the credit column, or vice versa, it will cause a difference which is twice this amount. If a debit balance of Rs 250 in the Plant Account has been entered in the credit column of the Trial Balance, it will cause a difference of Rs 500 in the Trial Balance total.

Step 4 Check from the ledger if any account shows a balance equal to the difference in the Trial Balance,

Step 5 Re-check the opening balances of all the accounts from the previous Balance Sheet.

Step 6 Cross check the amount in the Trial Balance with the balances in the ledger. Make sure that all the balances have been placed in the correct column of the Trial Balance.

Step 7 Re-compute the balances of each ledger account.

Step 8 If the errors remain undetected; check the postings from the journal and other books of original entry the ledger accounts. Put tick (✓) marks with a colored pencil in the journal and in the ledger after checking each figure. After completing the operation, look through the journal and the ledger for any unticked amount.

Step 9 If the errors still remain undetected; repeat the above steps with the help of other members of the staff, who are not in charge of maintaining the books of account.

			(Rs)	(Rs)
1.	Plant & Machinery Account	Asset	✓	
2.	Furniture Account	Asset	✓	
3.	Salary Account	Expense	✓	
4.	Discount Allowed Account	Expense	✓	
5.	Bank Overdraft Account	Liability		✓
6.	Cash in Hand Account	Asset	✓	
7.	Creditors Account	Liability		✓
8.	Sundry Debtors Account	Asset	✓	
9.	Carriage Inward Account	Expense	✓	
10.	Carriage Outward Account	Expense	✓	
11.	Sales Account	Income		✓
12.	Purchases Account	Expense	✓	
13.	Discount Received Account	Income		✓
14.	Interest Paid Account	Expense	✓	

The Adjusted Trial Balance

When final accounts are to be prepared, the ledger balances need to be updated to include the effects of transactions that are either unrecorded or unrecorded improperly, **For example**, outstanding expenses, depreciation and closing stock, etc.

Adjusting entries are necessary to bring the ledger balances to their proper levels. After all the necessary adjusting entries have been journalized and posted, a 2nd Trial Balance is prepared to prove that the ledger is still in balance and this 2nd Trial Balance is called **the adjusted Trial Balance**. This Trial Balance provides a complete listing of the account balances to be used in preparing the Final Accounts.

Practical Questions

Record Journal Entries, Ledger accounts and Trial Balance of each of the following questions:

Question 1

20x8

- June 1 Started business with Rs. 4,000 cash.
- June 2 Paid Rs. 2,000 of the opening cash into the bank.
- June 3 Purchase goods on credit Rs. 180 from S Ltd.
- June 4 Purchase a motor vehicle by cheque Rs. 600.
- June 5 Purchase goods for cash Rs. 250.
- June 6 Sell goods on credit Rs. 300 to D Moore.
- June 8 Sell goods for cash Rs. 400.
- June 9 Bought fixtures on credit from Kingston Equipment Co Rs. 150.
- June 10 P Ltd lent us Rs. 1,000 paying us the money by cheque.
- June 11 We paid S Ltd his account by cheque Rs. 180.
- June 12 We paid Kingston Equipment Co by cheque Rs. 150.

Question 2

20x9

- Sep 1 Started business with Rs. 2,000 in the bank.
- Sep 2 Purchase goods Rs. 400 on credit from M Ltd.
- Sep 3 Buy fixtures and fittings Rs. 200 paying by cheque.
- Sep 4 Sell goods for cash Rs. 500.
- Sep 5 Buy goods on credit Rs. 300 from Ahmed.
- Sep 6 Pay rent by cash Rs. 20.
- Sep 7 Buy stationary Rs. 50, paying in cash.
- Sep 8 Sell goods on credit to Asif for Rs. 450.
- Sep 9 buy a car paying by cheque Rs. 500.
- Sep10 Paid the month's wages by cash Rs. 150.
- Sep11 The Proprietor took cash for his own personal use Rs. 100.

Question 3

On 1st May 20x7 Ashfaq Ahmed set up a business in which he sold frozen fish, meat and vegetable dishes from door to door in a specially adapted van. His transactions for the first two weeks of trading were as follows:

1. Paid Rs. 10,000 of his pension saving money into a business bank account.
2. Used Rs. 3,600 to buy a second hand van by writing a cheque.
3. Paid Rs. 400 by cheque for his first assignment of frozen food.
4. Received Rs. 110 of cheques and Rs. 80 of cash for sales in his first week of trading.
5. Bought a back up freezer in which to store additional inventories paying by cheque Rs. 260.
6. Paid Rs. 190 by cheque for additional frozen food assignment.
7. Received Rs. 170 of cheques and Rs. 50 of cash for sales in his second week of trading.
8. Paid his next door neighbor Rs. 40 in cash as wages for help in moving inventory from the freezer to the van.
9. Withdrew Rs. 60 in cash from the business bank account as living expenses.

4. Introduction & Purpose of Financial Statements

Definition:

“A written report of the financial condition of a firm. Financial statements include the balance sheet, income statement, statement of changes in net worth and statement of cash flow”.

The first step in developing a financial management system is the creation of financial statements. To manage proactively, you should plan to generate financial statements on a monthly basis. Your financial statements should include an income statement, a balance sheet and a cash-flow statement.

Financial statements are a structured representation of the financial position (Balance Sheet) and financial performance (Income Statement) of an entity.

The objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions.

Financial statements also show the results of management’s stewardship of the resources entrusted to it. To meet this objective, financial statements provide information about an entity’s:

- (a) assets
- (b) liabilities
- (c) equity
- (d) income and expenses, including gains and losses
- (e) other changes in equity; and
- (f) cash flows

This information, along with other information in the notes, assists users of financial statements in predicting the entity’s future cash flows and, in particular, their timing and certainty.

Components of Financial Statements

- ❖ A complete set of financial statements comprises:
 - A balance sheet;
 - An income statement;
 - A statement of changes in equity showing either:
 - All changes in equity, or
 - Changes in equity other than those arising from transactions with equity holders acting in their capacity as equity holders:

- ❖ A cash flow statement; and
- ❖ Notes, comprising a summary of significant accounting policies and other explanatory notes.

Balance Sheet:

It is also called a statement of financial position, a balance sheet is a financial “snapshot” of the business at a given date in time. It lists your assets, your liabilities, and the difference between the two, which is your equity, or net worth. The balance sheet is a real-life example of the accounting equation because it shows that $\text{assets} = \text{liabilities} + \text{owner's equity}$.

Once you master the above accounting terms and concepts, you are ready to learn about the following day-to-day accounting terms.

The following terms are often used by accountants. Definitions are also scattered throughout the text:

Accounts Payable:

It is also called A/P, accounts payable are the bills your business owes to suppliers.

Accounts Receivable:

It is also called A/R, accounts receivable are the amounts owed to you by your customers.

Adjusting Entries:

Adjusting Entries are special accounting entries that must be made when you close the books at the end of an accounting period. Adjusting entries are necessary to update your accounts for items that are not recorded in your daily transactions.

Aging Report:

An aging report is a list of customers' accounts receivable amounts and their due dates. It alerts you to any slow-paying customers. You can also prepare an aging report for your accounts payable, which will help you manage your outstanding bills.

Capital:

Money invested in the business by the owners. It is also called Equity.

Closing:

Closing the books refers to procedures that take place at the end of an accounting period. Adjusting entries are made, and then the income and expense accounts are “**Closed.**” The net profit

that results from the closing of the income and expense accounts is transferred to an equity account such as retained earnings.

Cost Of Goods Sold:

Cost of inventory items sold to your customers. It may consist of several cost components, such as merchandise purchase costs, freight, and manufacturing costs.

Drawing Account:

A general ledger account used by some sole proprietorships and partnerships to keep track of amounts drawn out of the business by an owner.

Expense Accounts:

These are the accounts you use to keep track of the costs of doing business: where your money goes. Examples are advertising, payroll taxes, and wages. Expenses are income statement accounts.

Fixed Assets:

Fixed Assets are the assets that are generally not converted to cash within one year. Examples are equipment and vehicles.

Income Statement:

It is also called a Profit and Loss statement or a "P & L". It lists your income, expenses, and net profit (or loss). The net profit (or loss) is equal to your income minus your expenses.

Long Term Liabilities:

Liabilities that is not due within one year. An example would be a mortgage payable.

Prepaid Expenses:

Amounts you have paid in advance to a vendor or creditor for goods or services. A prepaid expense is actually an asset of your business because your vendor or supplier owes you the goods or services you will be performing in the future.

Retained Earnings:

Retained Earnings are the profits of the business that have not been paid to the owners; profits that have been "Retained" in the business. Retained earnings are an "Equity" account that is presented on the balance sheet and on the statement of changes in owners' equity.

Trial Balance:

A trial balance is prepared at the end of an accounting period by adding up all the account balances in your general ledger. The debit balances should equal the credit balance.

Unearned Revenue:

It is also called prepaid income, it represents money you have received in advance of providing a service to your customer. It is actually a liability of your business because you still owe the service to the customer. An example would be an advance payment to you for some consulting services you will be performing in the future.

Introduction to Financial Statements –

Reporting Framework

The reporting frame work is applicable in Pakistan while preparing and presenting of financial statements is as follows:

	Applicable Laws and Regulations	Regulating Authority
Listed Companies other than, Insurance, NBFCs', Modaraba and Bank	<ul style="list-style-type: none"> • Companies Ordinance 1984. • International Financial Reporting Framework (IFRS) as applicable in Pakistan • Stock Exchange Listing Regulations 	Securities and Exchange Commission of Pakistan (SECP)
Banking Companies	<ul style="list-style-type: none"> • International Financial Reporting Framework (IFRS) as applicable in Pakistan • Companies Ordinance 1984. • Stock Exchange Listing Regulations (Particularly Code of Corporate Governance) • Banking Ordinance 1962 • Prudential Regulations (Corporate, SMEs' and Consumers) 	Securities and Exchange Commission of Pakistan and State Bank of Pakistan.
Insurance Companies	<ul style="list-style-type: none"> • International Financial Reporting Framework (IFRS) as applicable in Pakistan • Companies Ordinance 1984 • Stock Exchange Listing Regulations • Insurance Ordinance and Rules 	Securities and Exchange Commission of Pakistan.
Non Banking Finance Companies (Leasing Companies, Investment Companies,	<ul style="list-style-type: none"> • International Financial Reporting Framework (IFRS). • Companies Ordinance 1984. • Stock Exchange Listing Regulations (Particularly Code of Corporate Governance) • NBFC Rules. • Prudential Regulations for NBFCs' • Prudential Regulations for Leasing Company 	Securities and Exchange Commission of Pakistan.
Modarba	<ul style="list-style-type: none"> • International Financial Reporting Framework (IFRS). • Companies Ordinance 1984. • Stock Exchange Listing Regulations (Particularly Code of Corporate Governance) • Modarba Act and Rules 	Securities and Exchange Commission of Pakistan and Registrar of Modarba

Users of Financial Statements

User of the financial statements	Interest of the user
Equity investors (existing and potential)	They are interested whether buy, hold or sell the shares in hand and also enable them in payment of dividends.
Loan creditors ie, existing and potential holders of debentures and loan stock, and	The amount will be paid when due and for continuation of the business.

providers of short-term loans	
Employees (existing, potential and past)	Interested in stability and profitability for employment opportunities, remuneration and retirement benefits.
Business contacts including customers, trade creditors, competitors and potential take-over bidders	Whether the payment of loan will be made in due dates and enable sustainability of business for future business with the enterprise.
Government , including tax authorities, government departments and local authorities	Interested in allocation of resources and also to regulate the activities of an enterprise and determining tax policies and as a basis for national income.
Public , including tax payers, ratepayers and environmental groups	Trends and recent development in the prosperity of the entity and range of it's activities.

Need for Audit



Objective of Audit

The objective of the audit is to express an opinion on the financial statements whether or not the financial statements present fairly.

Section 233(3) of the Companies Ordinance requires:

“The balance-sheet and the profit and loss account or income and expenditure account shall be audited by the auditor of the company, in the manner hereinafter provided, and the auditor’s report shall be attached thereto.”

Section 237(3) of the Companies Ordinance requires:

“Every auditor of a holding company appointed under section 252 shall also report on consolidated financial statements and exercise all such powers and duties as are vested in him under section 255.”

Section 252(1) of the Companies Ordinance requires:

“Every company shall at each annual general meeting appoint an auditor or auditors to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting.”

Required by the Section 35 (1) of the Banking Ordinance 1962.

“The balance sheet and profit and loss account prepared in accordance with section 34 (**Accounts and balance-sheet**) of shall be audited by a person who is duly qualified, under the Chartered Accountants Ordinance, 1961 (X of 1961), or any other law for the time being in force, to be an auditor of companies and is borne on the panel of auditors maintained by the State Bank for the purposes of audit of banking companies.”

Section 48 (1) of the Insurance Ordinance 2000 requires:

“Every insurer shall appoint an auditor who shall be approved by the Commission as qualified to perform audits of insurance companies.”

Section 14(1)(ii) and Section 15 of Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980 requires:

Section 14(1) (ii)

The Modaraba Company shall, within six months from the close of the accounting year, prepare and circulate to the holders of Modaraba Certificates:

“A report of auditor on the balance sheet and profit and loss account”

Section 15

“The accounts of a Modaraba shall be audited by an auditor who is Chartered Accountant appointed by a Modaraba Company with the approval of Registrar.”

Basic Accounting Principles

As accounting concepts underlie the preparation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed, together with the reasons.

The following are recognised by the “International Accounting Standard Committee” as fundamental accounting assumptions:

Over all considerations of preparing and presenting financial statements

- Fair Presentation and Compliance with IFRS.
- Going Concern
- Accrual Basis of Accounting
- Consistency of Presentation
- Materiality and Aggregation
- Off setting
- Comparative Information

Basic Accounting Principles

Fair Presentation and Compliance with IFRS.

Financial statements shall present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the *Framework*.

The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.

Basic Accounting Principles - Going Concern

When preparing financial statements, management shall make an assessment of an entity’s ability to continue as a going concern. Financial statements shall be prepared on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity’s ability to continue as a going concern, those uncertainties shall be disclosed. When financial statements are not prepared on a going concern basis, that fact shall be disclosed, together with the basis on which the financial statements are prepared and the reason why the entity is not regarded as a going concern.

Accrual Basis of Accounting

An entity shall prepare its financial statements, except for cash flow information, using the accrual basis of accounting.

Consistency of Presentation

The presentation and classification of items in the financial statements shall be retained from one period to the next unless:

- It is apparent, following a significant change in the nature of the entity's operations or a review of its financial statements, that another presentation or classification would be more appropriate having regard to the criteria for the selection and application of accounting policies in IAS 8; or
- A Standard or an Interpretation requires a change in presentation.

Materiality and Aggregation

- Each material class of similar items shall be presented separately in the financial statements. Items of a dissimilar nature or function shall be presented separately unless they are immaterial.

Off setting

- Assets and liabilities, and income and expenses, shall not be offset unless required or permitted by a Standard or an Interpretation.

Comparative Information

- Except when a Standard or an Interpretation permits or requires otherwise, comparative information shall be disclosed in respect of the previous period for all amounts reported in the financial statements. Comparative information shall be included for narrative and descriptive information when it is relevant to an understanding of the current period's financial statements.

Areas of Balance Sheet

In this section we will cover the following important areas of the Balance Sheet:

- Property, Plant and Equipments
- Investments
- Loans and Advances
- Stock in Trade
- Trade Debtors
- Cash and Bank Balances
- Deferred Liabilities
- Long term Loans from Baking Companies
- Trade Creditors
- Taxation
- Contingencies and Commitments

Property, Plant and Equipments

Operating Fixed Assets

- Inspect assets & trace to records
- Vouch additions & deletions with supporting documents.
- Examine documents of title.
- Re compute gain/loss on disposals.
- Check/recalculate depreciation charge.
- Check impairment.

Capital Work in Progress

- Review board minutes regarding significant additions.
- Verify cost incurred with supporting documents
- Borrowing cost capitalized are directly attributable to construction, acquisition or production

Investments

- Inspect securities in hand and evidence for title of securities held.
- Review investments for income reconciliation.
- Vouch sale and re compute gain/loss.
- Review classification and description.
- Vouch purchases made during the year.

Cash & Bank Balances

- Perform physical cash count
- Circularize direct confirmations
- Obtain reconciliation statements
- Review age analysis of long outstanding cheques

Loans and Advances

- Review agreements
- Circularise direct confirmations

- Re compute interest and exchange loss
- Check subsequent repayment
- Check disclosure

Stock in Trade

- Perform physical count/inspection
- Investigate reasons for any difference between the physical and records
- Check valuation as per company's policy
- Identify slow moving items

Trade Debtors

- Circularise direct confirmations
- Check subsequent clearance
- Perform age analysis

Deferred Liabilities

- Obtain actuarial report and assess reasonableness of assumptions
- Voucher payments during the period to ensure completeness
- Ensure disclosure requirement of IAS 19

Taxation-Current & deferred

- Review updated tax position
- Check working of provision for taxation
- Voucher payments
- Check working of deferred taxation
- Ensure disclosure with IAS 12

Trade Creditors

- Circularise direct confirmations
- Check subsequent clearance
- Perform age analysis

Loans from Banking Companies

- Review agreements
- Circularise direct confirmations
- Check interest and exchange effects
- Check subsequent repayment
- Check disclosure

Contingencies and Commitments

- Obtain list of commitment and contingencies

- Circularise direct confirmations to legal advisors
- Review legal fees
- Review minutes of Board of Directors meeting

Reporting Period

Financial statements shall be presented at least annually. When an entity's balance sheet date changes and the annual financial statements are presented for a period longer or shorter than one year, an entity shall disclose, in addition to the period covered by the financial statements:

- The reason for using a longer or shorter period; and
- The fact that comparative amounts for the income statement, statement or changes in equity, cash flow statement and related notes are not entirely comparable.

Note:

Normally, financial statements are consistently prepared covering a one-year period. However, for practical reasons, some entities prefer to report, **for example**, for a 52-week period. This Standard does not preclude this practice, because the resulting financial statements are unlikely to be materially different from those that would be presented for one year.

Definitions of Components of Financial Statements

Balance Sheet:

Balance Sheet is a combination of entity's assets and liabilities and shows the financial position of that particular entity.

“The balance sheet provides a snapshot of the business's assets, liabilities and owner's equity for a given time. Again, using an apparel manufacturer as an example, here are the key components of the balance sheet”

Current Assets:

These are the assets in a business that can be converted to cash in one year or less. They include cash, stocks and other liquid investments, accounts receivable, inventory and prepaid expenses. For a clothing manufacturer, the inventory would include raw materials (yarn, thread, etc.), work-in-progress (started but not finished), and finished goods (shirts and pants ready to sell to customers). Accounts receivable represents the amount of money owed to the business by customers who have purchased on credit.

Fixed Assets:

These are the tangible assets of a business that won't be converted to cash within a year during the normal course of operation. Fixed assets are for long-term use and include land, buildings, leasehold improvements, equipment, machinery and vehicles. Intangible assets: These are assets that you cannot touch or see but that have value. Intangible assets include franchise rights, goodwill, non-compete agreements, patents and many other items.

Other Assets:

There are many assets that can be classified as other assets, and most business balance sheets have an "other assets" category as a catchall. Some of the most common other assets include cash value of life insurance, long-term investment property and compensation due from employees.

Current Liabilities:

These are the obligations of the business that are due within one year. Current liabilities include notes payable on lines of credit or other short-term loans, current maturities of long-term debt, accounts payable to trade creditors, accrued expenses and taxes (an accrual is an expense such as the payroll that is due to employees for hours worked but has not been paid), and amounts due to stockholders.

Long-term Liabilities:

These are the obligations of the business that aren't due for at least one year. Long-term liabilities typically consist of all bank debt or stockholder loans payable outside of the following 12-month period.

Owner's Equity:

This figure represents the total amount invested by the stockholders plus the accumulated profit of the business. Components include common stock, paid-in-capital (amounts invested not involving a stock purchase) and retained earnings (cumulative earnings since inception of the business less dividends paid to stockholders).

Income Statement:

Income Statement is a statement that shows the financial performance of the entity by showing the profit or loss of the entity.

“Simply put, the income statement measures all your revenue sources vs. business expenses for a given time period. To help explain things easily, let's consider an apparel manufacturer as an example in outlining the major components of the income statement”

Sales:

This is the gross revenue generated from the sale of clothing less returns (cancellations) and allowances (reduction in price for discounts taken by customers).

Cost of goods sold:

This is the direct cost associated with manufacturing the clothing. These costs include materials used, direct labor, plant manager salaries, freight and other costs associated with operating a plant (for example, utilities, equipment repairs, etc.)

Gross profit:

The gross profit represents the amount of direct profit associated with the actual manufacturing of the clothing. It's calculated as sales less the cost of goods sold.

Operating expenses:

These are the selling, general and administrative expenses that are necessary to run the business. Examples include office salaries, insurance, advertising, sales commissions and rent.

Depreciation:

Depreciation expense is usually included in operating expenses and/or cost of goods sold, but it is worthy of special mention due to its unusual nature. Depreciation results when a company purchases a fixed asset and expenses it over the entire period of its planned use, not just in the year purchased. The IRS requires certain depreciation schedules to be followed for tax reasons. Depreciation is a noncash expense in that the cash flows out when the asset is purchased, but the cost is taken over a period of years depending on the type of asset.

Whether depreciation is included in cost of goods sold or in operating expenses depends on the type of asset being depreciated. Depreciation is listed with cost of goods sold if the expense associated with the fixed asset is used in the direct production of inventory. Examples include the purchase of production equipment and machinery and a building that houses a production plant.

Depreciation is listed with operating expenses if the cost is associated with fixed assets used for selling, general and administrative purposes. Examples include vehicles for salespeople or an office computer and phone system.

Operating profit:

This is the amount of profit earned during the normal course of operations. It is computed by subtracting the operating expenses from the gross profit.

Other income and expenses:

Other income and expenses are those items that don't occur during the normal course of business operation. For instance, a clothing maker doesn't normally earn income from rental property or interest on investments, so these income sources are accounted for separately. Interest expense on debt is also included in this category. A net figure is computed by subtracting other expenses from other income.

Net profit before taxes:

This figure represents the amount of income earned by the business before paying taxes. The number is computed by adding other income (or subtracting if other expenses exceed other income) to the operating profit.

Income taxes:

This is the total amount of state and federal income taxes paid.

Net profit after taxes:

This is the "bottom line" earnings of the business. It's computed by subtracting taxes paid from net income before taxes.

Cash Flow Statement:

Cash Flow Statement shows the inflows and outflows of cash and cash equivalents.

“The cash-flow statement is designed to convert the accrual basis of accounting used to prepare the income statement and balance sheet back to a cash basis. This may sound redundant, but it's necessary”.

The accrual basis of accounting generally is preferred for the income statement and balance sheet because it more accurately matches revenue sources to the expenses incurred generating those specific revenue sources. However, it also is important to analyze the actual level of cash flowing into and out of the business.

Like the income statement, the cash-flow statement measures financial activity over a period of time. The cash-flow statement also tracks the effects of changes in balance sheet accounts.

The cash-flow statement is one of the most useful financial management tools you will have to run your business. The cash-flow statement is divided into four categories:

1. Net cash flow from operating activities:

Operating activities are the daily internal activities of a business that either require cash or generate it. They include cash collections from customers; cash paid to suppliers and employees; cash paid for operating expenses, interest and taxes; and cash revenue from interest dividends.

2. Net cash flow from investing activities:

Investing activities are discretionary investments made by management. These primarily consist of the purchase (or sale) of equipment.

3. Net cash flow from financing activities:

Financing activities are those external sources and uses of cash that affect cash flow. These include sales of common stock, changes in short- or long-term loans and dividends paid.

4. **Net change in cash and marketable securities:**

The results of the first three calculations are used to determine the total change in cash and marketable securities caused by fluctuations in operating, investing and financing cash flow. This number is then checked against the change in cash reflected on the balance sheet from period to period to verify that the calculation has been done correctly.

Statement of Changes in Equity:

Statement of changes in equity shows the movement of the equity of the equity holders during the year.

Notes:

Notes consist on a summary of significant accounting policies and other explanatory notes.

Information to be presented on the face of the Balance Sheet

As a minimum, the face of the balance sheet shall include line items that present the following amounts to the extent that they are not presented.

- a) Property, plant and equipment;
- b) Investment property;
- c) Intangible assets;
- d) Financial assets (excluding amounts shown under (e), (h) and (i));
- e) Investments accounted for using the equity method;
- f) Biological assets;
- g) Inventories;
- h) Trade and other receivables;
- i) Cash and cash equivalents;

Elements Related to Measurement of Financial Position

The elements directly related to the measurement of financial position are assets, liabilities and equity. These are defined as follows:

- a) An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.
- b) A liability is a present obligation of the enterprise arising from past events, the resources embodying economic benefits.
- c) Equity is the residual interest in the assets of the enterprise after deducting all its liabilities.

Basis of Measurement

Historical Cost

Assets are recorded at the amount of cash or cash equivalent paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (**for example**, Income Taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

Current Cost

Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or and equivalents asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

Realizable (settlement) Value

Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values; that is, the undiscounted amounts of cash or cash equivalents expected to be paid satisfy the liabilities in the normal course of business.

Present Value

Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.