



# Contents

---

	PAGE
<i>About the Author</i>	<i>I-5</i>
<i>Few words from the Author</i>	<i>I-7</i>

## 1

### ACCOUNTING - FUNDAMENTALS

1.1	Introduction	1
1.2	Informational needs of users of Accounting Information	3
1.3	Branches of Accounting	5
1.3-1	Financial Accounting	5
1.3-2	Management Accounting	5
1.4	Meaning of Financial Accounting	7
1.4-1	Generation of Financial Information	7
1.4-2	Use of financial information	9
1.5	Functions of Accounting	10
1.6	Advantages of Accounting	11
1.7	Limitations of Financial Accounting	12
1.8	Bases of Accounting	13
1.9	Conceptual Framework of Accounting	14
1.10	Accounting Vocabulary	16
	REVIEW QUESTIONS	17

## 2

### FINANCIAL ACCOUNTING PRINCIPLES

2.1	Need and Meaning	19
2.2	Nature of GAAP	19
2.3	Principles vs. Concepts vs. Conventions	20
2.4	Financial Accounting Principles (or GAAP)	21
2.5	Relevance of GAAP	31
	REVIEW QUESTIONS	32

## 3

### FINANCIAL ACCOUNTING STANDARDS

3.1	Accounting Standards	35
-----	----------------------	----

	PAGE
<b>3.2</b> Accounting Standards at International Level	35
<b>3.2A</b> International Financial Reporting Standards	36
<b>3.3</b> Accounting Standards at National Level - India	36
<b>3.4</b> Standard Setting Process of ICAI	38
<b>3.5</b> The changing scenario (the IFRS complaint India - Globalized Accounting Standards)	41
<b>3.6</b> Accounting Policies	42
<b>3.7</b> Summary of AS-1 Disclosure of Accounting Policies	44
REVIEW QUESTIONS	46

## **4**

### **ACCOUNTING EQUATION AND ACCOUNTING PROCESS**

<b>4.1</b> Origin of business transactions	49
<b>4.2</b> Analysis of business transactions	49
<b>4.3</b> Accounting equation approach	49
<b>4.4</b> Traditional Approach	56
<b>4.5</b> Advantages of Double Entry System	59
<b>4.6</b> Analysis of some transactions	59
<b>4.7</b> Voucher System	64
<b>4.8</b> Journal	65
<b>4.9</b> Ledger	69
<b>4.10</b> Trial balance	74
<b>4.11</b> Objectives of Preparing a Trial Balance	75
<b>4.12</b> Adjusted Trial Balance	75
<b>4.13</b> Accounting Mechanics (Multiple Journals) - Special Journals and Ledger	76
<b>4.14</b> Cash Book	77
<b>4.15</b> Petty Cash Book	82
<b>4.16</b> Purchases Book	86
<b>4.17</b> Sales Book	88
<b>4.18</b> Purchases Return Book (Return Outwards Book)	89
<b>4.19</b> Sales Return Book (Return Inwards Book)	89
<b>4.20</b> Bills receivable book	89
<b>4.21</b> Bills payable book	90
<b>4.22</b> Journal proper (General journal)	90
<b>4.23</b> Distinction between Books of Original Entry and Principal Book of Account	98
<b>4.24</b> Sub-division of Ledger - Multiple Ledger System	98
<b>4.25</b> Errors in Financial Statements	99
<b>4.26</b> Type of errors	99
<b>4.27</b> Error Management	100
<b>4.28</b> Rectification of two sided errors	101

	PAGE
<b>4.29</b> Rectification of one-sided errors before the preparation of trial balance	<i>103</i>
<b>4.30</b> Rectification of one-sided errors after the preparation of trial balance	<i>104</i>
<b>4.31</b> Rectification of errors after finalisation of accounts or in the next accounting period	<i>107</i>
<b>4.32</b> Introduction	<i>110</i>
<b>4.33</b> Causes of difference in Bank balance as per cash book and pass book	<i>110</i>
<b>4.34</b> Utility of Bank reconciliation statement	<i>112</i>
<b>4.35</b> Preparation of Bank Reconciliation statement with unadjusted cash book balance	<i>112</i>
REVIEW QUESTIONS	<i>114</i>
PRACTICAL PROBLEMS	<i>116</i>

## 5

### INVENTORY VALUATION

<b>5.1</b> Introduction	<i>123</i>
<b>5.2</b> Need for Inventory	<i>123</i>
<b>5.3</b> Nature of Inventory	<i>124</i>
<b>5.4</b> Purpose of Inventory Valuation	<i>124</i>
<b>5.5</b> Valuation of Inventory	<i>125</i>
<b>5.6</b> Systems of Inventory	<i>125</i>
<b>5.7</b> Historical Cost Methods	<i>127</i>
<b>5.7-1</b> Specific Identification Method	<i>127</i>
<b>5.7-2</b> First in First Out (FIFO) Method	<i>128</i>
<b>5.7-3</b> Last in First Out (LIFO) Method	<i>132</i>
<b>5.7-4</b> Weighted Average Method	<i>133</i>
<b>5.7-5</b> Evaluation of FIFO, LIFO and Weighted Average under Rising Prices	<i>139</i>
<b>5.8</b> Non-historical cost methods	<i>140</i>
<b>5.8-1</b> Standard Cost Method	<i>140</i>
<b>5.8-2</b> Stock Estimation and Adjusted Selling Price (Retail Inventory) Method	<i>140</i>
<b>5.9</b> Valuation of inventory below cost (Application of LCM Principle)	<i>142</i>
<b>5.10</b> Salient features of AS-2	<i>144</i>
REVIEW QUESTIONS	<i>145</i>
PRACTICAL PROBLEMS	<i>146</i>

## 6

### DEPRECIATION (INCLUDING AMORTIZATION OF INTANGIBLES)

<b>6.1</b> Introduction	<i>149</i>
<b>6.2</b> Causes of Depreciation	<i>150</i>
<b>6.3</b> Need for Charging Depreciation	<i>150</i>
<b>6.4</b> Factors in Determining the Amount of Depreciation	<i>151</i>

## CONTENTS

**I-14**

	PAGE
<b>6.5</b> Effective date for calculation of depreciation	153
<b>6.6</b> Accounting treatment	153
<b>6.7</b> Methods of computing depreciation	155
<b>6.7-1</b> Fixed Instalment Method	155
<b>6.7-2</b> Diminishing Balance Method	161
<b>6.8</b> Change of the method of depreciation	165
<b>6.9</b> Exchange of used asset with a new asset	176
<b>6.10</b> Revision of useful life of asset	180
<b>6.11</b> Revaluation of Fixed Asset and Impairment of Asset	181
<b>6.12</b> Effect of change in the long-term liability on account of exchange rate fluctuations	184
<b>6.13</b> Effect of any addition or extension to the existing asset	184
<b>6.14</b> Errors of principle and their rectification	187
<b>6.15</b> Salient features of AS-6	188
REVIEW QUESTIONS	190
PRACTICAL PROBLEMS	193

## 7

### **FINANCIAL STATEMENTS OF NON-CORPORATE BUSINESS ENTITIES**

<b>7.1</b> Introduction	198
<b>7.2</b> Trading Account	198
<b>7.3</b> Profit and Loss Account	203
<b>7.4</b> Balance Sheet	204
<b>7.5</b> Some relevant terms and hints	206
<b>7.6</b> Vertical form of presentation of accounts	213
<b>7.7</b> Operating profit (Earnings before interest and tax)	214
<b>7.8</b> Adjustment entries	215
<b>7.9</b> Preparation of Appropriation Account	279
<b>7.10</b> Manufacturing Account	282
REVIEW QUESTIONS	294
PRACTICAL PROBLEMS	295

## 8

### **FINANCIAL STATEMENT ANALYSIS**

<b>8.1</b> Meaning of Financial Statement Analysis	316
<b>8.2</b> Objectives of Financial Statement Analysis	317
<b>8.3</b> Tools of Financial Statement Analysis	318
<b>8.4</b> Types of Financial Analysis	318
<b>8.5</b> Limitations of Financial Statement Analysis	319

	PAGE
<b>8.6</b> Comparative Financial Statements	320
<b>8.7</b> Common Size Statements	324
<b>8.8</b> Introduction to Ratio Analysis	326
<b>8.9</b> Classification of Accounting Ratio	327
<b>8.10</b> Solvency Ratios	327
<b>8.11</b> Liquidity Ratios	331
<b>8.12</b> Turnover (or Activity) Ratios	335
<b>8.13</b> Profitability Ratios	340
<b>8.14</b> Objectives of Ratio Analysis	351
<b>8.15</b> Limitations of Ratio Analysis	351
<b>8.16</b> Inter-Relationships among Ratios and Preparation of Financial Statements	352
REVIEW QUESTIONS	365
PRACTICAL PROBLEMS	367

## 9

### FUNDS FLOW STATEMENT

<b>9.1</b> Introduction	383
<b>9.2</b> Statement of changes in Financial Position	384
<b>9.3</b> Funds (Net Working Capital) Flow Statement	384
<b>9.4</b> Preparation of Funds Flow Statement	388
<b>9.5</b> Calculation of Funds from Operating Activities	390
<b>9.6</b> Projected Funds Flow Statement	421
<b>9.7</b> Uses of Funds Flow Statement	426
<b>9.8</b> Limitations of Funds Flow Statement	427
<b>9.9</b> Distinction between 'Funds Flow Statement' and 'Profit and Loss Account'	427
<b>9.10</b> Distinction between 'Funds Flow Statement' and 'Balance Sheet'	428
<b>9.11</b> Distinction between 'Funds Flow Statement' and 'Schedule of Changes in Net Working Capital'	428
<b>9.12</b> Effect of Depreciation on Sources and Uses of Funds	428
REVIEW QUESTIONS	429
PRACTICAL PROBLEMS	429

## 10

### CASH FLOW STATEMENT

<b>10.1</b> Introduction	442
<b>10.2</b> Statement of changes in Financial Position	442
<b>10.3</b> Definition of Cash	443
<b>10.4</b> Classification of Cash flows	443
<b>10.5</b> Calculation of Cash flows from Operating Activities	444
<b>10.6</b> Disclosure requirements of some items	448

## CONTENTS

**I-16**

	PAGE
<b>10.7</b> Calculation of Cash flows from Investing Activities	453
<b>10.8</b> Calculation of Cash flows from Financing Activities	454
<b>10.9</b> Preparation of Cash flow statement	455
<b>10.10</b> Distinction between Cash flow statement and Funds flow statement	481
<b>10.11</b> Objectives of Cash flow statement	482
<b>10.12</b> Uses of Cash flow statement	483
<b>10.13</b> Limitations of Cash flow statement	484
<b>10.14</b> Distinction between 'Cash flow statement' and 'Income statement'	484
<b>10.15</b> Distinction between 'Cash flow statement' and 'Balance sheet'	484
REVIEW QUESTIONS	485
PRACTICAL PROBLEMS	486