

EPFO • APFC-2026

Accounting, Auditing and Insurance

(Complete Concept Notes with 500+ MCQs)

Lalit Mohan

CMA – AIR 16 | UGC NET Commerce | B.Com



EPFO APFC 2026
Accountancy, Auditing and Insurance
Concepts • PYQs • Practice Questions

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First Edition • 2026

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Preface

Preparing for a competitive examination is not simply about studying more; it is about **studying what matters most**.

Accountancy, Auditing and Insurance is a vast subject, and preparing it from a conventional academic perspective can make the process unnecessarily lengthy. This book has therefore been created specifically from the **UPSC EPFO/APFC examination perspective**, keeping **Previous Year Questions (PYQs), recurring concepts, examination trends and conceptual importance** in mind.

The objective is to provide **focused explanations, relevant examples and examination-oriented practice** so that aspirants can understand the concepts and revise them effectively.

The priority system used in this book is designed to help readers **focus their time on the topics that matter most**, rather than treating every topic with equal importance.

I would like to sincerely thank **Mr. Saras Yadav** for his valuable contribution, suggestions and support in the preparation of this book.

I hope this book makes your preparation more **focused, structured and effective**.

Lalit Mohan
2026

How to Use This Book

This book uses a **two-level priority system** to help you direct your study time toward the topics that matter most in the examination.

Core Focus

The **highest-priority topics**, identified through exam trends, past questions, conceptual importance, and question potential. These deserve **thorough preparation and repeated revision**.

High Yield

Topics with **strong exam relevance** that rank just below Core Focus. Study these carefully after completing the Core Focus topics.

Unmarked Topics — Quick Read

All unmarked topics provide supporting knowledge, context, or completeness. Understand them, but **do not let them consume revision time at the expense of priority topics**.

A Simple Revision Strategy

First Pass: Read the chapter completely for understanding.

Revision: Prioritise **Core Focus**, followed by **High Yield**.

Before the Exam: Revise **Core Focus** first, then High Yield if time permits.

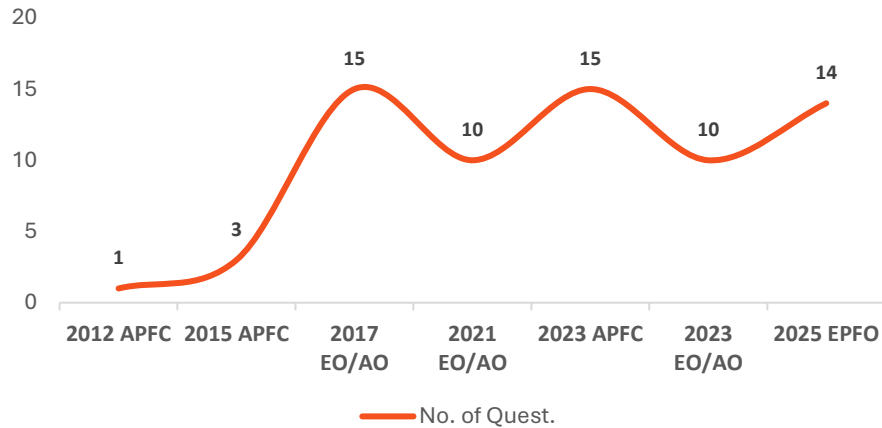
Cover everything. Prioritise wisely. Revise what matters most.

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Why Accounting is the highest-ROI subject in EPFO

- One of the most scoring and predictable sections in the EPFO exam.
- The syllabus is limited, and questions frequently repeat with only minor changes.
- Since 2017, it has become a permanent and high-weightage section.
- The trend shows its importance is steadily increasing, making it a high-priority topic for preparation.

No. of Question from 2012-2025

Chapter 1: Fundamentals of Accounting

- Accounting is the process of identifying, measuring, recording, classifying, summarising and communicating financial information to permit informed judgements by users.

Book-keeping vs accounting vs Accountancy

Dimension	Book-keeping	Accounting	Accountancy
Scope	Recording only	Recording + summarising + interpreting	The whole body of knowledge
Skill level	Clerical, routine	Analytical, judgemental	Conceptual, normative
Stage	Primary	Secondary — begins where book-keeping ends	Tertiary
Output	Journals, ledgers	Financial statements, analysis	Principles, standards, theory

Branches of accounting

Branch	Primary user	Governed by	Mandatory?
Financial Accounting	External — shareholders, lenders, government	AS / Ind AS, Companies Act	Yes
Cost Accounting	Internal management	Cost Accounting Standards	Only for notified industries
Management Accounting	Internal management	No prescribed format	No
Tax Accounting	Tax authorities	Income Tax Act, ICDS	Yes
Social / Environmental Accounting	Society, regulators	BRSR, voluntary frameworks	Partly (listed cos.)

Users of accounting information

I. Internal Users

- Owners / Proprietors** – Assess the return on investment and decide whether the business should continue or expand.
- Management** – Evaluate operational efficiency, control costs, and allocate resources effectively.
- Employees & Trade Unions** – Assess job security, bonus potential, and strengthen wage negotiations.

II. External Users

- Potential Investors** – Evaluate the risk–return profile before investing.
- Lenders / Banks** – Assess liquidity, solvency, and the firm's ability to repay loans.
- Suppliers / Trade Creditors** – Determine whether the business can pay its outstanding dues on time.
- Customers** – Judge the long-term stability of the business, especially for after-sales service and warranties.
- Government & Regulators** – Verify tax compliance, collect statistical data, and ensure adherence to legal requirements.
- EPFO / Statutory Authorities** – Check wage records, EPF contribution liabilities, and identify defaults.
- Public / Researchers** – Study employment generation, CSR initiatives, environmental impact, and overall economic contribution.

Accounting concepts - *Core Focus*

- A **concept** is a basic assumption about the environment in which accounting operates.
- A **convention** is a practice adopted by usage to make statements useful. Concepts tell you *what reality to assume*; conventions tell you *how to present*.

1. **Business Entity Concept:** The business is treated as an entity separate and distinct from its owners. Capital introduced by the proprietor is therefore a *liability* of the business towards the owner, and drawings reduce that liability. Without this concept, a sole proprietor's household expenses **would** contaminate the profit figure.

Consequence:

- Capital Account carries a **credit** balance in the business's books.
- Consequence: Interest on capital is an expense of the business and income of the owner.
- This is an *accounting* separation, not a legal one — a sole proprietor remains personally liable for business debts.

2. **Money Measurement Concept:** Only those transactions and events which can be expressed in monetary terms are recorded in the books of account. Everything else — however commercially significant — stays out.

- What this concept *excludes*: the quality of the management team, the loyalty of the workforce, a strike threat, a new competitor entering the market, a dispute between the production and marketing departments, the reputation of the brand (unless purchased), the health of the founder.

3. **Going Concern Concept:** The enterprise is assumed to continue in operation for the foreseeable future, with neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations. This is a *fundamental accounting assumption* under AS-1.

Everything downstream depends on it:

- Fixed assets are shown at **historical cost less depreciation**, not at realisable or break-up value — because we do not intend to sell them.
- Depreciation itself only makes sense if the asset will be used over future periods.
- The distinction between **current** and **non-current** presupposes a future in which the non-current items will be consumed.
- Prepaid expenses and deferred revenue expenditure are carried forward as assets only because future periods exist to absorb them.
- If going concern fails, the entity switches to **liquidation basis** — all assets at net realisable value, all liabilities current.

• **The three Fundamental Accounting Assumptions** are **Going Concern, Consistency, and Accrual.**

4. **Cost (Historical Cost) Concept:** An asset is recorded at the price actually paid to acquire it, plus all costs incurred to bring it to its present location and condition, and this amount is the basis for all subsequent accounting for that asset. Market fluctuations are ignored.

- Advantage: objective, verifiable, supported by a document.
- Disadvantage: balance sheet values drift far from economic reality over time.
- Example: an asset acquired free of cost, or self-generated goodwill, is not recorded at all — it has no cost.

5. **Dual Aspect Concept:** Every transaction has two aspects — a debit and a credit of equal amount — and therefore Assets always equal Liabilities plus Capital. This is the foundation of double-entry book-keeping and the reason a Trial Balance can tally at all.

The accounting equation and its expanded form:

- Assets = Liabilities + Capital
- Assets = Liabilities + (Opening Capital + Additional Capital + Revenue – Expenses – Drawings)

- 6. Accounting Period Concept (Periodicity):** The indefinite life of an enterprise is divided into shorter, equal segments — usually twelve months — for which performance is measured and reported. Users cannot wait until liquidation to learn whether the business is profitable.
- In India the statutory financial year is **1 April to 31 March** (Section 2(41), Companies Act 2013).
 - Periodicity is what creates the entire apparatus of **adjusting entries** — outstanding, prepaid, accrued, unearned. Without period-cutting, no adjustments would be needed.
- 7. Accrual Concept:** Revenues and costs are recognised as they are **earned or incurred** — not as money is received or paid — and are recorded in the financial statements of the periods to which they relate. This is a *fundamental accounting assumption* under AS-1, and is mandatory for companies under Section 128(1) of the Companies Act 2013.
- 8. Matching Concept:** Expenses of a period must be matched against the revenues of that same period, irrespective of when cash moves. Revenue is recognised first; then all costs incurred to earn that revenue are set against it.
- 9. Revenue Recognition (Realisation) Concept:** Revenue is recognised when it is earned and the significant risks and rewards of ownership have passed to the buyer, and it is measurable and collectible — not necessarily when cash is received. Governed in India by **AS-9 (Revenue Recognition)** and by **Ind AS 115** for Ind AS entities.

The three ordinary triggers under AS-9:

Type of transaction	Revenue recognised when
Sale of goods	Property in goods transferred; significant risks and rewards passed; no significant uncertainty in collection
Rendering of services	Proportionate completion method, or completed service method
Interest / Royalty / Dividend	Interest — time proportion basis; Royalty — accrual per agreement; Dividend — when right to receive is established

Note: Where a sale is *assured* under a government guarantee or a forward contract, or where a **homogeneous market exists and there is negligible risk of failure to sell**, revenue may be recognised on **completion of production**, before any sale takes place. AS-9 gives the classic examples: **gold and silver bullion, and certain agricultural produce**. For gold, the revenue arises in the period in which it is **mined**, because gold has a guaranteed world market and a determinable price.

Accounting Conventions

Basis	Accounting Assumptions	Accounting Conventions
Meaning	Basic principles presumed to be followed while preparing financial statements.	Established accounting practices developed through usage and professional experience.
Nature	Fundamental and mandatory unless disclosed otherwise.	Guidelines followed to ensure reliability and uniformity of financial statements.
Disclosure	Disclosure is required only if a fundamental assumption is not followed (AS 1).	No such disclosure requirement; conventions are followed unless an accounting standard or law requires otherwise.
Objective	Provide the foundation for accounting.	Improve the quality, reliability, and comparability of accounting information.
Number (AS 1)	Three	Four (commonly accepted)

1. Convention of Conservatism (Prudence)

Anticipate no profit, but provide for all possible losses. Where two values are defensible, choose the one that understates income and assets and overstates liabilities.

* Common Applications

- Inventory valued at Cost or Net Realisable Value (NRV), whichever is lower** – Recognises losses when NRV falls but does not recognise unrealised gains when NRV rises.
- Provision for Doubtful Debts** – Creates a provision for expected bad debts before the actual loss occurs.
- Provision for Discount on Debtors** – Recognises the likely reduction in collections due to future discounts.

- **Provision for Diminution in Value of Investments / Investment Fluctuation Reserve** – Anticipates a probable decline in the value of long-term investments.
- **Self-generated Goodwill is not recognised** – Prevents recording unrealised gains that cannot be measured reliably.
- **Research Expenditure charged to Profit & Loss Account** – Avoids capitalising benefits that are uncertain.
- **Contingent Losses are provided for, but Contingent Gains are not recognised** – Reflects the asymmetric treatment required under the prudence principle.

2. Convention of Consistency

Accounting policies once adopted should be applied uniformly from period to period, so that the financial statements of successive years are comparable. Consistency does not forbid change; it forbids *undisclosed* or *unjustified* change.

- A change is permitted if it is required by statute, required by an accounting standard, or results in a **more appropriate presentation**.
- When a policy changes, AS-1 requires disclosure of the change, the reason, and the **monetary effect** where ascertainable.
- Consistency has three dimensions: **vertical** (across items in one year's statements), **horizontal** (same entity across years), and **third-dimensional / inter-firm** (across entities in an industry).
- Consistency is a **fundamental accounting assumption** under AS-1 — not merely a "consideration in selecting policies".

3. Convention of Full Disclosure

All information of material interest to the users of financial statements must be disclosed fully, fairly and adequately — whether inside the statements or by way of notes. The statements should not merely be *not false*; they should be *not misleading by omission*.

Where full disclosure operates:

- **Notes appended for contingent liabilities** — guarantees given, bills discounted not yet matured, disputed tax demands, pending litigation. The liability may never arise, so it is not booked; but hiding it would mislead, so it is disclosed.
- Disclosure of accounting policies (AS-1) as a single block at one place in the statements.
- Related-party transactions (AS-18), segment information (AS-17), events after the balance sheet date (AS-4).
- Schedule III of the Companies Act 2013 prescribes the disclosure format precisely so that disclosure cannot be selectively curtailed.

4. Convention of Materiality

An item is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Immaterial items may be treated in whatever way is most convenient, provided the treatment does not mislead.

- Materiality has a **quantitative** side (size relative to profit, turnover, or asset base) and a **qualitative** side (a small payment that is illegal, or a small transaction with a director, is material regardless of amount).
- Practical application: a ₹500 calculator is expensed rather than capitalised and depreciated over five years — technically wrong, materially irrelevant.
- Materiality is what makes an audit possible; a 100% check of every transaction is neither required nor economic.

Practice Questions

Q1. (EPFO EO/AO 2017)

As per the traditional approach, the expense to be matched with revenue is based on

- (a) original cost
- (b) opportunity cost
- (c) replacement cost
- (d) cash cost

Q2. (EPFO EO/AO 2017)

In case of gold, revenue is recognized in the accounting period in which the gold is

- (a) delivered
- (b) sold
- (c) mined
- (d) identified to be mined

Q3. (EPFO EO/AO 2021)

What is the underlying accounting concept that supports no anticipation of profits but provision for all possible losses?

- (a) Matching
- (b) Materiality
- (c) Consistency
- (d) Conservatism

Q4. (EPFO EO/AO 2021)

Which one of the following accounting concepts is applied by an entity, when events such as a new competitor entering the market and a rift between production and marketing departments are not disclosed in the books of accounts?

- (a) Matching
- (b) Money Measurement
- (c) Revenue Recognition
- (d) Cost

Q5. (EPFO APFC 2023)

In a business firm, assets of the business are valued on the basis of their intrinsic value rather than realizable value. This accounting is based on

- (a) money measurement concept
- (b) matching concept
- (c) going concern assumption
- (d) consistency principle

Q6. (EPFO APFC 2023)

The value of long-term investment in shares is subject to wide fluctuations. A provision created against fluctuation in value of investments is based on the convention of

- (a) conservatism
- (b) full disclosure
- (c) materiality
- (d) consistency

Q7. (EPFO EO/AO 2023)

The practice of appending notes regarding contingent liability in accounting statements is pursuant to

- (a) Convention of consistency
- (b) Money measurement concept
- (c) Convention of conservatism
- (d) Convention of full disclosure

Q8. (UPSC EPFO, 2025)

The principle of inventory valuation — "cost or net realisable value, whichever is lower" — is based on

- (a) Accrual Concept
- (b) Matching Concept
- (c) Money Measurement Concept
- (d) Convention of Conservatism

Q9. A proprietor introduces ₹5,00,000 cash into his business and subsequently withdraws ₹50,000 for personal use. Which of the following correctly describes the effect of these transactions on the accounting equation?

- (a) Assets increase by ₹4,50,000 and capital increases by ₹4,50,000
- (b) Assets increase by ₹5,00,000 and liabilities increase by ₹5,00,000
- (c) Assets increase by ₹4,50,000 and liabilities increase by ₹4,50,000
- (d) Assets remain unchanged and capital increases by ₹4,50,000

Q10. A business receives ₹1,20,000 in cash during the year, of which ₹20,000 relates to services to be provided in the next accounting year. If the business recognises the entire ₹1,20,000 as revenue of the current year, which accounting principle has primarily been violated?

- (a) Money Measurement
- (b) Accrual
- (c) Dual Aspect
- (d) Going Concern

Q11. A company is aware that a probable loss may arise from a pending legal claim and makes an appropriate provision, while also disclosing the relevant details in the financial statements. Which pair of accounting conventions is most directly reflected?

- (a) Consistency and Materiality
- (b) Conservatism and Full Disclosure
- (c) Materiality and Consistency
- (d) Full Disclosure and Money Measurement

Q12. A business changes its method of depreciation every year solely to obtain a more favourable reported profit, without any change in the underlying circumstances. Which accounting principle is most directly violated?

- (a) Matching
- (b) Consistency
- (c) Prudence
- (d) Money Measurement

Q13. A machine is purchased for ₹10,00,000. Its market value rises to ₹14,00,000 by the end of the year, but the business continues to use the machine and does not revalue it under the applicable accounting framework. Which accounting concept most directly supports recording the asset on the basis of its acquisition cost rather than simply recognising the ₹4,00,000 increase?

- (a) Going Concern
- (b) Historical Cost

- (c) Matching
(d) Accounting Period

Q14. Which of the following transactions would ordinarily NOT be recorded in the books of account because it cannot be reliably expressed in monetary terms?

- (a) Purchase of machinery for ₹8,00,000
(b) Appointment of a highly experienced Chief Executive Officer
(c) Payment of salary of ₹1,50,000
(d) Purchase of inventory on credit for ₹3,00,000

Q15. Capital brought in by the proprietor results in

- (a) Increase in asset and increase in liability.
(b) Increase in asset and increase in capital.
(c) Increase in asset and decrease in liability.
(d) Decrease in asset and increase in capital.

Q16. A businessman purchased goods for ₹25,00,000 and sold 80% of such goods during the accounting year ended 31st March, 20X1. The market value of the remaining goods was ₹4,00,000. He valued the closing inventory at cost. He violated the concept of

- (a) Money measurement.
(b) Conservatism.
(c) Cost.
(d) Matching.

Q17. The concept of conservatism when applied to the balance sheet results in

- (a) Understatement of assets.
(b) Overstatement of assets.
(c) Overstatement of capital.
(d) Overstatement of income.

Q18. Purchase of machinery for cash

- (a) Decreases total assets.
(b) Increases total assets.
(c) Retains total assets unchanged.
(d) Increases owner's capital.

Q19. Accounting is the process of identifying, measuring, recording, classifying, summarising and communicating financial information. This definition emphasises the role of accounting as:

- (a) A recording process only
(b) An information system for decision-making
(c) A legal requirement
(d) A cost-control tool

Q20. Which of the following correctly distinguishes Book-keeping from Accounting?

- (a) Book-keeping is analytical; Accounting is clerical
(b) Book-keeping is primary; Accounting begins where Book-keeping ends
(c) Book-keeping includes interpretation; Accounting is only recording
(d) Both are identical in scope

Q21. The Business Entity Concept treats the business as:

- (a) Legally separate from the owner in all cases
(b) Separate and distinct from its owners for accounting purposes
(c) Identical with the owner
(d) A temporary association

Q22. Historical Cost Concept means an asset is recorded at:

- (a) Current market value
(b) Replacement cost
(c) Price actually paid to acquire it
(d) Net realisable value

Q23. The Accounting Period Concept leads to the need for:

- (a) No adjustments
(b) Adjusting entries
(c) Continuous audit
(d) Liquidation basis

Q24. Accrual Concept requires revenues and costs to be recognised:

- (a) When cash is received or paid
(b) When earned or incurred
(c) Only at year-end
(d) On cash basis for all entities

Q25. Matching Concept requires expenses to be matched against:

- (a) Cash receipts of the period
(b) Revenues of the same period
(c) Capital introduced
(d) Closing stock

Q26. Revenue is recognised under AS-9 when:

- (a) Cash is received
(b) Significant risks and rewards have passed and it is measurable and collectible
(c) Goods are manufactured
(d) Order is received

Q27. Interest on capital is:

- (a) Expense of the business and income of the owner
(b) Income of the business
(c) Not recorded
(d) Capital receipt

Q28. The Convention of Conservatism is also known as:

- (a) Consistency
(b) Prudence
(c) Materiality
(d) Full disclosure

Q29. "Anticipate no profit, but provide for all possible losses" is the statement of:

- (a) Matching concept
(b) Conservatism
(c) Going concern
(d) Dual aspect

Q30. Which of the following is NOT recognised as an internally generated intangible asset under the relevant accounting principles?

- (a) Internally generated goodwill
- (b) Purchased goodwill
- (c) Purchased patent
- (d) Acquired trademark

Q31. Consistency does not forbid change; it forbids:

- (a) Any change
- (b) Undisclosed or unjustified change
- (c) Change required by statute
- (d) Change resulting in better presentation

Q32. When a probable loss is provided for and details are disclosed, the pair of conventions reflected is:

- (a) Consistency and Materiality
- (b) Conservatism and Full Disclosure
- (c) Materiality and Consistency
- (d) Full Disclosure and Money Measurement

Q33. A machine purchased for ₹10,00,000 whose market value rises to ₹14,00,000 is continued to be shown at cost. This is supported by:

- (a) Going concern
- (b) Historical cost
- (c) Matching
- (d) Accounting period

Q34. Provision for doubtful debts is an application of:

- (a) Consistency
- (b) Conservatism
- (c) Materiality
- (d) Full disclosure

Q35. Notes regarding contingent liability are appended pursuant to:

- (a) Conservatism
- (b) Full disclosure
- (c) Consistency
- (d) Money measurement

Q36. The three fundamental accounting assumptions under AS-1 are:

- (a) Going Concern, Consistency, Accrual
- (b) Going Concern, Conservatism, Materiality
- (c) Consistency, Matching, Accrual
- (d) Going Concern, Accounting Period, Accrual

Answers & Explanations

Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.
1	a	2	c	3	d	4	b	5	c
6	a	7	d	8	d	9	a	10	b
11	b	12	b	13	b	14	b	15	b
16	b	17	a	18	c	19	b	20	b
21	b	22	c	23	b	24	b	25	b
26	b	27	a	28	b	29	b	30	a
31	b	32	b	33	b	34	b	35	b
36	a								

Q1. Answer: (a) Original cost

Traditional accounting is historical-cost accounting; the expense is the original acquisition cost of the resource consumed. Options (b) and (c) belong to economic/current-value models.

Q2. Answer: (c) Mined

Gold falls under the completed production basis exception to AS-9: a homogeneous world market and an assured price mean the critical event is extraction, not sale. Contrast with ordinary goods, where the trigger is transfer of risks and rewards on sale.

Q3. Answer: (d) Conservatism

The formula "anticipate no profit, provide for all possible losses" is the textbook statement of conservatism

(prudence). Note that this is a convention, not a concept, despite the question's wording — examiners use the two words loosely, so students must answer on substance.

Q4. Answer: (b) Money Measurement

Neither a competitor's entry nor an internal departmental rift can be expressed in rupees, so neither enters the books. This is the classic "what accounting leaves out" question.

Q5. Answer: (c) Going concern assumption

Valuing at intrinsic (cost-based, use-value) rather than realisable (sale) value is meaningful only if the firm is not going to sell — i.e. only under going concern.

Q6. Answer: (a) Conservatism

A provision created against a possible future fall in value is the definition of providing for a probable loss that has not yet crystallised.

Q7. Answer: (d) Convention of full disclosure

A contingent liability is disclosed, not provided for. The act of disclosing is full disclosure. If the question had said "a provision was created for a probable liability", the answer would flip to conservatism.

Q8. Answer: (d) Convention of Conservatism

The rule books the loss when $NRV < \text{cost}$ but never books the gain when $NRV > \text{cost}$ — perfectly asymmetric, therefore conservatism. This is also the measurement rule of AS-2.

Q9. Answer: (a) Assets increase by ₹4,50,000 and capital increases by ₹4,50,000

The proprietor's initial introduction of ₹5,00,000 increases both cash (asset) and capital by ₹5,00,000. The subsequent drawings of ₹50,000 reduce both cash and capital. Therefore, the net increase in assets and capital is ₹4,50,000.

Q10. Answer: (b) Accrual

Under the accrual concept, revenue is recognised when it is earned, not merely when cash is received. The ₹20,000 relating to services to be provided in the next accounting year cannot be treated as current-year revenue.

Q11. Answer: (b) Conservatism and Full Disclosure

Recognising a provision for a probable loss reflects conservatism, while disclosing the relevant details of the legal claim reflects full disclosure. The two conventions can operate together in the same transaction.

Q12. Answer: (b) Consistency

Changing the depreciation method every year merely to obtain a favourable reported profit violates the consistency principle. Accounting policies should be applied consistently from one period to another unless there is a justified reason for change.

Q13. Answer: (b) Historical Cost

The historical cost concept supports recording an asset on the basis of its acquisition cost rather than automatically recognising an increase in market value. The ₹4,00,000 rise in market value does not by itself become accounting income.

Q14. Answer: (b) Appointment of a highly experienced Chief Executive Officer

The Money Measurement Concept restricts accounting recognition to transactions and events that can be expressed reliably in monetary terms. Although the experience and ability of a CEO may have significant business value, they are not ordinarily recorded as an asset merely because of the appointment.

Q15. Answer: (b) Increase in asset and increase in capital

Capital introduced by the proprietor results in an increase in asset and an increase in capital.

Q16. Answer: (b) Conservatism

The remaining inventory has a cost of ₹5,00,000 but a market value of ₹4,00,000. Under the prudence/conservatism principle, inventory should not be carried above the amount expected to be realised. Valuing it at ₹5,00,000 instead of ₹4,00,000 results in an overstatement of inventory and profit.

Q17. Answer: (a) Understatement of assets

Conservatism requires anticipated losses to be recognised while gains are not anticipated. When applied to the Balance Sheet, this principle therefore tends to prevent overstatement of assets and may result in their understatement.

Q18. Answer: (c) Retains total assets unchanged

When machinery is purchased for cash, one asset—cash—decreases, while another asset—machinery—increases by the same amount. Therefore, total assets remain unchanged. There is also no direct effect on owner's capital.

Q19. Answer: (b) An information system for decision-making

Accounting does not merely record financial transactions. It identifies, measures, classifies, summarises and communicates financial information to users for informed decision-making. Therefore, accounting is an information system for decision-making.

Q20. Answer: (b) Book-keeping is primary; Accounting begins where Book-keeping ends

Book-keeping is primarily concerned with the systematic recording of financial transactions. Accounting is broader and includes classification, summarisation, analysis, interpretation and communication of financial information. Thus, accounting begins where book-keeping ends.

Q21. Answer: (b) Separate and distinct from its owners for accounting purposes

The Business Entity Concept treats the business and its owner as separate entities for accounting purposes. Transactions of the business are therefore recorded separately from the personal transactions of the proprietor.

Q22. Answer: (c) Price actually paid to acquire it

Under the Historical Cost Concept, an asset is initially recorded at the amount actually paid to acquire it, including relevant acquisition costs. Its subsequent market-value changes do not automatically replace the historical cost.

Q23. Answer: (b) Adjusting entries

The Accounting Period Concept divides the continuous life of a business into specific accounting periods. Since some revenues and expenses relate to more than one

period, adjusting entries are required to determine the correct income and financial position for each period.

Q24. Answer: (b) When earned or incurred

The Accrual Concept requires revenues to be recognised when they are earned and expenses when they are incurred, irrespective of the actual receipt or payment of cash.

Q25. Answer: (b) Revenues of the same period

The Matching Concept requires expenses incurred in generating revenue to be matched with the revenues of the same accounting period. This helps in determining the correct profit or loss for the period.

Q26. Answer: (b) Significant risks and rewards have passed and it is measurable and collectible

Under AS-9, revenue recognition generally depends on the transaction satisfying the relevant recognition conditions, including the transfer of significant risks and rewards, measurability of consideration and reasonable certainty of collection.

Q27. Answer: (a) Expense of the business and income of the owner

Interest on capital is treated as an expense from the business's perspective because it represents a charge against business profit. At the same time, it is income for the proprietor.

Q28. Answer: (b) Prudence

The Convention of Conservatism is also known as the Prudence principle. It requires caution in recognising uncertain gains and losses, particularly by avoiding anticipation of profits while providing for probable losses.

Q29. Answer: (b) Conservatism

“Anticipate no profit, but provide for all possible losses” expresses the principle of Conservatism, also referred to as prudence. It requires probable losses to be recognised appropriately while unrealised profits are not anticipated.

Q30. Answer: (a) Internally generated goodwill

Explanation: Internally generated goodwill is not recognised as an asset because its cost cannot be reliably distinguished from the cost of developing the business as a whole. In contrast, identifiable intangible assets acquired separately, such as purchased patents and

trademarks, may be recognised subject to the applicable recognition criteria.

Q31. Answer: (b) Undisclosed or unjustified change

The Consistency Principle does not mean that accounting policies can never be changed. A change may be made when justified, such as when required by law or when it results in more appropriate financial reporting. What is objectionable is an undisclosed or unjustified change merely to manipulate reported results.

Q32. Answer: (b) Conservatism and Full Disclosure

Providing for a probable loss reflects Conservatism, while disclosing the relevant details in the financial statements reflects Full Disclosure. Therefore, both conventions are reflected.

Q33. Answer: (b) Historical cost

When a machine purchased for ₹10,00,000 continues to be shown at its acquisition cost despite its market value increasing to ₹14,00,000, the treatment is supported by the Historical Cost Concept. The unrealised increase in market value is not automatically recognised as income.

Q34. Answer: (b) Conservatism

A provision for doubtful debts recognises the possibility that some receivables may not be recovered. Recognising such a probable loss reflects the principle of Conservatism (Prudence).

Q35. Answer: (b) Full disclosure

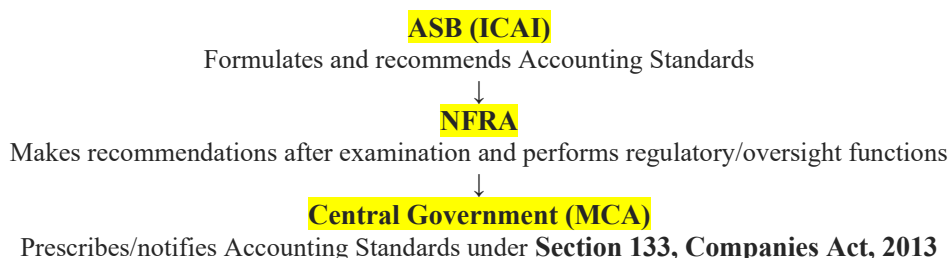
A contingent liability is generally disclosed in the notes to the financial statements when it does not meet the criteria for recognition as an actual liability. Appending notes regarding such liability therefore reflects the Full Disclosure Convention.

Q36. Answer: (a) Going Concern, Consistency, Accrual

Under AS-1, the three fundamental accounting assumptions are Going Concern, Consistency and Accrual. These assumptions form the basic foundation for preparing financial statements.

Chapter 2: Accounting Standards, Ind AS and IFRS

- Accounting Standards are formal rules governing the recognition, measurement, presentation and disclosure of accounting transactions.
- Their broad purpose is to reduce unnecessary differences in accounting practices and make financial statements more **reliable and comparable**.



Note: IASB → Develops and issues **IFRS** at the international level.

- AS** = the older Indian Accounting Standards (AS-1 to AS-29), still applicable to companies not covered by Ind AS and to non-corporate entities.
- Ind AS** = Indian Accounting Standards, converged with (not identical to) IFRS; notified under the Companies (Indian Accounting Standards) Rules, 2015.
- IFRS** = International Financial Reporting Standards, issued by IASB, used in 140+ jurisdictions.
- India has adopted **convergence**, not **adoption** — carve-outs exist to suit Indian legal and economic conditions.

Ind AS applicability roadmap

- Phase I (from 1 April 2016):** listed and unlisted companies with net worth $\geq$ ₹500 crore, and their holding, subsidiary, joint venture and associate companies.
- Phase II (from 1 April 2017):** all listed companies (or in the process of listing), and unlisted companies with net worth $\geq$ ₹250 crore.
- Banks, NBFCs and insurance companies follow a separate notified roadmap.
- Once an entity adopts Ind AS, it **cannot revert** to AS.

AS vs Ind AS vs IFRS — comparison

Point	AS (Indian GAAP)	Ind AS	IFRS
Issued by	ICAI, notified by MCA	MCA under Companies (Ind AS) Rules 2015	IASB
Numbering	AS-1 to AS-29	Ind AS 101–117 & 1–41	IFRS 1–18, IAS 1–41
Measurement base	Predominantly historical cost	Extensive fair value	Extensive fair value
Statement of P&L	Profit & Loss Account	Statement of Profit and Loss including Other Comprehensive Income (OCI)	Same
Components of financial statements	BS, P&L, Cash Flow, Notes	Adds Statement of Changes in Equity and OCI	Same
Substance over form	Applied	Applied more aggressively	Applied
Approach in India	—	Convergence with carve-outs	—

Q1. (EPFO EO/AO 2017)

In the context of accounting, the term IFRS stands for

- (a) International Financial Reporting Standards
- (b) Indian Financial Reporting Standards
- (c) Indian Financial Reporting System
- (d) International Financial Reporting System

AS-1: Disclosure of Accounting Policies *Core Focus*

Three **FUNDAMENTAL ACCOUNTING ASSUMPTIONS**

These are normally presumed to be followed.

C**Consistency**

Same accounting policies from period to period.

A**Accrual**

Recognise revenues and expenses in the period to which they relate, not merely when cash is received or paid.

G**Going Concern**

Business will continue for the foreseeable future.

Three **MAJOR CONSIDERATIONS** in selecting accounting policies

These guide the choice and application of accounting policies.

M**Materiality**

Consider only what is material; omit what is immaterial.

S**Substance over Form**

Account for the economic substance rather than merely the legal form.

P**Prudence**

Do not anticipate profits; provide for possible losses where appropriate.

Disclosure requirements of AS-1

- All significant accounting policies must be disclosed **at one place**, forming part of the financial statements.
- Any **change** in an accounting policy that has a material effect must be disclosed, along with the **amount of the effect** where ascertainable; if not ascertainable, that fact must be stated.
- If a **fundamental accounting assumption is not followed**, that fact must be disclosed.

Q2. (EPFO APFC 2023)

According to Accounting Standard-1, which of the following are the fundamental accounting assumptions?

- (a) Going Concern, Consistency, Accrual
- (b) Going Concern, Money Measurement, Conservatism
- (c) Going Concern, Consistency, Conservatism
- (d) Going Concern, Accounting Period, Accrual

Q3. (EPFO APFC 2023)

Which of the following is not a major consideration in the selection and application of accounting policies?

- (a) Prudence
- (b) Consistency
- (c) Substance over form
- (d) Materiality

Q4. (UPSC EPFO, 2025)

Which one of the following is not a 'fundamental accounting assumption' in the preparation of financial statements?

- (a) Matching concept
- (b) Going concern
- (c) Accrual
- (d) Consistency

Q5. Which of the following correctly represents the three major considerations in the selection and application of accounting policies under Accounting Standard-1?

- (a) Prudence, Substance over Form, Materiality
- (b) Prudence, Consistency, Materiality
- (c) Substance over Form, Accrual, Materiality
- (d) Materiality, Consistency, Going Concern

Q6. Which of the following is NOT correctly classified under Accounting Standard-1?

- (a) Accrual — Fundamental Accounting Assumption
- (b) Materiality — Major Consideration
- (c) Substance over Form — Major Consideration
- (d) Consistency — Major Consideration

Answers & Explanations

Q2. Answer: (a) Going Concern, Consistency, Accrual

Straight recall of AS-1. Note how every distractor keeps "Going Concern" and swaps only the second or third element — the discriminating knowledge is Consistency + Accrual.

Q3. Answer: (b) Consistency

The three considerations are Prudence, Substance over Form and Materiality. Consistency belongs to the other list — the fundamental assumptions. A student who has learned only one of the two lists gets this wrong.

Q4. Answer: (a) Matching concept

The same fact tested in the negative. Going concern, accrual and consistency are the three; matching is a concept, not a fundamental assumption. Two years apart, the same single line of AS-1 has yielded two marks.

Q5. Answer: (c) Going concern assumption

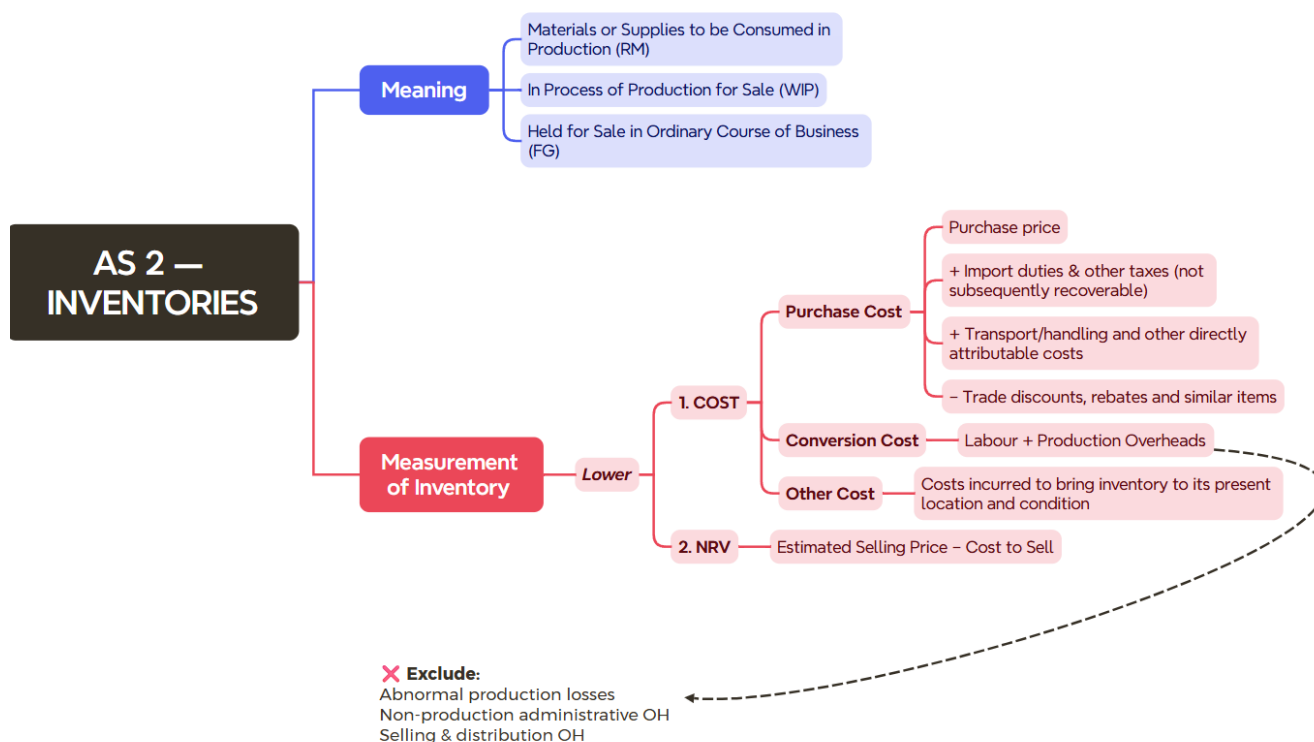
Assets are valued based on their continued use in the business rather than their immediate realisable value.

Q6. Answer: (a) Conservatism

A provision for possible decline in investment value recognises anticipated losses, reflecting conservatism.

AS-2 · Valuation of Inventories *Core Focus*

- Inventories shall be valued at the lower of cost and net realisable value.



- Lower of **Cost and NRV**
- Cost includes purchase and conversion costs and other costs necessary to bring inventory to its present location and condition.
- Abnormal wastage, unrelated administrative overheads and selling/distribution costs are generally excluded.
- FIFO and Weighted Average** are permitted cost formulas.
- LIFO is not permitted for financial reporting under AS-2/Ind AS 2**
- For detailed inventory valuation and numerical → Chapter 6

Net Realisable Value: Estimated selling price in the ordinary course of business – estimated costs of completion – estimated costs necessary to make the sale.

- The lower-of-cost-or-NRV comparison is normally made **item by item**, not on the total of the inventory.
- Materials held for use in production are **not written down below cost** if the finished goods in which they will be incorporated are expected to be sold at or above cost.

Q7. (EPFO EO/AO 2023)

Which of the following is included in the 'Cost of Inventory' according to Accounting Standard-2 (Inventory Valuation)?

- (a) Administrative overheads that do not contribute to bringing inventories to their present location and condition
- (b) Storage costs which are necessary in the production process prior to a further production stage
- (c) Selling and distribution costs
- (d) Duties and taxes paid on purchases, subsequently recoverable from the taxing authorities

Q8. (UPSC EPFO, 2025)

Which one of the following costs is generally not included in computing the cost of inventory?

- (a) Administration overheads
- (b) All cost of purchase
- (c) Normal wastage of materials
- (d) Storage cost assuming a special storage is required as part of the production process

Q7. Answer: (b) Storage costs which are necessary in the production process prior to a further production stage

- Options (a), (c) and (d) are the three textbook exclusions. Only (b) survives, because such storage is part of the production process itself — whisky in the cask is still being manufactured.

Q8. Answer: (a) Administration overheads

- The 2023 question inverted. Purchase costs and normal wastage are included; production-necessary storage is included; general administration overhead is not. Note the deliberate word normal in (c) — had it read abnormal, (c) would also have been excluded.

AS-9 · Revenue Recognition

- Revenue = gross inflow of cash, receivables or other consideration arising in the **ordinary course** of activities from the sale of goods, rendering of services, and use by others of enterprise resources yielding interest, royalties and dividends.
- **Excluded from AS-9:** revenue from construction contracts, hire-purchase and lease agreements, government grants, and revenue of insurance companies from insurance contracts.
- **Excluded from "revenue" itself:** realised gains on disposal of fixed assets, unrealised holding gains, natural increases in herds/agricultural produce, and changes in value of current assets.
- Where **collectability is uncertain at the time of the sale**, revenue recognition is **postponed**. Where uncertainty arises **subsequently**, revenue stands recognised and a **separate provision for bad debts** is made — the revenue is not reversed.

AS-10 (Property, Plant and Equipment) and depreciation standards

- The old AS-6 (Depreciation Accounting) has been **withdrawn** and merged into the revised **AS-10, Property, Plant and Equipment**. The corresponding standard for Ind AS entities is **Ind AS 16**.
- Cost of an item of PPE includes purchase price, import duties and non-refundable taxes, directly attributable costs of bringing the asset to location and condition (site preparation, initial delivery and handling, installation and assembly, professional fees, testing), and the initial estimate of dismantling and site restoration costs.
- Depreciable amount = **Cost – Residual value**, allocated on a systematic basis over the **useful life**.
- The depreciation method must reflect the **pattern of consumption of future economic benefits** and is reviewed at least at each financial year end; a change is treated as a **change in accounting estimate**, applied prospectively.
- **Component accounting** is mandatory: significant parts of an asset with different useful lives are depreciated separately.

IND-AS PAIRINGS

AS-2	→ Ind AS 2	— Inventories
AS-3	→ Ind AS 7	— Cash Flow Statements
AS-9	→ Ind AS 115	— Revenue
AS-10	→ Ind AS 16	— Property, Plant & Equipment
AS-11	→ Ind AS 21	— Foreign Exchange
AS-16	→ Ind AS 23	— Borrowing Costs
AS-18	→ Ind AS 24	— Related Party Disclosures
AS-28	→ Ind AS 36	— Impairment of Assets
AS-29	→ Ind AS 37	— Provisions & Contingencies

Practice Questions

Q1. Accounting Standards are formal rules governing:

- (a) Only disclosure
- (b) Recognition, measurement, presentation and disclosure
- (c) Only measurement
- (d) Tax computation

Q2. In India, Accounting Standards are finally notified by:

- (a) ICAI
- (b) NFRA
- (c) Central Government (MCA) under Section 133
- (d) RBI

Q3. IFRS stands for:

- (a) Indian Financial Reporting Standards
- (b) International Financial Reporting Standards
- (c) International Financial Reporting System
- (d) Indian Financial Reporting System

Q4. India has adopted:

- (a) Full adoption of IFRS
- (b) Convergence with IFRS (with carve-outs)
- (c) Only AS
- (d) US GAAP

Q5. Once an entity adopts Ind AS, it:

- (a) Can revert to AS
- (b) Cannot revert to AS
- (c) Can switch every year
- (d) Must follow both

Q6. The three fundamental accounting assumptions under AS-1 are:

- (a) Going Concern, Consistency, Accrual
- (b) Going Concern, Prudence, Materiality
- (c) Consistency, Substance over form, Materiality
- (d) Accrual, Matching, Conservatism

Q7. Which is NOT a major consideration in selection of accounting policies under AS-1?

- (a) Prudence
- (b) Consistency
- (c) Substance over form
- (d) Materiality

Q8. Under AS-2, inventories are valued at:

- (a) Cost
- (b) Net Realisable Value
- (c) Lower of cost and NRV
- (d) Higher of cost and NRV

Q9. Which cost is generally NOT included in cost of inventory under AS-2?

- (a) Purchase cost
- (b) Normal wastage
- (c) Administrative overheads that do not contribute to

bringing inventories to present location and condition
(d) Storage costs necessary in production process

Q10. LIFO is:

- (a) Permitted under AS-2
- (b) Not permitted under AS-2 / Ind AS 2 for financial reporting
- (c) Mandatory
- (d) Preferred method

Q11. AS-9 deals with:

- (a) Inventories
- (b) Revenue Recognition
- (c) Depreciation
- (d) Cash Flow

Q12. Under AS-9, when collectibility is uncertain at the time of sale:

- (a) Revenue is still recognised
- (b) Revenue recognition is postponed
- (c) Revenue is reversed later
- (d) Provision is created after recognition

Q13. Match List I with List II:

List I	List II
(a) AS-2	(i) Revenue Recognition
(b) AS-3	(ii) Leases
(c) AS-9	(iii) Valuation of Inventories
(d) AS-19	(iv) Cash Flow Statement

code:

- (a) (a)-(iii), (b)-(iv), (c)-(i), (d)-(ii)
- (b) (a)-(i), (b)-(iii), (c)-(ii), (d)-(iv)
- (c) (a)-(iv), (b)-(ii), (c)-(iii), (d)-(i)
- (d) (a)-(ii), (b)-(i), (c)-(iv), (d)-(iii)

Q14. Match List I with List II:

List I	List II
(a) Ind AS 2	(i) Property, Plant and Equipment
(b) Ind AS 7	(ii) Separate Financial Statements
(c) Ind AS 16	(iii) Cash Flow Statement
(d) Ind AS 27	(iv) Inventories

code:

- (a) (a)-(iv), (b)-(iii), (c)-(i), (d)-(ii)
- (b) (a)-(iii), (b)-(iv), (c)-(ii), (d)-(i)
- (c) (a)-(ii), (b)-(i), (c)-(iv), (d)-(iii)
- (d) (a)-(i), (b)-(ii), (c)-(iii), (d)-(iv)

Q15. Storage costs necessary in the production process prior to a further production stage are:

- (a) Excluded from inventory cost
- (b) Included in inventory cost
- (c) Treated as administrative overhead
- (d) Charged to P&L immediately

Q16. Selling and distribution costs under AS-2 are:

- (a) Included in inventory
- (b) Generally excluded

- (c) Capitalised
(d) Treated as deferred revenue

Q17. Duties and taxes subsequently recoverable from taxing authorities are:

- (a) Included in cost of inventory
(b) Excluded from cost of inventory
(c) Treated as prepaid expense
(d) Added to capital

Q18. The lower-of-cost-or-NRV comparison is normally made:

- (a) On total inventory
(b) Item by item
(c) On category basis only
(d) At management's discretion

Q19. Materials held for use in production are not written down below cost if:

- (a) Finished goods are expected to be sold at or above cost
(b) Market price has fallen
(c) They are obsolete
(d) Management decides so

Q20. AS-10 deals with:

- (a) Inventories
(b) Property, Plant and Equipment

- (c) Revenue
(d) Provisions

Q21. Depreciable amount under AS-10 is:

- (a) Cost
(b) Cost less residual value
(c) Market value
(d) Replacement cost

Q22. Change in depreciation method is treated as:

- (a) Change in accounting policy
(b) Change in accounting estimate (prospective)
(c) Prior period error
(d) Extraordinary item

Q23. Which of the following is NOT a component of financial statements under Ind AS?

- (a) Balance Sheet
(b) Statement of Profit and Loss including OCI
(c) Statement of Changes in Equity
(d) Manufacturing Account

Q24. NFRA's role in the standard-setting process is primarily:

- (a) Formulating standards
(b) Making recommendations after examination and oversight
(c) Notifying standards
(d) Issuing IFR

Answers & Explanations

Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.
1	b	2	c	3	b	4	b	5	b
6	a	7	c	8	c	9	c	10	b
11	b	12	b	13	a	14	a	15	b
16	b	17	b	18	b	19	a	20	b
21	b	22	b	23	d	24	b		

Q1. Answer: (b) Recognition, measurement, presentation and disclosure

Accounting Standards provide rules for recognition, measurement, presentation and disclosure of financial information.

Q2. Answer: (c) Central Government (MCA) under Section 133

Accounting Standards are notified by the Central Government through the MCA under Section 133 of the Companies Act, 2013.

Q3. Answer: (b) International Financial Reporting Standards

IFRS stands for **International Financial Reporting Standards**, issued by the IASB.

Q4. Answer: (b) Convergence with IFRS (with carve-outs)

India follows **Ind AS**, which is based on IFRS with certain Indian-specific modifications called carve-outs.

Q5. Answer: (b) Cannot revert to AS

Once an entity is required to adopt Ind AS, it cannot voluntarily revert to the earlier Accounting Standards.

Q6. Answer: (a) Going Concern, Consistency, Accrual

AS-1 identifies **Going Concern, Consistency and Accrual** as the three fundamental accounting assumptions.

Q7. Answer: (b) Consistency**Q8. Answer: (c) Lower of cost and NRV**

Under AS-2, inventories are valued at the **lower of cost and net realisable value (NRV)**.

Q9. Answer: (c) Administrative overheads that do not contribute to bringing inventories to present location and condition

Such administrative overheads do not form part of inventory cost and are generally charged as expenses.

Q10. Answer: (b) Not permitted under AS-2 / Ind AS 2 for financial reporting

LIFO is not permitted as an inventory cost formula under AS-2 or Ind AS 2.

Q11. Answer: (b) Revenue Recognition
AS-9 deals with **Revenue Recognition**.**Q12. Answer: (b) Revenue recognition is postponed**

When collectibility is uncertain at the time of sale, revenue recognition is postponed until appropriate certainty exists.

Q13. Answer: (a)

AS-2 relates to **Valuation of Inventories**, AS-3 to **Cash Flow Statement**, AS-9 to **Revenue Recognition**, and AS-19 to **Leases**.

Q14. Answer: (a)

Ind AS 2 relates to **Inventories**, Ind AS 7 to **Cash Flow Statement**, Ind AS 16 to **Property, Plant and Equipment**, and Ind AS 27 to **Separate Financial Statements**.

Q15. Answer: (b) Included in inventory cost

Storage costs necessary in the production process before a further production stage are included in inventory cost.

Q16. Answer: (b) Generally excluded

Selling and distribution costs do not bring inventories to their present location and condition and are generally excluded from inventory cost.

Q17. Answer: (b) Excluded from cost of inventory

Duties and taxes that are subsequently recoverable from taxing authorities are excluded from inventory cost.

Q18. Answer: (b) Item by item

The lower of cost and NRV comparison is normally applied **item by item** to inventories.

Q19. Answer: (a) Finished goods are expected to be sold at or above cost

Materials are not written down below cost when the finished goods in which they will be incorporated are expected to be sold at or above cost.

Q20. Answer: (b) Property, Plant and Equipment
AS-10 deals with **Property, Plant and Equipment (PPE)**.**Q21. Answer: (b) Cost less residual value**

Depreciable amount is the **cost of an asset less its residual value**.

Q22. Answer: (b) Change in accounting estimate (prospective)

A change in depreciation method is treated as a **change in accounting estimate** and is applied prospectively.

Q23. Answer: (d) Manufacturing Account

The financial statements under Ind AS include the Balance Sheet, Statement of Profit and Loss including OCI, and Statement of Changes in Equity. A Manufacturing Account is not a component of Ind AS financial statements.

Q24. Answer: (b) Making recommendations after examination and oversight

NFRA examines and oversees the accounting and auditing framework and makes recommendations relating to accounting standards; the Central Government notifies the standards.

Chapter 3: The Accounting Process

Every transaction a business enters into travels through the same sequence of steps before it can appear in a financial statement. This sequence — the accounting cycle — is what gives double-entry bookkeeping its discipline: nothing reaches the Balance Sheet without first being recorded, classified and cross-checked.

- Transaction and source document — an event occurs and generates documentary evidence: an invoice, a voucher, a receipt.
- **Journal (Books of Original Entry)** — the first formal record, where the transaction is analysed into its debit and credit aspects.
- **Ledger** — entries from the journal and subsidiary books are posted, classifying them account by account.
- **Balancing of ledger accounts** — each account's two sides are totalled and reduced to a single closing balance.
- **Trial Balance** — an arithmetical proof, listing every ledger balance, that total debits equal total credits.
- **Adjusting entries** — outstanding and prepaid items, depreciation, closing stock and provisions are brought into the books.
- **Final Accounts** — the Trading Account, Profit & Loss Account and Balance Sheet are prepared.
- **Closing entries** — nominal accounts are closed off, and balances carry forward to open the next period.

Q1. (EPFO EO/AO 2021)

Which one of the following is the first book in which the transactions of a business unit are recorded?

- (a) Balance Sheet (b) Cash Book (c) Ledger (d) Journal

Answer: (d) Journal

- The Journal is the book of original entry. The Cash Book is a book of original entry too, but only for cash and bank transactions — it is a subsidiary book, a specialised extract of the journal. The general answer to "the first book" is Journal.

Classification of accounts *Core Focus*

1. Traditional (English) approach

- The traditional approach sorts every ledger account into one of three baskets — Personal, Real or Nominal — and each basket carries its own **golden rule** that decides which side of the account gets debited and which gets credited.

Account Type	Meaning	Sub-types & Common Examples	Golden Rule
Personal Account	Accounts relating to persons and legal entities.	• Natural Personal: Ramesh, Suresh • Artificial Personal: HDFC Bank A/c, XYZ Ltd. A/c, Clubs, Co-operative Societies, Government Bodies • Representative Personal: Outstanding Salary, Outstanding Rent, Prepaid Insurance, Accrued Income, Income Received in Advance, Capital A/c, Drawings A/c	• Debit the Receiver • Credit the Giver
Real Account	Accounts of tangible and intangible assets.	Cash, Building, Machinery, Furniture, Stock, Goodwill, Patents, Trademarks, Copyrights	• Debit what comes in • Credit what goes out
Nominal Account	Accounts relating to expenses, losses, incomes and gains.	Salary, Rent, Wages, Interest, Commission, Discount, Trading A/c, Profit & Loss A/c, Income & Expenditure A/c	• Debit all Expenses & Losses • Credit all Incomes & Gains

Note:

- Any expense or income prefixed by "**Outstanding**", "**Prepaid**", "**Accrued**", "**Unearned**" or "**Received in Advance**" ceases to be Nominal and becomes a **REPRESENTATIVE PERSONAL** account — because it now represents the person to whom money is owed or by whom it is owed. *Rent A/c = Nominal. Outstanding Rent A/c = Representative Personal*
- Goodwill is a REAL account** — it is an asset, and intangibility is irrelevant to the classification. The same applies to Patents, Trademarks, Copyrights and Designs.

Questions — Classify each account (Personal / Real / Nominal) under the Traditional Approach

1. Ram's Account (a debtor)	14. Bank Overdraft Account	25. Trademark Account
2. Cash Account	15. Purchases Account	26. Municipal Corporation Account (paying property tax)
3. Building Account	16. Sales Account	27. Charity/Donation Account
4. Goodwill Account	17. Discount Received Account	28. Investment Account
5. Patents Account	18. Discount Allowed Account	29. Income and Expenditure Account
6. Salaries Account	19. Bad Debts Account	30. Branch Account (under Debtors System)
7. Outstanding Salaries Account	20. Bad Debts Recovered Account	31. Suspense Account
8. Prepaid Insurance Account	21. Provision for Doubtful Debts Account	32. Loan from X Account
9. Rent Received in Advance Account	22. Depreciation Account	33. Stock/Inventory Account
10. Accrued Interest Account	23. Interest on Capital Account	34. Wages Account
11. Capital Account	24. Interest on Drawings Account	35. Carriage Inward Account
12. Drawings Account		
13. Bank Account (e.g., HDFC Bank A/c)		

Answers

1. Personal (Natural) — an account of a living person	19. Nominal — loss
2. Real — tangible asset	20. Nominal — gain
3. Real — tangible asset	21. Nominal — a charge against profit, not a real asset/liability account itself
4. Real — intangible, but still an asset	22. Nominal — loss/expense
5. Real — intangible asset	23. Nominal — expense (from the business's point of view)
6. Nominal — expense	24. Nominal — income (from the business's point of view)
7. Personal (Representative) — "Outstanding" prefix → represents the employee to whom it's owed	25. Real — intangible asset
8. Personal (Representative) — "Prepaid" prefix → represents the insurer who owes the service	26. Personal (Artificial) — a body corporate/local authority is an artificial person
9. Personal (Representative) — represents the tenant to whom the amount/service is owed	27. Nominal — expense
10. Personal (Representative) — represents the party who owes the interest	28. Real — asset
11. Personal (Artificial/Representative) — represents the owner's claim on the business	29. Nominal — summary account of revenue items (NPO equivalent of P&L)
12. Personal — represents the proprietor as a person taking value out	30. Nominal — it's a profit-computing account, not a real debtor
13. Personal (Artificial) — bank is an artificial legal person	31. Personal (Artificial) — technically a "nowhere" account, but usually treated as Personal since it holds unmatched amounts pending identification
14. Personal (Artificial) — same reasoning, just a credit balance	32. Personal (Natural/Artificial, depending on lender) — represents the lender
15. Nominal — expense-type account	33. Real — asset
16. Nominal — income-type account	34. Nominal — direct expense
17. Nominal — gain	35. Nominal — direct expense
18. Nominal — loss/expense	

Q2. (EPFO APFC 2023) Goodwill Account is a/an

- (a) Personal Account
- (b) Real Account
- (c) Nominal Account
- (d) Expense Account

Q3. (EPFO EO/AO 2023) 'Outstanding rent' may be classified as

- (a) Natural personal account
- (b) Representative personal account
- (c) Real account
- (d) Nominal account

Q4. (EPFO EO/AO 2017) Income and Expenditure Account is

- (a) Real Account
- (b) Personal Account
- (c) Nominal Account
- (d) Capital Account

Q5. (EPFO EO/AO 2021) Which one of the following statements is correct about Income and Expenditure Account?

- (a) It is a Real Account.
- (b) It is a Personal Account.
- (c) It is a Nominal Account.
- (d) It is a Representative Personal Account.

Q6. (EPFO EO/AO 2017) Branch Account under Debtors System is

- (a) Real Account
- (b) Personal Account
- (c) Nominal Account
- (d) Liability Account

Q2. Answer: (b) Real Account

Goodwill is an intangible asset, and all asset accounts — tangible or intangible — are Real accounts.

Q3. Answer: (b) Representative personal account

Outstanding Rent represents the landlord to whom rent is due. The prefix converts a Nominal account into a Representative Personal account.

Q4. Answer: (c) Nominal Account

It is the not-for-profit equivalent of the Profit & Loss Account — a summary of revenue incomes and revenue expenditures. All such summary accounts are Nominal.

Q5. Answer: (c) It is a Nominal Account.

EO/AO 2017 and 2021 EO/AO tested the same concept.

Q6. Answer: (c) Nominal Account

Under the Debtors System the Branch Account is a profit-finding account maintained in the Head Office books: goods sent, expenses and opening balances are debited, sales and closing balances credited, and the balancing figure is branch profit. Because its purpose is to compute profit, it is a Nominal account.

2. Modern (American) approach

Class	Increase	Decrease	Examples
Asset accounts	Debit	Credit	Cash, Machinery, Debtors
Liability accounts	Credit	Debit	Creditors, Loans, Outstanding expenses
Capital accounts	Credit	Debit	Capital, Reserves
Revenue accounts	Credit	Debit	Sales, Commission received
Expense accounts	Debit	Credit	Salaries, Rent, Purchases

- Since Capital is credited to increase, the **Capital Account normally carries a CREDIT balance**, never a debit balance.
- A debit balance in Capital means the proprietor has withdrawn more than the business owes him — a deficiency.

Q7. (UPSC EPFO, 2025)

Which one of the following statements is not correct?

- (a) Capital account has a debit balance.
- (b) Discount column of cash book records cash discount.
- (c) Under traditional approach, rent outstanding is a personal account.
- (d) Cash sales are not recorded in the sales day book.

Answer: (a) Capital account has a debit balance.

Capital normally has a credit balance. Statements (b), (c) and (d) are all correct: the cash book's discount columns record only cash discount (trade discount never enters the books); outstanding rent is a representative personal account; and cash sales bypass the sales day book and go straight into the Cash Book.

Books of original entry — the subsidiary books

- Rather than funnel every transaction through one crowded Journal, a business splits its routine, high-volume transactions into specialised subsidiary books, each dedicated to a single class of transaction and each ultimately feeding the ledger just as the Journal would.

Subsidiary Book	Records	Never records
Purchases Book (Purchase Day Book)	Credit purchases of goods only	Cash purchases; purchase of assets
Sales Book (Sales Day Book)	Credit sales of goods only	Cash sales ; sale of assets
Purchases Return / Returns Outward Book	Goods returned to suppliers	—
Sales Return / Returns Inward Book	Goods returned by customers	—
Bills Receivable Book	Bills accepted by customers in our favour	—
Bills Payable Book	Bills accepted by us in favour of creditors	—
Cash Book	All cash and bank receipts and payments	Credit transactions
Journal Proper	Residual book, catching every transaction that does not fit any of the above: opening entries, closing entries, rectification entries, and — as above — credit purchases or sales of assets.	—

- The Purchases Book records **credit purchases of goods meant for resale** — nothing else. A **credit purchase of machinery** belongs in the **Journal Proper**. Recording it in the Purchases Book is not a clerical slip; it is an **error of principle**, because it converts a capital item into a revenue item. This exact scenario was asked in 2023

The Cash Book

- it is simultaneously a book of original entry and a ledger account, functioning as the Cash and Bank account in its own right. No separate Cash Account is ever opened in the ledger, because the Cash Book already is that account

Type	Columns	Note
Single column	Cash only	Simplest
Double column	Cash + Bank, or Cash + Discount	Contra entries appear in the Cash+Bank version
Triple column	Cash + Bank + Discount	Most common in exams
Petty Cash Book	Small recurring expenses	Run on the Imprest System

In the books of Udhayakumar

Dr.

Three column cash book

Cr.

Date	Particulars	R.N	L.F	Amount ₹			Date	Particulars	V.N	L.F	Amount ₹		
				Discount Allowed	Cash	Bank					Discount Received	Cash	Bank
2017							2017						
Sep 1	To Balance b/d				25,000		Sep 1	By Balance b/d					13,070
3	To Cash A/c		C			15,000	3	By Bank A/c		C		15,000	
4	To Shyamala & Co. A/c			120	9,380		11	By Purchases A/c				11,750	
10	To Sales A/c				7,600		12	By Padma A/c			125		21,375
23	To Rajasekar A/c			180	14,320		18	By Printer A/c					7,600
30	To Balance c/d					27,045	30	By Balance c/d				29,550	
				300	56,300	42,045					125	56,300	42,045
Oct 1	To Balance b/d				29,550		Oct 1	By Balance b/d					27,045

- The Cash Book is **both a journal and a ledger** — a book of original entry *and* the Cash/Bank account itself. No separate Cash Account is opened in the ledger.
- Contra entry** — a transaction affecting both cash and bank (cash deposited into bank, cash withdrawn from bank for office use). Marked "C" in the L.F. column; it is **not posted to the ledger**.
- Discount columns are memorandum columns**, not accounts. They are **totalled and posted, never balanced**. Discount allowed (debit side) is posted to the debit of Discount Allowed A/c; discount received (credit side) to the credit of Discount Received A/c.
- Only **cash discount** ever appears in the books. **Trade discount is deducted on the invoice itself** and is never recorded anywhere in the accounts.
- Imprest system**: the petty cashier is given a fixed float; at the end of the period he is reimbursed exactly what he spent, restoring the float to the original figure.



Credit terms

- **Credit terms are written as [discount %] / [days within which it applies], net [final due date].** A term written "2½/10, 1/20, net 30" means: deduct 2.5% if paid within 10 days; deduct 1% if paid within 20 days; otherwise pay the full amount by day 30.
- **Method for a credit-terms numerical:** for each invoice, find the *latest* discount slab whose day-limit is not yet exceeded on the payment date, apply that percentage, and total.

Q8. (EPFO APFC 2015)

A firm is purchasing two items, both on credit on the same day. The credit term offered for the first item is 2½/10, 1/20, net 30; and the credit term offered for the second item is 3/5, 2/15, net 30. The declared purchase cost of item 1 is ₹60,000 and that of item 2 is ₹1,40,000. If both credits can be settled on the 14th day, what will be the total amount to be paid out?

- (a) ₹1,97,200
- (b) ₹1,97,500
- (c) ₹1,96,600
- (d) ₹1,98,400

Answer: (c) ₹1,96,600

- Item 1 — $60,000 \times 99\% = ₹59,400$.
- Item 2 — $1,40,000 \times 98\% = ₹1,37,200$.
- Total = $59,400 + 1,37,200 = ₹1,96,600$.

Q9. A firm purchases two items on credit on the same day. The credit terms offered for the first item are 2/10, 1/20, net 30, while those offered for the second item are 3/5, 2/15, net 30. The purchase cost of item 1 is ₹80,000 and that of item 2 is ₹1,20,000. If both amounts are settled on the 12th day, what will be the total amount paid by the firm?

- (a) ₹1,96,800 (b) ₹1,97,200 (c) ₹1,98,000 (d) ₹1,95,600

Ledger and posting

- **Ledger** is the principal book — the "book of final entry" — containing all accounts in classified form. Its index is the **Ledger Folio (L.F.)**.
- **Posting** is the transfer of debit and credit entries from the journal or subsidiary books to the respective ledger accounts.
- **Balancing:** total both sides, insert the difference on the smaller side as "Balance c/d", and bring it down on the opposite side as "Balance b/d" for the next period. **Nominal accounts are not balanced** — they are *closed* by transfer to Trading or P&L Account.
- Normal balances: **Assets & Expenses → Debit. Liabilities, Capital & Incomes → Credit.**

Trial Balance *Core Focus*

A Trial Balance is a statement — not an account and not a book — containing the debit and credit balances of all ledger accounts of an entity as on a particular date, prepared to verify the arithmetical accuracy of the ledger.

Characteristics

- It is a **statement**, prepared *on a particular date, not for a period*.
- It is **not part of the double-entry system** and is **not** a financial statement; preparing it is not compulsory.
- Its totals **always agree**, provided there are no arithmetical or one-sided errors — this is a mechanical consequence of the dual aspect concept.
- It is the **link between the ledger and the final accounts**.

Transactions → Journal Entries → Ledger → Trial Balance → Final Accounts

Transactions

1. Started business with ₹1,00,000 cash
2. Purchased goods for cash ₹30,000
3. Purchased goods on credit from Amit ₹20,000
4. Sold goods for cash ₹50,000
5. Sold goods on credit to Ravi ₹30,000
6. Paid rent in cash ₹10,000
7. Received ₹15,000 from Ravi and paid ₹10,000 to Amit
8. At the end of the year, closing stock = ₹25,000.

Journal Entries

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
Apr. 1	Cash A/c Dr.		1,00,000	
	To Capital A/c			1,00,000
	(Being business started with cash)			
Apr. 3	Purchases A/c Dr.		30,000	
	To Cash A/c			30,000
	(Being goods purchased for cash)			
Apr. 5	Purchases A/c Dr.		20,000	
	To Amit A/c			20,000
	(Being goods purchased on credit from Amit)			
Apr. 10	Cash A/c Dr.		50,000	
	To Sales A/c			50,000
	(Being goods sold for cash)			
Apr. 15	Ravi A/c Dr.		30,000	
	To Sales A/c			30,000
	(Being goods sold on credit to Ravi)			
Apr. 20	Rent A/c Dr.		10,000	
	To Cash A/c			10,000
	(Being rent paid in cash)			
Apr. 25	Cash A/c Dr.		15,000	
	To Ravi A/c			15,000
	(Being cash received from Ravi)			
Apr. 25	Amit A/c Dr.		10,000	
	To Cash A/c			10,000
	(Being payment made to Amit)			
	Total		2,65,000	2,65,000

Ledger**Cash A/c**

Dr.	Amount (₹)	Cr.	Amount (₹)
To Capital A/c	1,00,000	By Purchases A/c	30,000
To Sales A/c	50,000	By Rent A/c	10,000
To Ravi A/c	15,000	By Amit A/c	10,000
		By Balance c/d	1,15,000
Total	1,65,000	Total	1,65,000

Purchases A/c

Dr.	Amount (₹)	Cr.	Amount (₹)
To Cash A/c	30,000	By Balance c/d	50,000
To Amit A/c	20,000		
Total	50,000	Total	50,000

Ravi A/c

Dr.	Amount (₹)	Cr.	Amount (₹)
To Sales A/c	30,000	By Cash A/c	15,000
		By Balance c/d	15,000
Total	30,000	Total	30,000

Capital A/c

Dr.	Amount (₹)	Cr.	Amount (₹)
To Balance c/d	1,00,000	By Cash A/c	1,00,000
Total	1,00,000	Total	1,00,000

Sales A/c

Dr.	Amount (₹)	Cr.	Amount (₹)
To Balance c/d	80,000	By Cash A/c	50,000
		By Ravi A/c	30,000
Total	80,000	Total	80,000

Sales A/c

Dr.	Amount (₹)	Cr.	Amount (₹)
To Balance c/d	80,000	By Cash A/c	50,000
		By Ravi A/c	30,000
Total	80,000	Total	80,000

Trial Balance

S. No.	Name of Account	L.F.	Debit (₹)	Credit (₹)
1	Cash A/c		1,15,000	—
2	Ravi A/c		15,000	—
3	Purchases A/c		50,000	—
4	Rent A/c		10,000	—
5	Capital A/c		—	1,00,000
6	Sales A/c		—	80,000
7	Amit A/c		—	10,000
	Total		1,90,000	1,90,000

Q10. (EPFO EO/AO 2021)

Which one of the following statements about Trial Balance is correct?

- (a) It is a book containing different accounts of an entity.
- (b) It is a statement containing balances of debtors of an entity.
- (c) It is a statement containing balances of debtors and creditors of an entity.
- (d) It is a statement containing the various ledger balances of an entity on a particular date.

Q11. (EPFO EO/AO 2021)

Is the total of the Debit and Credit side of a Trial Balance the same?

- (a) No, there are sometimes good reasons why they differ.
- (b) Yes, always.
- (c) Yes, except where the Trial Balance is extracted at the year end.
- (d) No, because it is not a Balance Sheet.

Q12. Which one of the following is the primary purpose of preparing a Trial Balance?

- (a) To ascertain the net profit or loss of the business
- (b) To ascertain the financial position of the business
- (c) To check the arithmetical accuracy of the ledger accounts
- (d) To determine the cash balance of the business

Q13. From which of the following is a Trial Balance generally prepared?

- (a) Journal
- (b) Ledger
- (c) Cash Book only
- (d) Balance Sheet

Q14. If the Trial Balance of an entity agrees, which one of the following conclusions can be drawn?

- (a) There are no errors in the books of accounts.
- (b) The financial statements are necessarily correct.
- (c) The arithmetical accuracy of the books is indicated, but certain errors may still remain undetected.
- (d) The entity has earned a profit during the accounting period.

Q10. Answer: (d) It is a statement containing the various ledger balances of an entity on a particular date.

- Option (a) describes the Ledger (a book, not a statement). Options (b) and (c) describe a Schedule of Debtors / Creditors. Only (d) captures both essentials: statement + all ledger balances + on a date.

Q11. Answer: (b) Yes, always.

- By the dual aspect concept, every debit has an equal credit, so the two totals must agree. A disagreement is evidence of an error, not of a legitimate difference.
Note: agreement proves arithmetical accuracy only — it does not prove the ledger is free from error.

Q12. Answer: (c) To check the arithmetical accuracy of the ledger accounts.

- Trial Balance is prepared mainly to verify whether total debit balances equal total credit balances.

Q13. Answer: (b) Ledger.

- Trial Balance is prepared from the balances of various ledger accounts.

Q14. Answer: (c) The arithmetical accuracy of the books is indicated, but certain errors may still remain undetected.

- Agreement of Trial Balance does not rule out errors such as errors of omission, principle, or compensating errors.

Practice Questions

Q1. The first book in which transactions of a business unit are recorded is:

- (a) Ledger
- (b) Journal
- (c) Trial Balance
- (d) Balance Sheet

Q2. Under the Traditional Approach, accounts are classified into:

- (a) Asset, Liability, Capital
- (b) Personal, Real, Nominal
- (c) Debit and Credit only
- (d) Current and Non-current

Q3. Golden rule for Personal Account is:

- (a) Debit what comes in, Credit what goes out
- (b) Debit the receiver, Credit the giver
- (c) Debit all expenses, Credit all incomes
- (d) Debit assets, Credit liabilities

Q4. Golden rule for Real Account is:

- (a) Debit the receiver, Credit the giver
- (b) Debit what comes in, Credit what goes out
- (c) Debit expenses, Credit incomes
- (d) Debit capital, Credit drawings

Q5. Golden rule for Nominal Account is:

- (a) Debit what comes in
- (b) Debit the receiver
- (c) Debit all expenses and losses, Credit all incomes and gains
- (d) Credit what goes out

Q6. Goodwill Account is a:

- (a) Personal Account
- (b) Real Account
- (c) Nominal Account
- (d) Representative Personal Account

Q7. Outstanding Rent is a:

- (a) Nominal Account
- (b) Real Account
- (c) Representative Personal Account
- (d) Natural Personal Account

Q8. Income and Expenditure Account is a:

- (a) Real Account
- (b) Personal Account
- (c) Nominal Account
- (d) Capital Account

Q9. Branch Account under Debtors System is a:

- (a) Real Account
- (b) Personal Account
- (c) Nominal Account
- (d) Liability Account

Q10. Capital Account normally has a:

- (a) Debit balance
- (b) Credit balance

- (c) Nil balance
- (d) Either debit or credit

Q11. Purchases Book records:

- (a) All purchases
- (b) Credit purchases of goods only
- (c) Cash purchases of goods
- (d) Purchase of assets

Q12. Sales Book records:

- (a) All sales
- (b) Credit sales of goods only
- (c) Cash sales
- (d) Sale of assets

Q13. Cash sales are recorded in:

- (a) Sales Book
- (b) Cash Book
- (c) Journal Proper
- (d) Purchases Book

Q14. Credit purchase of machinery is recorded in:

- (a) Purchases Book
- (b) Journal Proper
- (c) Sales Book
- (d) Cash Book

Q15. The Cash Book is:

- (a) Only a journal
- (b) Only a ledger
- (c) Both a journal and a ledger
- (d) Neither

Q16. A contra entry is an entry that involves:

- (a) Cash and Bank accounts
- (b) Cash and Capital accounts
- (c) Bank and Purchases accounts
- (d) Cash and Sales accounts

Q17. Discount columns in Cash Book are:

- (a) Balanced
- (b) Memorandum columns – totalled and posted, never balanced
- (c) Real accounts
- (d) Personal accounts

Q18. Trade discount is:

- (a) Recorded in the books
- (b) Deducted on the invoice and never recorded
- (c) Posted to Discount Allowed A/c
- (d) Treated as expense

Q19. Imprest system is used for:

- (a) Main Cash Book
- (b) Petty Cash Book
- (c) Purchases Book
- (d) Sales Book

Q20. Trial Balance is:

- (a) A book
- (b) A statement containing ledger balances on a particular date
- (c) A financial statement
- (d) A list of only debtors

Q21. Primary purpose of Trial Balance is to:

- (a) Ascertain profit
- (b) Check arithmetical accuracy of ledger accounts
- (c) Prepare Balance Sheet
- (d) Determine cash balance

Q22. If Trial Balance agrees, it indicates:

- (a) No errors at all
- (b) Arithmetical accuracy, but certain errors may still remain
- (c) Financial statements are correct
- (d) Profit has been earned

Q23. Under Modern Approach, increase in Asset is:

- (a) Credited
- (b) Debited
- (c) Not recorded
- (d) Shown in journal only

Q24. Increase in Liability is:

- (a) Debited
- (b) Credited
- (c) Ignored
- (d) Shown as expense

Q25. Ledger is the:

- (a) Book of original entry
- (b) Principal book / book of final entry

- (c) Statement
- (d) Subsidiary book only

Q26. Nominal accounts are:

- (a) Balanced
- (b) Closed by transfer to Trading or P&L Account
- (c) Carried forward
- (d) Shown in Balance Sheet

Q27. Credit terms "2½/10, net 30" means:

- (a) 2.5% discount if paid within 10 days, otherwise full amount in 30 days
- (b) 2.5% interest
- (c) 10% discount
- (d) Net payment in 2½ days

Q28. A transaction affecting both cash and bank is called:

- (a) Simple entry
- (b) Contra entry
- (c) Compound entry
- (d) Opening entry

Q29. Balancing of ledger accounts means:

- (a) Closing the account permanently
- (b) Finding the difference and bringing it down
- (c) Transferring to P&L
- (d) Ignoring the difference

Q30. Journal Proper is used for:

- (a) Cash transactions
- (b) Credit purchases of goods
- (c) Opening, closing, rectification and transactions not fitting other subsidiary books
- (d) Only sales

Answers & Explanations

Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.
1	b	2	b	3	b	4	b	5	c
6	b	7	c	8	c	9	b	10	b
11	b	12	b	13	b	14	b	15	c
16	a	17	b	18	b	19	b	20	b
21	b	22	b	23	b	24	b	25	b
26	b	27	a	28	b	29	b	30	c

Q1. Answer: (b) Journal

Journal is the **book of original entry** where transactions are first recorded.

Q2. Answer: (b) Personal, Real, Nominal

Under the Traditional Approach, accounts are classified into **Personal, Real and Nominal accounts**.

Q3. Answer: (b) Debit the receiver, Credit the giver

The golden rule for a Personal Account is **Debit the receiver, Credit the giver**.

Q4. Answer: (b) Debit what comes in, Credit what goes out

The golden rule for a Real Account is **Debit what comes in, Credit what goes out**.

Q5. Answer: (c) Debit all expenses and losses, Credit all incomes and gains

Nominal accounts record **expenses, losses, incomes and gains**.

Q6. Answer: (b) Real Account

Goodwill is an **intangible asset** and is therefore classified as a Real Account.

Q7. Answer: (c) Representative Personal Account

Outstanding rent represents an amount payable to the person to whom the rent is due, so it is a **Representative Personal Account**.

Q8. Answer: (c) Nominal Account

Income and Expenditure Account records **revenue incomes and expenses** and is therefore a Nominal Account.

Q9. Answer: (b) Personal Account

Under the Debtors System, the Branch Account represents the branch and is treated as a **Personal Account**.

Q10. Answer: (b) Credit balance

Capital is a liability of the business towards the owner and normally has a **credit balance**.

Q11. Answer: (b) Credit purchases of goods only

Purchases Book records **credit purchases of goods** dealt in by the business. Cash purchases and asset purchases are excluded.

Q12. Answer: (b) Credit sales of goods only

Sales Book records **credit sales of goods**. Cash sales are recorded in the Cash Book.

Q13. Answer: (b) Cash Book

Cash sales involve immediate receipt of cash and are therefore recorded in the **Cash Book**.

Q14. Answer: (b) Journal Proper

Machinery is an asset, not goods for resale. Therefore, its credit purchase is recorded in **Journal Proper**.

Q15. Answer: (c) Both a journal and a ledger

The Cash Book records transactions chronologically like a **journal** and also serves as a **ledger** for cash and bank accounts.

Q16. Answer: (a) Cash and Bank accounts

A contra entry involves both **Cash and Bank accounts**, such as cash deposited into or withdrawn from the bank.

Q17. Answer: (b) Memorandum columns – totalled and posted, never balanced

Discount columns in the Cash Book are **memorandum columns**. Their totals are posted to the respective accounts but the columns themselves are not balanced.

Q18. Answer: (b) Deducted on the invoice and never recorded

Trade discount is deducted from the invoice price and is **not recorded separately in the books**.

Q19. Answer: (b) Petty Cash Book

The **imprest system** is commonly used for maintaining the Petty Cash Book.

Q20. Answer: (b) A statement containing ledger balances on a particular date

Trial Balance is a statement showing the **debit and credit balances of ledger accounts** on a particular date.

Q21. Answer: (b) Check arithmetical accuracy of ledger accounts

The primary purpose of Trial Balance is to check the **arithmetical accuracy** of ledger accounts.

Q22. Answer: (b) Arithmetical accuracy, but certain errors may still remain

Agreement of the Trial Balance indicates arithmetical agreement, but errors such as **complete omission or compensating errors** may still exist.

Q23. Answer: (b) Debited

Under the Modern Approach, an **increase in an asset is debited**.

Q24. Answer: (b) Credited

Under the Modern Approach, an **increase in a liability is credited**.

Q25. Answer: (b) Principal book / book of final entry

Ledger is the **principal book of accounts** where transactions recorded in the books of original entry are classified into individual accounts.

Q26. Answer: (b) Closed by transfer to Trading or P&L Account

Nominal accounts are temporary accounts and are **closed at the end of the accounting period** by transferring their balances to the appropriate final account.

Q27. Answer: (a) 2.5% discount if paid within 10 days, otherwise full amount in 30 days

“**2½/10, net 30**” means a 2.5% cash discount is available if payment is made within 10 days; otherwise, the net amount is due within 30 days.

Q28. Answer: (b) Contra entry

A transaction affecting both **cash and bank** accounts is known as a contra entry.

Q29. Answer: (b) Finding the difference and bringing it down

Balancing a ledger account means finding the **difference between the two sides** and bringing the balance down.

Q30. Answer: (c) Opening, closing, rectification and transactions not fitting other subsidiary books

Journal Proper records **opening, closing and rectification entries**, along with transactions that cannot be recorded in other subsidiary books.

Chapter 4: Capital and Revenue — Expenditure, Receipts

Capital expenditure *Core Focus*

Capital expenditure is expenditure incurred to acquire, extend or improve a fixed asset, or to bring an existing asset to its working condition, the benefit of which extends beyond the current accounting period. It is shown in the **Balance Sheet** as an asset.

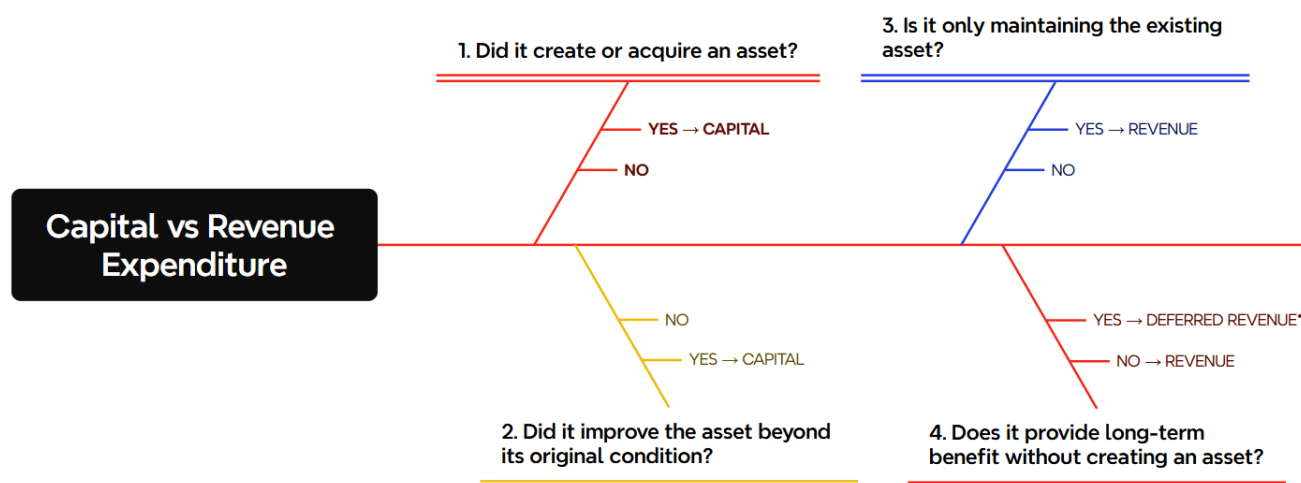
Capital expenditure is present when the expenditure:

- **Acquires** a fixed asset — land, building, plant, furniture, patents, goodwill.
- **Brings an asset into working condition** — freight inward on machinery, transit insurance, import duty, wages paid for **installation** or erection, foundation costs, trial-run costs, architect's and legal fees on purchase of property.
- **Increases the earning capacity** of an existing asset — converting a temporary shed into a permanent building, adding a floor, replacing a petrol engine with a diesel engine to improve mileage, a major overhaul that raises efficiency or extends useful life beyond the original estimate.
- **Reduces future operating costs** — installing a machine that cuts labour cost.
- Is incurred on a **second-hand asset before it is put to use** — repairs, reconditioning and overhauling of second-hand machinery are *capitalised*, because they are part of the cost of making the asset usable.
- Is incurred to acquire a **right** — legal fees to acquire property, cost of obtaining a licence to run a business.

Revenue expenditure *Core Focus*

Revenue expenditure is expenditure whose benefit is exhausted within the current accounting period, incurred to maintain earning capacity rather than to increase it, or to run the business day to day. It is charged to the **Trading or Profit & Loss Account**.

- Purchase of goods for resale; wages and salaries; rent, rates and taxes; carriage inwards on goods.
- **Ordinary repairs and maintenance** — replacing a worn-out part with a similar part, whitewashing, servicing.
- **Depreciation** of fixed assets — the systematic writing-off of a capital cost against revenue.
- Interest on loans, bank charges, insurance premium.
- Bad debts written off.



Examples

<i>Situation</i>	<i>Treatment</i>	<i>Reason</i>
Wages paid for installation of machinery	Capital — debit Machinery A/c	Brings the asset to working condition
Wages paid to workers for production	Revenue	Consumed in the period
Repairs to a second-hand machine before first use	Capital	Part of making it usable
Repairs to a machine already in use	Revenue	Maintains, does not enhance
Overhauling to improve fuel efficiency	Capital	Increases earning capacity / reduces running cost
Replacement of a worn-out part with an identical part	Revenue	Restores original capacity only
Conversion of a temporary shed into a permanent building	Capital	Enhancement of the asset
Freight and insurance on machinery purchased	Capital	Directly attributable acquisition cost
Freight on goods purchased for resale	Revenue (Carriage Inward, Trading A/c)	Trading cost
Foreign tour expenses for purchasing a new machine	Capital	Directly attributable to acquisition
Legal fees to acquire a property	Capital	Cost of acquiring the asset
Licence fee to run a cinema hall	Capital if it creates an enduring right; revenue if it is an annual renewal	Test the duration of the right
Whitewashing of factory building	Revenue	Routine maintenance
Cost of shifting the factory to a new site	Deferred revenue (or revenue if small)	Benefit spread over years but no asset created
Preliminary expenses of a company	Deferred revenue expenditure	Large one-off benefit spread over years; under Ind AS, written off immediately
Heavy advertising to launch a new product	Deferred revenue expenditure	Benefit spread over several years

Q1. (EPFO EO/AO 2021)

Wages paid for installation of machinery is debited to which one of the following accounts?

- (a) Wages Account
- (b) Machinery Account
- (c) Installation Account
- (d) Profit and Loss Account

Q2. (EPFO EO/AO 2017)

Preliminary expenses are the examples of

- (a) capital expenditure
- (b) capital gain
- (c) deferred revenue expenditure
- (d) revenue expenditure/expense

Q3. (EPFO EO/AO 2017)

Depreciation of fixed assets is an example of

- (a) deferred revenue expenditure
- (b) capital expenditure
- (c) capital gain
- (d) revenue expenditure/expense

Q4. (EPFO APFC 2023)

Which of the following is not a capital expenditure?

- (a) ₹5,000 spent to remove a worn-out part. This part needs to be replaced with a new engine
- (b) Expenses on foreign tour for purchasing a new machine
- (c) Freight and insurance of the machinery purchased
- (d) Amount spent on repairing a second-hand machine before put to use

Q5. (EPFO EO/AO 2023)

Overhauling expenses of ₹25,000 for the engine of a motor car to get better fuel efficiency is

- (a) Deferred revenue expenditure
- (b) Revenue receipt
- (c) Capital expenditure
- (d) Revenue expenditure

Q6. (UPSC EPFO, 2025)

Which one of the following is a revenue expenditure?

- (a) Overhaul expenses of a second-hand machinery purchased
- (b) Legal fees to acquire a property
- (c) Amount spent for replacement of worn-out portion of a machine
- (d) Expenses in connection with obtaining a license for running the cinema hall

Q1. Answer: (b) Machinery Account

- Installation wages are a directly attributable cost of bringing the machine into working condition, so they are capitalised into the Machinery Account. Debiting Wages A/c would be an error of principle.

Q2. Answer: (c) Deferred revenue expenditure

- Preliminary expenses (company incorporation costs) create no asset, so they are not capital; but the benefit is not confined to one year, so they are not pure revenue. They occupy the middle category — deferred revenue expenditure, written off over several years. (Under Ind AS they must be expensed immediately, but for AS-based questions the classical answer stands.)

Q3. Answer: (d) Revenue expenditure/expense

- Depreciation is the periodic charge that converts a capital cost into a revenue expense. The purchase of the asset was capital; the depreciation is revenue.

Q4. Answer: (a) ₹5,000 spent to remove a worn-out part

- Removal of a worn-out part merely restores the asset — it is maintenance, hence revenue. Options (b), (c) and (d) are all directly attributable costs of acquiring or readying an asset, hence capital.

Q5. Answer: (c) Capital expenditure

- The words "to get better fuel efficiency" are decisive: the expenditure increases earning capacity / reduces future running cost, so it is capitalised. Had the stem said "routine overhauling to keep the engine running", the answer would be revenue expenditure.

Q6. Answer: (c) Amount spent for replacement of worn-out portion of a machine

- (a) is capital because the machine is second-hand and not yet in use; (b) and (d) acquire enduring rights. Only (c) restores existing capacity.

Capital and revenue receipts *High Yield*

<i>Capital Receipt</i>	<i>Revenue Receipt</i>
Received in the course of financing or investing activity	Received in the course of normal trading activity
Shown in the Balance Sheet	Shown in Trading / P&L Account
Not available for distribution as profit	Available for distribution as profit
Non-recurring in nature	Recurring in nature
Examples: capital introduced, loan taken, sale proceeds of a fixed asset, issue of shares/debentures, insurance claim received for a fixed asset destroyed, sale of investments, government grant for a specific asset	Examples: sale of goods, commission received, rent received, interest received, insurance claim for loss of stock or loss of profit, bad debts recovered, discount received

Note:

- An insurance claim takes the character of the thing that was lost. Claim for a machine/building destroyed → CAPITAL receipt. Claim for stock destroyed → REVENUE receipt (it replaces sales revenue). Claim for loss of profit / consequential loss → REVENUE receipt. This distinction was directly asked in APFC 2023.

Q7. (EPFO APFC 2023)

The insurance claim received on account of machinery damaged completely by fire is

- (a) capital receipt
- (b) revenue receipt
- (c) capital expenditure
- (d) revenue expenditure

Answer: (a) Capital receipt

- The claim substitutes for a fixed asset that has been lost. Since the sale of a machine would be a capital receipt, so is the insurance compensation for its destruction. Only the excess of claim over written-down value is a profit taken to P&L.

Deferred revenue expenditure

Deferred revenue expenditure is revenue expenditure of a heavy, non-recurring nature whose benefit is expected to accrue over several accounting periods, and which is therefore written off over those periods rather than in the year of incurrence. The unwritten-off portion is shown on the assets side of the Balance Sheet as a fictitious asset.

- Classic examples: **preliminary expenses**, heavy launch advertising, cost of shifting the factory, discount on issue of debentures, underwriting commission, large research and development expenditure (older treatment).
- **Fictitious assets** are debit balances that are not assets at all — preliminary expenses, advertisement suspense, discount on issue of shares/debentures, and **profit and loss account (debit balance)**. They represent losses yet to be written off.
- **Modern position:** AS-26 and Ind AS require most such items to be **written off immediately**; the concept survives in exams chiefly through preliminary expenses.

Practice questions

Q1. Capital expenditure is expenditure whose benefit:

- (a) Is exhausted within the current accounting period
- (b) Extends beyond the current accounting period
- (c) Is always revenue in nature
- (d) Is never shown in the Balance Sheet

Q2. Wages paid for installation of machinery are:

- (a) Debited to Wages Account
- (b) Debited to Machinery Account
- (c) Debited to Profit and Loss Account
- (d) Debited to Installation Account

Q3. Preliminary expenses are an example of:

- (a) Capital expenditure
- (b) Deferred revenue expenditure
- (c) Revenue expenditure
- (d) Capital gain

Q4. Depreciation of fixed assets is an example of:

- (a) Deferred revenue expenditure
- (b) Capital expenditure
- (c) Capital gain
- (d) Revenue expenditure

Q5. Which of the following is NOT a capital expenditure?

- (a) Expenses on foreign tour for purchasing a new machine
- (b) Freight and insurance of machinery purchased
- (c) Amount spent on repairing a second-hand machine before put to use
- (d) ₹5,000 spent to remove a worn-out part

Q6. Overhauling expenses of ₹25,000 for the engine of a motor car to get better fuel efficiency is:

- (a) Deferred revenue expenditure
- (b) Revenue receipt
- (c) Capital expenditure
- (d) Revenue expenditure

Q7. Amount spent for replacement of worn-out portion of a machine is:

- (a) Capital expenditure
- (b) Revenue expenditure
- (c) Deferred revenue expenditure
- (d) Capital receipt

Q8. Legal fees to acquire a property are:

- (a) Revenue expenditure
- (b) Capital expenditure
- (c) Deferred revenue expenditure
- (d) Revenue receipt

Q9. The insurance claim received on account of machinery damaged completely by fire is:

- (a) Capital receipt
- (b) Revenue receipt
- (c) Capital expenditure
- (d) Revenue expenditure

Q10. Insurance claim for loss of stock is:

- (a) Capital receipt
- (b) Revenue receipt
- (c) Capital expenditure
- (d) Deferred revenue expenditure

Q11. Repairs to a second-hand machine before first use are:

- (a) Revenue expenditure
- (b) Capital expenditure
- (c) Deferred revenue expenditure
- (d) Not recorded

Q12. Ordinary repairs and maintenance are:

- (a) Capital expenditure
- (b) Revenue expenditure
- (c) Deferred revenue expenditure
- (d) Capital receipt

Q13. Conversion of a temporary shed into a permanent building is:

- (a) Revenue expenditure
- (b) Capital expenditure
- (c) Deferred revenue expenditure
- (d) Revenue receipt

Q14. Freight on goods purchased for resale is:

- (a) Capital expenditure
- (b) Revenue expenditure (Carriage Inward)
- (c) Deferred revenue expenditure
- (d) Capital receipt

Q15. Heavy advertising to launch a new product is generally treated as:

- (a) Pure revenue expenditure
- (b) Deferred revenue expenditure
- (c) Capital expenditure
- (d) Capital receipt

Q16. Fictitious assets include:

- (a) Goodwill
- (b) Preliminary expenses
- (c) Patents
- (d) Land

Q17. Under modern Ind AS, most deferred revenue expenditures are:

- (a) Capitalised permanently
- (b) Written off immediately
- (c) Shown as liability
- (d) Ignored

Q18. Sale proceeds of a fixed asset are:

- (a) Revenue receipt
- (b) Capital receipt
- (c) Revenue expenditure
- (d) Capital expenditure

Q19. Capital introduced by the proprietor is:

- (a) Revenue receipt
- (b) Capital receipt
- (c) Revenue expenditure
- (d) Capital expenditure

Q20. Loan taken by the business is:

- (a) Revenue receipt
- (b) Capital receipt
- (c) Revenue expenditure
- (d) Capital expenditure

Q21. Interest received on investments is:

- (a) Capital receipt
- (b) Revenue receipt
- (c) Capital expenditure
- (d) Deferred revenue expenditure

Q22. Cost of shifting the factory to a new site is generally treated as:

- (a) Pure capital expenditure
- (b) Deferred revenue expenditure (or revenue if small)
- (c) Revenue receipt
- (d) Capital receipt

Q23. Whitewashing of factory building is:

- (a) Capital expenditure
- (b) Revenue expenditure
- (c) Deferred revenue expenditure
- (d) Capital receipt

Q24. Licence fee to run a cinema hall (creating enduring right) is:

- (a) Always revenue
- (b) Capital if it creates an enduring right
- (c) Always deferred revenue
- (d) Not recorded

Q25. Loss on sale of a fixed asset is:

- (a) Capital loss
- (b) Revenue expenditure
- (c) Capital receipt
- (d) Revenue receipt

Q26. Which of the following increases the earning capacity of an existing asset?

- (a) Ordinary repairs
- (b) Major overhaul that raises efficiency
- (c) Whitewashing
- (d) Replacement of identical worn-out part

Q27. Expenditure incurred on a second-hand asset before it is put to use is:

- (a) Always revenue
- (b) Capitalised
- (c) Deferred revenue
- (d) Ignored

Q28. Government grant for a specific asset is:

- (a) Revenue receipt
- (b) Capital receipt
- (c) Revenue expenditure
- (d) Capital expenditure

Q29. Bad debts written off are:

- (a) Capital expenditure
- (b) Revenue expenditure
- (c) Capital receipt
- (d) Deferred revenue expenditure

Q30. The distinction between capital and revenue is important because:

- (a) It affects only the Trial Balance
- (b) It affects both profit measurement and financial position
- (c) It is required only for tax purposes
- (d) It has no accounting significance

Answer Key

Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.
1	b	2	b	3	b	4	d	5	d
6	c	7	b	8	b	9	a	10	b
11	b	12	b	13	b	14	b	15	b
16	b	17	b	18	b	19	b	20	b
21	b	22	b	23	b	24	b	25	a
26	b	27	b	28	b	29	b	30	b

Q1. Answer: (b) Extends beyond the current accounting period

Capital expenditure provides benefits extending beyond the current accounting period and is generally capitalised.

Q2. Answer: (b) Debited to Machinery Account

Wages incurred for installing machinery are necessary to bring the asset into working condition and are therefore capitalised.

Q3. Answer: (b) Deferred revenue expenditure

Preliminary expenses were traditionally treated as deferred revenue expenditure, although modern accounting standards generally do not permit such expenditure to remain as a fictitious asset.

Q4. Answer: (d) Revenue expenditure

Depreciation is a revenue expense representing the allocation of the depreciable amount of a fixed asset over its useful life.

Q5. Answer: (d) ₹5,000 spent to remove a worn-out part

Routine replacement of a worn-out part generally maintains the existing asset rather than creating an additional enduring benefit, so it is revenue expenditure.

Q6. Answer: (c) Capital expenditure

An overhaul that improves the efficiency of an existing asset and provides additional benefit is treated as capital expenditure.

Q7. Answer: (b) Revenue expenditure

Replacement of a worn-out portion that merely maintains the existing efficiency of a machine is generally revenue expenditure.

Q8. Answer: (b) Capital expenditure

Legal fees incurred to acquire a property are directly attributable to its acquisition and are therefore capitalised.

Q9. Answer: (a) Capital receipt

An insurance claim received for a fixed asset destroyed by fire relates to a capital asset and is treated as a capital receipt.

Q10. Answer: (b) Revenue receipt

An insurance claim for loss of stock relates to trading operations and is therefore a revenue receipt.

Q11. Answer: (b) Capital expenditure

Repairs necessary to make a second-hand machine ready for its first use are capitalised as part of the asset's cost.

Q12. Answer: (b) Revenue expenditure

Ordinary repairs and maintenance merely maintain an asset in its existing working condition.

Q13. Answer: (b) Capital expenditure

Converting a temporary shed into a permanent building creates or improves a long-term asset and is therefore capital expenditure.

Q14. Answer: (b) Revenue expenditure (Carriage Inward)

Freight on goods purchased for resale is a direct expense of bringing goods to the business and is treated as carriage inward.

Q15. Answer: (b) Deferred revenue expenditure

Heavy advertising for launching a new product was traditionally treated as deferred revenue expenditure when its benefit was expected to extend over more than one period.

Q16. Answer: (b) Preliminary expenses

Preliminary expenses were traditionally classified as **fictitious assets** because they do not represent tangible or identifiable real assets.

Q17. Answer: (b) Written off immediately

Under modern Ind AS, expenditure that does not meet the criteria for recognition as an asset is generally recognised as an expense rather than carried forward as deferred revenue expenditure.

Q18. Answer: (b) Capital receipt

Sale proceeds of a fixed asset arise from the disposal of a capital asset and are therefore treated as a capital receipt.

Q19. Answer: (b) Capital receipt

Capital introduced by the proprietor increases the owner's capital and is a capital receipt for the business.

Q20. Answer: (b) Capital receipt

A loan creates a liability and is not income from ordinary business operations; hence, it is a capital receipt.

Q21. Answer: (b) Revenue receipt

Interest received on investments is income arising from the use of funds and is generally a revenue receipt.

Q22. Answer: (b) Deferred revenue expenditure (or revenue if small)

Traditional accounting may treat substantial shifting expenses as deferred revenue expenditure when the benefit extends over several periods.

Q23. Answer: (b) Revenue expenditure

Whitewashing maintains the factory building in its existing condition and does not normally increase its earning capacity.

Q24. Answer: (b) Capital if it creates an enduring right

A licence fee is capital in nature when it creates an enduring right or benefit; otherwise, it may be revenue expenditure.

Q25. Answer: (a) Capital Loss

A loss on sale of a fixed asset is a **capital loss**, not an operating revenue expenditure.

Q26. Answer: (b) Major overhaul that raises efficiency

Expenditure that increases the earning capacity or efficiency of an existing asset is capital in nature.

Q27. Answer: (b) Capitalised

Expenditure incurred on a second-hand asset before it is put to use, when necessary to bring it into usable condition, is capitalised.

Q28. Answer: (b) Capital receipt

A government grant received for a specific asset is generally treated as a capital-related receipt and adjusted against the asset cost or treated according to the applicable accounting standard.

Q29. Answer: (b) Revenue expenditure

Bad debts arise from credit sales and represent a loss connected with ordinary business operations.

Q30. Answer: (b) It affects both profit measurement and financial position

Correct classification ensures that capital expenditure is reflected in assets while revenue expenditure is charged against current-period profit.

Chapter 5: Depreciation, Provisions and Reserves

Depreciation – *High Yield*

Depreciation is the systematic ALLOCATION of the depreciable amount of an asset over its useful life. It is a process of ALLOCATION, not of VALUATION. This single sentence has been examined directly, and it is the most commonly misunderstood idea in the Chapter.

What depreciation **is**:

- A **non-cash** expense — it reduces profit but involves no outflow of cash.
- A **charge against profit**, not an appropriation of profit — it must be provided whether or not the business has earned a profit.
- An application of the **matching concept** — the cost of a long-lived asset is spread over the periods that enjoy its benefit.
- A **revenue expenditure**.

What depreciation is **not**:

- It is **not** a process of valuation. The written-down value of an asset is not, and is not intended to be, its market value.
- It is **not** a fund. Charging depreciation does not by itself set aside cash for replacement (that requires a *Depreciation Fund* / sinking fund investment).
- It is **not** optional. Section 123(1) of the Companies Act 2013 makes provision of depreciation a precondition for declaring a dividend.

Causes of Depreciation

- **Wear & Tear** — Physical deterioration caused by regular use; the **most common cause** of depreciation.
- **Efflux of Time** — Reduction in value simply due to the passage of time, even without extensive use; common in leases, patents and copyrights.
- **Obsolescence** — Loss of usefulness because of **technological advancement, changes in demand, or newer alternatives**, even though the asset may still be physically functional.
- **Depletion** — Gradual exhaustion of a **natural/wasting asset** through extraction or use, e.g., **mines, quarries and oil wells**.
- **Accidents** — Sudden and permanent loss in value caused by events such as **fire, flood or major breakdown**.
- **Fall in Market Value** — A decline in market price **is generally not considered a cause of depreciation**; depreciation is primarily concerned with the systematic allocation of an asset's depreciable amount.

Need for providing depreciation

- To ascertain **true profit or loss** — a cost consumed must be charged.
- To present a **true and fair view** of the financial position — assets must not be overstated.
- To **retain funds for replacement** — by reducing distributable profit, depreciation indirectly conserves resources.
- To comply with **statutory requirements** — Companies Act 2013 Section 123 and Schedule II.
- To ensure **correct cost ascertainment** for pricing decisions.

Q1. (EPFO EO/AO 2023)

Which one of the following statements is not correct?

- Depreciation is a non-cash expense.
- Depreciation is the process of valuation of assets.
- The main cause of depreciation is wear and tear caused by usage.
- Depreciation must be charged so as to ascertain true profit or loss of a business.

Answer: (b) Depreciation is the process of valuation of assets.

- Depreciation is a process of allocation of cost, not valuation. (a), (c) and (d) are all correct statements.

Methods of depreciation

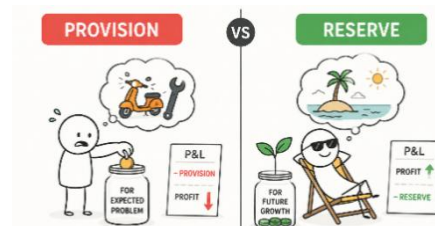
- The **Straight-Line Method (SLM)** and **Written Down Value Method (WDV)** are two important methods of calculating depreciation, differing mainly in the basis of calculation and the pattern of depreciation charged each year.

Point	Straight Line Method (SLM)	Written Down Value Method (WDV)
Base for calculation	Original cost of the asset	Book value at the beginning of each year
Annual depreciation	Constant every year	Decreasing every year
Book value at end of useful life	Can become zero	Generally never becomes zero; it approaches zero
Recognised under Income Tax Act	No, except for certain power-generating units	Yes — generally used for tax depreciation in India
Example	Asset cost = ₹1,00,000; useful life = 5 years → Depreciation = ₹20,000 every year	Asset cost = ₹1,00,000; depreciation rate = 20% → Year 1 = ₹20,000, Year 2 = ₹16,000 (20% of ₹80,000)

Provisions vs Reserves - *Core Focus*

- Provisions and reserves** both involve setting aside amounts in accounting, but they serve different purposes. A **provision** is made to cover an expected loss or liability, whereas a **reserve** represents an appropriation of profit kept aside to strengthen the financial position of the business or meet future needs.

Point	Provision	Reserve
Meaning	Amount kept aside for a known expected loss/liability	Profit kept aside for future needs
Purpose	To cover an expected expense/loss	To strengthen the business
Profit required?	No — can be created even in loss	Yes — created out of profit
Effect on profit	Reduces profit - A charge against profit	Does not reduce net profit ; it is an appropriation of profit
Dividend	Generally, not available for dividend	Revenue reserves may be available for dividend
Examples	Provision for doubtful debts, taxation	General reserve, dividend equalisation reserve



Provision is a CHARGE; Reserve is an APPROPRIATION." A charge is compulsory and comes *before* profit is computed. An appropriation is optional and comes *after*. A **provision can be created in a year of loss; a reserve cannot**.

Types of reserves

Reserve	Nature	Created from	Use
General Reserve (Free Reserve / Contingency Reserve)	Revenue	Distributable profits	Any purpose — no restriction
Specific Reserve	Revenue	Distributable profits	Only the stated purpose — e.g. Dividend Equalisation Reserve, Debenture Redemption Reserve, Workmen Compensation Reserve
Capital Reserve	Capital	Capital profits , not trading profits	Cannot be distributed as dividend; used to write off capital losses or issue bonus shares
Secret Reserve (Hidden/Inner Reserve)	Undisclosed	Understating assets / overstating liabilities	Prohibited for most companies; permitted for banks and insurance companies historically
Revenue Reserve	Revenue	Trading profits	Freely distributable

Trap Statements for Exam

Trap Statement	Correct Concept
“Reserve is a charge against profit.”	Reserve is an appropriation of profit .
“General Reserve is created for a specific purpose.”	General Reserve has no specific purpose .
“Dividend Equalisation Reserve is a General Reserve.”	It is a Specific Reserve , created to maintain dividend stability.
“Capital Reserve is created out of distributable profits.”	Capital Reserve is created from capital profits .
“Provision is an appropriation of profit.”	Provision is a charge against profit .

Q2. (EPFO APFC 2023)

Which one of the following statements is correct?

- (a) Capital reserves are normally created out of free or distributable profits.
- (b) Dividend equalization reserve is an example of general reserve.
- (c) General reserve can be used only for some specific purposes.
- (d) 'Provision' is a charge against profit.

Q3. (UPSC EPFO, 2025)

In accounting context, which one of the following statements is correct?

- (a) Reserve created is a charge against profits.
- (b) Capital reserves are normally created out of distributable profits.
- (c) General reserve can be used only for some specific purposes.
- (d) 'Provision' is a charge against profit.

Q2. Answer: (d) 'Provision' is a charge against profit.

- capital reserves come from capital profits; (b) dividend equalisation is a specific reserve; (c) a general reserve has no specific purpose. Only (d) survives.

Q3. Answer: (d) 'Provision' is a charge against profit.

Provision for Doubtful Debts and Provision for Discount on Debtors**The order of operations**

- Start with **Trade Receivables (Sundry Debtors)** as per the Trial Balance.
- Deduct further/additional bad debts** given in the adjustments. → This gives **Net Debtors**.
- Compute **New Provision for Doubtful Debts** = Net Debtors × the specified rate.
- Compute **New Provision for Discount on Debtors** = (Net Debtors – New Provision for Doubtful Debts) × discount rate. *Discount is allowed only to those who will actually pay, so doubtful debts are removed first.*
- Amount charged to Profit & Loss Account = **Bad debts (as per Trial Balance) + Further bad debts + New provision – Old (existing) provision.**

CHARGE = (Old bad debts + New bad debts + Closing provision) – Opening provision.

Equivalently: *"Everything that went bad this year, plus what we now fear, minus what we already feared last year."*

If the answer comes out **negative**, the excess old provision is **credited** to P&L.

Q4. (EPFO APFC 2023)

Following is the Trial Balance of a firm as on 31-12-2022: Trade receivables ₹25,00,000; Provision for doubtful debts ₹1,40,000; Bad debts ₹40,000. Additional bad debts during the year are ₹2,00,000. The firm has a policy of maintaining a provision for doubtful debts equal to 10% of the trade receivables' balances. The total amount to be charged to the Profit and Loss A/c will be

- (a) ₹2,50,000
- (b) ₹1,30,000
- (c) ₹90,000
- (d) ₹3,30,000

Q5. (EPFO EO/AO 2023)

Following is the trial balance of a firm as on 31.03.2022:

- Trade receivables **Rs. 2,50,000**
- Provisions for discount **Rs. 14,000**
- Discount to debtors **Rs. 4,000**

Additional discount allowed to debtors during the year is **20,000**. The firm has a policy of maintaining a provision for discount to debtors equal to **10%** of the Trade Receivables' balances. Total amount to be charged to Profit and Loss Account (for the year ending 31.03.2022) for discount allowed and provision for discount created will be:

- (a) ₹25,000
 (b) ₹13,000
 (c) ₹9,000
 (d) ₹33,000

Q4. Answer: (d) ₹33,000

- Step 1 — Net debtors: 25,00,000 – 2,00,000 (further bad debts) = ₹23,00,000.
- Step 2 — New provision: 23,00,000 × 10% = ₹2,30,000.
- Step 3 — Charge to P&L: Bad debts per TB 40,000 + Further bad debts 2,00,000 + New provision 2,30,000 – Old provision 1,40,000 = ₹3,30,000.

Q5. Answer: (d) ₹33,000

- **Adjusted Trade Receivables** = ₹2,50,000 – ₹20,000 = **₹2,30,000**
- **Required Provision** = 10% × ₹2,30,000 = **₹23,000**
- **New Provision** = ₹23,000 – ₹14,000 = **₹9,000**
- **Total Discount Allowed** = ₹4,000 + ₹20,000 = **₹24,000**
- **Total P&L Charge** = ₹24,000 + ₹9,000 = **₹33,000**

Reserve Capital vs Capital Reserve

Point	Capital Reserve	Reserve Capital
Meaning	A reserve created out of capital profits	That part of uncalled share capital which the company resolves not to call except in the event of winding up
Created by	Accounting entry	Special resolution of the company
Governed by	Accounting principles / Schedule III	Section 65 of the Companies Act 2013 (erstwhile)
Disclosed in Balance Sheet?	Yes, under Reserves and Surplus	No — disclosed only by way of a note
Can be used during the life of the company?	Yes — for bonus issue, writing off capital losses	No — only on winding up

Practice questions

Q1. A machine is purchased for ₹2,40,000 with a residual value of ₹20,000 and a useful life of 5 years. The annual depreciation under the Straight Line Method will be:

- (a) ₹40,000
- (b) ₹45,000
- (c) ₹44,000
- (d) ₹48,000

Q2. Which one of the following statements is NOT correct regarding depreciation?

- (a) Depreciation is a non-cash expense.
- (b) Depreciation is a charge against profit.
- (c) Depreciation is related to the matching of cost with revenue.
- (d) Depreciation is the process of valuation of assets.

Q3. Under the Straight Line Method, depreciation charged on an asset is generally:

- (a) Increasing every year
- (b) Constant every year
- (c) Based only on market value
- (d) Decreasing every year

Q4. Under the Written Down Value Method, depreciation is generally:

- (a) Decreasing every year
- (b) Constant every year
- (c) Based on residual value only
- (d) Increasing every year

Q5. A machine costing ₹2,00,000 is depreciated at 20% per annum under the Written Down Value Method. What will be the depreciation charged in the third year?

- (a) ₹40,000
- (b) ₹32,000
- (c) ₹25,600
- (d) ₹20,000

Q6. A provision is generally regarded as:

- (a) An appropriation of profit
- (b) A capital reserve
- (c) A charge against profit
- (d) A contingent asset

Q7. A reserve is generally:

- (a) An appropriation of profit
- (b) A charge against profit
- (c) A liability of uncertain amount
- (d) A fictitious asset

Q8. A provision can be created:

- (a) Only when the business earns profit
- (b) Only out of capital profits
- (c) Even in a year of loss
- (d) Only after declaration of dividend

Q9. Which of the following best distinguishes a general reserve from a specific reserve?

- (a) General reserve is created only from capital profits
- (b) General reserve is a charge against profit
- (c) General reserve is maintained without a specific purpose
- (d) General reserve represents a liability

Q10. Dividend Equalisation Reserve is an example of:

- (a) Specific Reserve
- (b) General Reserve
- (c) Capital Reserve
- (d) Secret Reserve

Q11. Capital Reserve is normally created out of:

- (a) Revenue profits only
- (b) Capital profits
- (c) Free or distributable profits
- (d) Loan funds

Q12. Trade receivables are ₹4,00,000. Additional bad debts of ₹20,000 are to be written off. The existing provision for doubtful debts is ₹15,000, and the required provision is 5% of the adjusted trade receivables. What is the total amount to be charged to the Profit and Loss Account for bad debts and provision adjustment?

- (a) ₹20,000
- (b) ₹19,000
- (c) ₹24,000
- (d) ₹39,000

Q13. A secret reserve may be created by:

- (a) Understating assets or overstating liabilities
- (b) Overstating assets or understating liabilities
- (c) Issuing bonus shares
- (d) Creating a general reserve

Q14. Provision for doubtful debts is primarily created to:

- (a) Increase the value of debtors
- (b) Increase sales revenue
- (c) Create a capital reserve
- (d) Recognise the expected loss from doubtful receivables

Q15. The provision for discount on debtors is generally calculated on debtors after deducting:

- (a) Cash sales only
- (b) Bad debts and provision for doubtful debts
- (c) Credit sales only
- (d) Outstanding expenses

Q16. If the required closing provision for doubtful debts is less than the existing provision, the difference is generally:

- (a) Debited to Profit and Loss Account
- (b) Transferred to Capital Reserve
- (c) Credited to Profit and Loss Account
- (d) Ignored

Q17. Reserve Capital refers to:

- (a) A reserve created out of capital profits

- (b) A reserve available for dividend
- (c) An amount transferred to General Reserve
- (d) That part of uncalled capital which is to be called only on winding up

Q18. Capital Reserve may generally be used for:

- (a) Issue of fully paid bonus shares or writing off capital losses
- (b) Payment of ordinary dividends
- (c) Payment of interest on capital
- (d) Creation of a secret reserve

Q19. Which of the following is a recognised cause of depreciation?

- (a) Increase in market value
- (b) Obsolescence
- (c) Increase in selling price
- (d) Appreciation of asset value

Q20. A fall in the market value of an asset is generally:

- (a) The only cause of depreciation
- (b) Always treated as revenue expenditure
- (c) A statutory method of depreciation
- (d) Not considered a cause of depreciation

Q21. Which of the following is a reason for providing depreciation?

- (a) To increase the reported profit
- (b) To ascertain true profit, present a proper financial position and comply with statutory requirements
- (c) To create a cash fund automatically
- (d) To increase the market value of assets

Q22. A machine costs ₹3,00,000, has a residual value of ₹30,000 and a useful life of 9 years. The annual depreciation under the Straight-Line Method will be:

- (a) ₹30,000
- (b) ₹33,333
- (c) ₹27,000
- (d) ₹36,000

Q23. Component accounting requires an asset to be:

- (a) Depreciated only under the Straight Line Method
- (b) Valued at its market value every year
- (c) Divided into significant components having different useful lives and depreciated separately
- (d) Treated as a single component irrespective of useful life

Q24. A change in the depreciation method is generally treated as:

- (a) A change in accounting estimate, applied prospectively
- (b) A prior-period item
- (c) An extraordinary item
- (d) A change in capital structure

Q25. The Depletion Method of depreciation is most appropriate for:

- (a) Furniture and fixtures
- (b) Patents and copyrights
- (c) Mines and quarries
- (d) Office buildings

Q26. The systematic writing off of the cost of an intangible asset over its useful life is known as:

- (a) Depletion
- (b) Depreciation
- (c) Obsolescence
- (d) Amortisation

Q27. When depreciation is charged directly against the asset account, the journal entry is:

- (a) Depreciation A/c Dr. To Asset A/c
- (b) Asset A/c Dr. To Depreciation A/c
- (c) Profit and Loss A/c Dr. To Asset A/c
- (d) Asset A/c Dr. To Profit and Loss A/c

Q28. A government grant received specifically for acquisition of a fixed asset is generally treated as:

- (a) Revenue expenditure
- (b) Revenue receipt
- (c) Capital receipt
- (d) Deferred revenue expenditure

Q29. Which one of the following statements is correct?

- (a) Reserve is a charge against profit
- (b) Provision is an appropriation of profit
- (c) General Reserve can be used only for a specific purpose
- (d) Provision is a charge against profit

Q30. Under the Written Down Value Method, the book value of an asset generally:

- (a) Becomes zero immediately after the first year
- (b) Remains equal to market value
- (c) Becomes negative after its useful life
- (d) Generally never becomes exactly zero through the normal percentage-based calculation

Answer Key

Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.
1	c	2	d	3	b	4	a	5	c
6	c	7	a	8	c	9	c	10	a
11	b	12	c	13	a	14	d	15	b
16	c	17	d	18	a	19	b	20	d
21	b	22	a	23	c	24	a	25	c
26	d	27	a	28	c	29	d	30	d

Q1. Answer: (c) ₹44,000

- Depreciable amount = ₹2,40,000 – ₹20,000 = ₹2,20,000. Annual depreciation = ₹2,20,000 ÷ 5 = ₹44,000.

Q2. Answer: (d) Depreciation is the process of valuation of assets

- Depreciation is a systematic allocation of the depreciable amount over the useful life of an asset, not a process of valuation.

Q3. Answer: (b) Constant every year

- Under the Straight Line Method, an equal amount of depreciation is charged every year over the useful life of the asset.

Q4. Answer: (a) Decreasing every year

- Under the Written Down Value Method, depreciation is calculated on the diminishing book value, so the amount generally decreases every year.

Q5. Answer: (c) ₹25,600

- First-year depreciation = ₹40,000 and second-year depreciation = ₹32,000. Book value at the beginning of the third year = ₹1,28,000; depreciation = 20% = ₹25,600.

Q6. Answer: (c) A charge against profit

- A provision is created to meet a known liability or anticipated loss and is treated as a charge against profit.

Q7. Answer: (a) An appropriation of profit

- A reserve is generally created by appropriating profits after determining the profit for the period.

Q8. Answer: (c) Even in a year of loss

- A provision is a charge against profit and may therefore be created even when the business incurs a loss.

Q9. Answer: (c) General reserve is maintained without a specific purpose

- A general reserve is created for general business purposes and is not earmarked for any specific purpose.

Q10. Answer: (a) Specific Reserve

- Dividend Equalisation Reserve is created for the specific purpose of maintaining stability in dividend payments.

Q11. Answer: (b) Capital profits

- Capital Reserve is normally created out of capital profits and is generally not available for distribution as ordinary dividend.

Q12. Answer: (c) ₹24,000

- Adjusted receivables = ₹4,00,000 – ₹20,000 = ₹3,80,000. Required provision = 5% = ₹19,000. Additional provision = ₹4,000. Total P&L charge = ₹24,000.

Q13. Answer: (a) Understating assets or overstating liabilities

- A secret reserve may be created by deliberately understating assets or overstating liabilities, thereby concealing part of the actual profits or net assets.

Q14. Answer: (d) Recognise the expected loss from doubtful receivables

- Provision for doubtful debts is created to recognise the expected loss on receivables that may not be fully realised.

Q15. Answer: (b) Bad debts and provision for doubtful debts

- Provision for discount on debtors is generally calculated on the amount of debtors remaining after deducting bad debts and provision for doubtful debts.

Q16. Answer: (c) Credited to Profit and Loss Account

- When the required closing provision is lower than the existing provision, the excess provision is written back and credited to the Profit and Loss Account.

Q17. Answer: (d) That part of uncalled capital which is to be called only on winding up

- Reserve Capital represents that portion of uncalled share capital which can be called only in the event of winding up.

Q18. Answer: (a) Issue of fully paid bonus shares or writing off capital losses

- Capital Reserve may generally be used for purposes such as issuing fully paid bonus shares and writing off certain capital losses.

Q19. Answer: (b) Obsolescence

- Obsolescence is a recognised cause of depreciation because an asset may become outdated due to technological or other changes.

Q20. Answer: (d) Not considered a cause of depreciation

- Depreciation is concerned with the systematic allocation of depreciable amount; a mere fall in market value is not itself a cause of depreciation.

Q21. Answer: (b) To ascertain true profit, present a proper financial position and comply with statutory requirements

- Depreciation helps in determining true profit, presenting assets appropriately and complying with applicable accounting and statutory requirements.

Q22. Answer: (a) ₹30,000

- Depreciable amount = ₹3,00,000 – ₹30,000 = ₹2,70,000. Annual depreciation = ₹2,70,000 ÷ 9 = ₹30,000.

Q23. Answer: (c) Divided into significant components having different useful lives and depreciated separately

- Component accounting requires significant parts of an asset having different useful lives to be separately identified and depreciated.

Q24. Answer: (a) A change in accounting estimate, applied prospectively

- A change in the method of depreciation is generally treated as a change in accounting estimate and is applied prospectively.

Q25. Answer: (c) Mines and quarries

- The Depletion Method is suitable for natural resources such as mines, quarries and oil wells, where the asset is exhausted through extraction.

Q26. Answer: (d) Amortisation

- Amortisation refers to the systematic allocation of the cost of an intangible asset over its useful life.

Q27. Answer: (a) Depreciation A/c Dr. To Asset A/c

- When depreciation is charged directly against the asset account, the asset account is credited and the depreciation account is debited.

Q28. Answer: (c) Capital receipt

- A government grant specifically received for acquisition of a fixed asset is generally treated as capital-related in nature.

Q29. Answer: (d) Provision is a charge against profit

- A provision is made before determining the final profit and is therefore treated as a charge against profit.

Q30. Answer: (d) Generally never becomes exactly zero through the normal percentage-based calculation

- Under the Written Down Value Method, depreciation is calculated on the diminishing book value, so the book value generally approaches zero without becoming exactly zero through the normal percentage calculation.

Chapter 6: Inventory Valuation

Why inventory valuation matters

Closing stock appears **twice** — as a credit in the Trading Account and as a current asset in the Balance Sheet. An error in inventory therefore misstates **both profit and financial position**, and the error reverses in the following year.

- **Overvalued Closing Stock** → Current-year profit overstated → Next-year profit understated
- **Undervalued Closing Stock** → Current-year profit understated → Next-year profit overstated

Inventory systems

1. **Periodic Inventory System:** Under the periodic system, purchases are recorded during the period, but the quantity of closing inventory is determined through a physical stock count at the end of the period.
 - $\text{Cost of Goods Sold} = \text{Opening Stock} + \text{Purchases} - \text{Closing Stock}$
 - Shortage or pilferage is not separately identified through the books; it gets absorbed into the cost of goods sold.
2. **Perpetual Inventory System:** Under the perpetual system, every receipt and issue of inventory is recorded as it occurs.
 - The inventory balance can therefore be determined from the stores ledger and is subsequently verified through physical counting.

Cost of Inventory – *Core Focus*

1. **FIFO — First In, First Out**
 - The **oldest costs** are issued first.
 - Therefore, closing inventory generally contains the **most recent purchases**.
2. **LIFO — Last In, First Out**
 - The **most recent costs** are issued first.
 - Therefore, closing inventory generally contains the **older costs**.
3. **Weighted Average**
 - All available units are assigned an **average cost**.
 - Under a perpetual system, the average is **recomputed after every purchase**.

FIFO (When prices are rising)

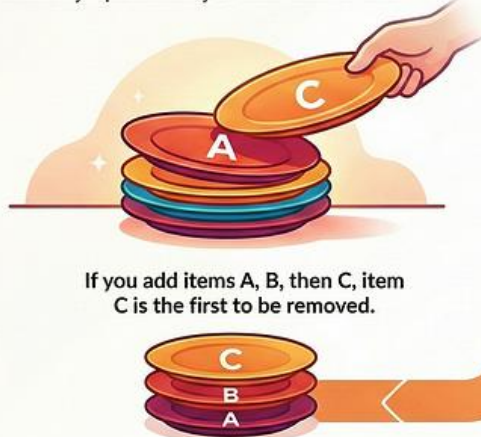
- Old, cheaper costs → issued first
- Therefore:
- $\text{COGS} \downarrow \rightarrow \text{Profit} \uparrow \rightarrow \text{Closing Stock} \uparrow$

LIFO (When prices are rising)

- Recent, higher costs → issued first
- Therefore:
- $\text{COGS} \uparrow \rightarrow \text{Profit} \downarrow \rightarrow \text{Closing Stock} \downarrow$

LIFO (Last-In, First-Out)

The last item added is the first item removed.
Commonly represented by a "Stack" data structure.



FIFO (First-In, First-Out)

The first item added is the first item removed.
Commonly represented by a "Queue" data structure.



Q1. (EPFO APFC 2015)

Data regarding inventory of a particular item used in the production activities of an organization are: the quantity in stock is 1,500 units and the value of this stock is ₹1,27,500 (an average unit cost of ₹85). During the ensuing year X, an additional 300 units are purchased at a unit cost of ₹95. Consumption in production during year X has been 600 units. Working on the First-In-First-Out basis, the value of the residual inventory at the end of year X will be

- (a) ₹1,00,000
- (b) ₹1,02,500
- (c) ₹1,05,000
- (d) ₹1,07,500

Q2. (EPFO EO/AO 2023)

Consider the following information:

Jan 1 Inventory 200 units @ ₹7;
 Jan 8 Purchases 1,100 units @ ₹8;
 Jan 25 Purchases 300 units @ ₹9;
 Jan 6 Issued 100 units;
 Jan 9 Issued 200 units.

What is the value of inventory on January 31 under the perpetual inventory system using the First-In-First-Out (FIFO) method?

- (a) ₹6,700
- (b) ₹8,700
- (c) ₹10,700
- (d) ₹12,000

Q3. (EPFO APFC 2023)

Consider the following information:

Jan 1 Inventory 200 units @ ₹7;
 Jan 8 Purchases 1,100 units @ ₹8;
 Jan 25 Purchases 300 units @ ₹9;
 Jan 6 Issued 100 units;
 Jan 9 Issued 200 units

What is the value of inventory on January 31 under the perpetual inventory system using the Last-In-First-Out (LIFO) method?

- (a) ₹6,600
- (b) ₹8,600
- (c) ₹10,600
- (d) ₹12,000

Q1. Answer: (c) ₹1,05,000

Particulars	Units	Rate (₹)	Value (₹)
Opening inventory	1,500	85	1,27,500
Add: Purchases	300	95	28,500
Total available	1,800		1,56,000
Less: Consumption — FIFO	600	85	51,000
Residual inventory	1,200		1,05,000

Q2. Answer: (c) ₹10,700

- Closing stock of 1,300 units under FIFO comprises the latest purchases: 300 @ ₹9 = ₹2,700 and 1,000 @ ₹8 = ₹8,000. Total ₹10,700.

Q3. Answer: (c) ₹10,600

Date	Transaction	Inventory after transaction
Jan 1	200 @ ₹7	200 @ ₹7
Jan 6	Issue 100 @ ₹7	100 @ ₹7
Jan 8	Purchase 1,100 @ ₹8	100 @ ₹7 + 1,100 @ ₹8
Jan 9	Issue 200 @ ₹8 (LIFO)	100 @ ₹7 + 900 @ ₹8
Jan 25	Purchase 300 @ ₹9	100 @ ₹7 + 900 @ ₹8 + 300 @ ₹9

Weighted average

Weighted Average Cost = Total cost of goods available for sale ÷ Total units available for sale, recomputed after every purchase under the perpetual (moving average) system.

Solving Q3. Above using Weighted Average

Date	Transaction	Calculation	Balance
Jan 1	200 @ ₹7	—	200 units = ₹1,400
Jan 6	Issue 100	100 × ₹7	100 units = ₹700
Jan 8	Purchase 1,100 @ ₹8	₹700 + ₹8,800 = ₹9,500	1,200 units @ ₹7.9167
Jan 9	Issue 200	200 × ₹7.9167 = ₹1,583.34	1,000 units = ₹7,916.66
Jan 25	Purchase 300 @ ₹9	₹7,916.66 + ₹2,700 = ₹10,616.66	1,300 units

Practice Questions

Q1. Overvalued Closing Stock results in:

- (a) Current-year profit understated
- (b) Current-year profit overstated and next-year profit understated
- (c) No effect on profit
- (d) Both years' profit overstated

Q2. Under Periodic Inventory System, Cost of Goods Sold =

- (a) Opening Stock + Purchases – Closing Stock
- (b) Opening Stock + Purchases + Closing Stock
- (c) Purchases – Closing Stock
- (d) Sales – Gross Profit

Q3. Under Perpetual Inventory System:

- (a) Stock is determined only by physical count
- (b) Every receipt and issue is recorded as it occurs
- (c) Shortage is absorbed in COGS without identification
- (d) No stores ledger is maintained

Q4. Under FIFO, closing inventory generally contains:

- (a) Oldest costs
- (b) Most recent purchases
- (c) Average costs
- (d) Opening stock only

Q5. Under LIFO, closing inventory generally contains:

- (a) Most recent costs
- (b) Older costs
- (c) Average costs
- (d) Highest costs always

Q6. When prices are rising, FIFO produces:

- (a) Higher COGS and lower profit
- (b) Lower COGS and higher profit
- (c) Same profit as LIFO
- (d) Lower closing stock

Q7. When prices are rising, LIFO produces:

- (a) Lower COGS and higher profit
- (b) Higher COGS and lower profit
- (c) Higher closing stock
- (d) Same as Weighted Average

Q8. Weighted Average Cost is recomputed:

- (a) Only at year-end
- (b) After every purchase under perpetual system
- (c) Never
- (d) Only after sales

Q9. LIFO is:

- (a) Permitted under AS-2
- (b) Not permitted under AS-2/Ind AS 2 for financial reporting
- (c) Mandatory
- (d) Preferred for tax

Q10. Opening inventory 1,200 units @ ₹80; Purchases 400 units @ ₹90; Consumption 500 units. Under FIFO, the value of residual inventory is:

- (a) ₹88,000
- (b) ₹90,000
- (c) ₹92,000
- (d) ₹94,000

Q11. Consider the following data:

- Opening inventory: 300 units @ ₹10
- Jan 8: Purchase 800 units @ ₹12
- Jan 25: Purchase 200 units @ ₹15
- Issues: 100 units + 250 units

Under the perpetual inventory system using FIFO, the closing stock value is:

- (a) ₹9,800
- (b) ₹10,200
- (c) ₹10,800
- (d) ₹12,000

Q12. Using the same data as **Q11**, under the perpetual inventory system using LIFO, the closing stock value is (Jan 30: Issue 100 units/Jan 31: Issue 250 units):

- (a) ₹9,800
- (b) ₹10,200
- (c) ₹10,800
- (d) ₹12,000

Q13. The ordering of values when prices are rising is:

- (a) LIFO > WAC > FIFO
- (b) FIFO > WAC > LIFO
- (c) WAC > FIFO > LIFO
- (d) All equal

Q14. Cost of inventory includes:

- (a) Abnormal wastage
- (b) Selling and distribution costs
- (c) Purchase and conversion costs + other costs to bring to present location and condition
- (d) Unrelated administrative overheads

Q15. Net Realisable Value =

- (a) Estimated selling price
- (b) Estimated selling price – estimated costs of completion – estimated costs to make the sale
- (c) Cost
- (d) Market value only

Q16. The lower-of-cost-or-NRV comparison is normally made:

- (a) On total inventory
- (b) Item by item
- (c) On category basis only
- (d) At random

Q17. Materials held for use in production are not written down below cost if:

- (a) Finished goods are expected to be sold at or above cost
- (b) Market price has fallen
- (c) They are slow-moving
- (d) Management decides

Q18. Shortage or pilferage under Periodic System:

- (a) Is separately identified
- (b) Gets absorbed into Cost of Goods Sold
- (c) Is capitalised
- (d) Is ignored completely

Q19. Under Perpetual System, inventory balance can be determined from:

- (a) Physical count only
- (b) Stores ledger (and verified by physical count)
- (c) Trial Balance only
- (d) Cash Book

Q20. Specific identification method is suitable when:

- (a) Goods are homogeneous
- (b) Goods are not interchangeable and individually identifiable
- (c) Prices are stable
- (d) Volume is very high

Q21. An error in inventory valuation:

- (a) Affects only current year
- (b) Misstates both profit and financial position, and reverses next year
- (c) Affects only Balance Sheet
- (d) Has no effect on profit

Q22. Which method assigns the most recent costs to COGS?

- (a) FIFO
- (b) LIFO
- (c) Weighted Average
- (d) Specific Identification always

Q23. Which method assigns the oldest costs to COGS?

- (a) LIFO
- (b) FIFO
- (c) Weighted Average
- (d) Base Stock

Q24. Under rising prices, which method reports higher inventory on Balance Sheet?

- (a) LIFO
- (b) FIFO
- (c) Weighted Average (always)
- (d) None

Q25. AS-2 permits which cost formulas?

- (a) Only LIFO
- (b) FIFO and Weighted Average
- (c) Only Specific Identification
- (d) All methods

Q26. Abnormal wastage is:

- (a) Included in cost of inventory
- (b) Generally excluded from cost of inventory
- (c) Capitalised
- (d) Treated as deferred revenue

Q27. The objective of inventory valuation is to:

- (a) Maximise profit
- (b) Show true and fair view of profit and financial position
- (c) Minimise tax only
- (d) Ignore market conditions

Answer Key

Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.
1	b	2	a	3	b	4	b	5	b
6	b	7	b	8	b	9	b	10	c
11	d	12	c	13	b	14	c	15	b
16	b	17	a	18	b	19	b	20	b
21	b	22	b	23	b	24	b	25	b
26	b	27	b						

Q1. Answer: (b) Current-year profit overstated and next-year profit understated

- Closing stock is deducted while calculating Cost of Goods Sold.
- If closing stock is overvalued, COGS is understated.
- Therefore, current-year profit is overstated.
- The overvaluation becomes opening stock in the next year, causing next year's profit to be understated.

Q2. Answer: (a) Opening Stock + Purchases – Closing Stock

- Under the Periodic Inventory System, COGS is calculated periodically.
- The basic formula is:
 - **COGS = Opening Stock + Net Purchases – Closing Stock**
- Therefore, among the given options, (a) is correct.

Q3. Answer: (b) Every receipt and issue is recorded as it occurs

- Under the Perpetual Inventory System, inventory records are updated continuously.
- Each receipt and issue of inventory is recorded as it occurs.
- Physical verification may still be carried out to identify discrepancies.

Q4. Answer: (b) Most recent purchases

- Under FIFO, the oldest inventory is assumed to be issued first.
- Therefore, the units remaining in closing inventory generally represent the most recent purchases.
- This is particularly relevant when prices are changing.

Q5. Answer: (b) Older costs

- Under LIFO, the latest purchases are assumed to be issued first.
- Therefore, the inventory remaining at the end generally consists of older costs.
- LIFO is not permitted under AS-2/Ind AS 2 for financial reporting.

Q6. Answer: (b) Lower COGS and higher profit

- When prices are rising, older inventory generally has lower costs.
- FIFO assumes these older, lower-cost units are issued first.
- Therefore:
 - COGS → lower
 - Closing inventory → higher
 - Profit → higher

Q7. Answer: (b) Higher COGS and lower profit

- Under LIFO, the latest purchases are assumed to be issued first.
- During rising prices, the latest purchases generally have higher costs.
- Therefore:
 - COGS → higher
 - Profit → lower

Q8. Answer: (b) After every purchase under perpetual system

- Under a perpetual inventory system using moving weighted average, the average cost is recalculated after each new purchase.
- This is commonly referred to as the moving weighted average method.
- Issues are then valued using the latest calculated average cost.

Q9. Answer: (b) Not permitted under AS-2/Ind AS 2 for financial reporting

- LIFO is not an accepted inventory cost formula under AS-2.
- Ind AS 2 also does not permit LIFO.
- Common permitted cost formulas include FIFO and Weighted Average.

Q10. Answer: (c) ₹92,000

- Total inventory:
 - 1,200 units @ ₹80
 - 400 units @ ₹90
- Consumption = 500 units.
- Under FIFO, the first 500 units are issued from the opening inventory.
- Remaining inventory:
 - 700 units @ ₹80 = ₹56,000
 - 400 units @ ₹90 = ₹36,000
- **Closing inventory = ₹92,000.**

Q11. Answer: (d) ₹12,000

- Total inventory:
 - 300 units @ ₹10
 - 800 units @ ₹12
 - 200 units @ ₹15
- Total units = 1,300 units.
- Total issues = 100 + 250 = 350 units.
- Under FIFO:
 - 300 units @ ₹10 are issued first.
 - Remaining 50 units are issued from the ₹12 layer.
- Closing inventory:

- 750 units @ ₹12 = ₹9,000
- 200 units @ ₹15 = ₹3,000
- **Closing stock = ₹12,000.**

Q12. Answer: (c) ₹10,800

- Total inventory = 1,300 units.
- Total issues = 350 units.
- Under LIFO, the latest inventory is issued first:
 - 200 units @ ₹15
 - 150 units @ ₹12
- Remaining inventory:
 - 300 units @ ₹10 = ₹3,000
 - 650 units @ ₹12 = ₹7,800
- **Closing stock = ₹10,800.**

Q13. Answer: (b) FIFO > WAC > LIFO

- When prices are rising:
 - FIFO generally gives the highest closing inventory.
 - Weighted Average gives an intermediate value.
 - LIFO gives the lowest closing inventory.
- Therefore, the usual order is **FIFO > WAC > LIFO**.

Q14. Answer: (c) Purchase and conversion costs + other costs to bring to present location and condition

- Inventory cost includes:
 - costs of purchase
 - costs of conversion
 - other costs incurred to bring inventory to its present location and condition.
- Abnormal wastage and selling/distribution costs are generally excluded.

Q15. Answer: (b) Estimated selling price – estimated costs of completion – estimated costs to make the sale

- Net Realisable Value represents the estimated amount expected to be realised from selling the inventory.
- Formula:
 - **NRV = Estimated selling price – Estimated costs of completion – Estimated costs necessary to make the sale**
- Inventory is generally measured at the lower of cost and NRV.

Q16. Answer: (b) Item by item

- Under the normal lower-of-cost-and-NRV approach, inventory is generally compared item by item.
- The carrying amount is determined based on the lower of cost and NRV for the relevant inventory item.

Q17. Answer: (a) Finished goods are expected to be sold at or above cost

- Materials held for production are generally not written down below cost when the finished goods in which they will be incorporated are expected to be sold at or above cost.
- In such a situation, the cost of the materials is expected to be recoverable through the sale of finished goods.

Q18. Answer: (b) Gets absorbed into Cost of Goods Sold

- Under the Periodic Inventory System, COGS is determined using the inventory and purchase figures available at the end of the period.
- Shortage or pilferage that is not separately identified can therefore become part of the cost of goods sold.
- It is not separately identified merely through the periodic calculation.

Q19. Answer: (b) Stores ledger (and verified by physical count)

- Under a Perpetual Inventory System, inventory records are maintained continuously.
- The stores ledger provides the recorded quantity and value of inventory.
- Physical verification can be used to identify shortages, excesses, or other discrepancies.

Q20. Answer: (b) Goods are not interchangeable and individually identifiable

- Specific Identification is suitable when individual items can be specifically identified with their respective costs.
- It is particularly relevant for:
 - unique items
 - high-value individually identifiable goods
 - non-interchangeable inventory

Q21. Answer: (b) Misstates both profit and financial position, and reverses next year

- Inventory is both:
 - an item in the Balance Sheet, and
 - a component affecting profit through COGS.
- Therefore, an inventory valuation error can affect both profit and financial position.
- The effect on profit generally reverses in the following accounting period.

Q22. Answer: (b) LIFO

- LIFO assumes that the latest costs are issued first.
- Therefore, under LIFO, the most recent costs are assigned to COGS.
- The older costs remain in closing inventory.

Q23. Answer: (b) FIFO

- FIFO assumes that the oldest inventory is issued first.
- Therefore, the oldest costs are assigned to COGS.
- The more recent costs generally remain in closing inventory.

Q24. Answer: (b) FIFO

- When prices are rising, recent purchases generally have higher costs.
- Under FIFO, these recent costs remain in closing inventory.
- Therefore, FIFO generally reports a higher closing inventory value than LIFO during rising prices.

Q25. Answer: (b) FIFO and Weighted Average

- AS-2 permits FIFO and Weighted Average as inventory cost formulas.
- LIFO is not permitted.
- Therefore, option (b) is correct.

Q26. Answer: (b) Generally excluded from cost of inventory

- Abnormal wastage does not represent a normal cost of bringing inventory to its present location and condition.
- Therefore, abnormal wastage is generally excluded from inventory cost.
- It is normally recognised as an expense of the period.

Q27. Answer: (b) Show true and fair view of profit and financial position

- Inventory valuation directly affects COGS, profit and current assets.
- Proper inventory valuation therefore helps present a reliable picture of the entity's financial position and performance.
- The objective is not to deliberately maximise profit or minimise tax.

Chapter 7: Rectification of Errors

Types of Error - *Core Focus*



Type	Definition	Examples	Detected by Trial Balance?
Error of Omission	A transaction is completely or partially left out of the books	Complete: a cash sale not recorded in the cash book at all; an invoice mislaid and never entered. Partial: entered in the subsidiary book but not posted to one ledger	Complete → NO (both sides missing). Partial → YES (one side missing)
Error of Commission	A transaction is recorded, but wrongly — wrong amount, wrong side, wrong account of the <i>same class</i> , wrong casting, wrong balancing, wrong carry-forward	Overcasting the sales book; posting ₹540 as ₹450; crediting Ramesh instead of Ramendra; wrong balancing of the Machinery Account	Sometimes — casting and posting-amount errors are caught; wrong-person errors are not
Error of Principle	A transaction is recorded in violation of an accounting principle — typically a capital item treated as revenue, or vice versa	Machinery purchase debited to Purchases A/c; installation wages debited to Wages A/c; conversion of a shed into a building charged to Repairs; purchase of an asset treated as an expense	NEVER — the debit and credit are equal, only misclassified
Compensating (Offsetting) Error	Two or more errors whose effects cancel each other out in amount and direction	Ram's A/c overcast by ₹1,000 on the debit side and Shyam's A/c overcast by ₹1,000 on the credit side	NEVER

- A tallied Trial Balance proves the books add up — it does not prove they are right

Q1. (EPFO EO/AO 2023)

A credit purchase of machinery recorded in the Purchase Book instead of the Journal Proper is an example of

- Compensating errors
- Errors of commission
- Errors of principle
- Errors of omission

Q2. (EPFO APFC 2023)

Which one of the following is not an error of commission?

- Overcasting of sales book

- Credit sales to Ramesh ₹5,000 credited to his account
- Wrong balancing of machinery account
- Cash sales not recorded in cash book

Q3. (UPSC EPFO, 2025)

When purchase of an asset is treated as an expense, in the accounting context, it is called

- Error of principle
- Error of omission
- Error of commission
- Compensating error

Q1. Answer: (c) Errors of principle

- Machinery is a fixed asset; the Purchases Book is only for goods meant for resale. Routing it through the Purchases Book converts a capital item into a revenue item — a violation of the capital/revenue principle, not a clerical slip.

Q2. Answer: (d) Cash sales not recorded in cash book

- wrong casting, (b) posting to the wrong side of the right account, and (c) wrong balancing are all errors of commission — the transaction was recorded, but incorrectly. In (d) the transaction was never recorded at all, which makes it an error of complete omission.

Q3. Answer: (a) Error of principle

- Capital treated as revenue = error of principle. Note this is the same idea as EO/AO 2023 Q43, stripped to its bare statement — the examiner asked the concept in narrative form in 2023 and in abstract form in 2025.

One-sided vs two-sided errors — the rectification method

Nature of error	Effect on Trial Balance	How to rectify
Two-sided error (affects two or more accounts)	TB still tallies	Pass a complete journal entry — debit the account wrongly credited/understated, credit the account wrongly debited/overstated. No Suspense Account involved.
One-sided error (affects only one account)	TB does not tally	Before final accounts: pass an entry through the Suspense Account . If discovered before the TB is prepared, simply correct the account by adding a note.

The Suspense Account

- When a Trial Balance does not agree and the difference cannot be located before the final accounts must be prepared, the difference is transferred to a **Suspense Account** so that the Balance Sheet can be completed.
- A **debit** balance in Suspense appears on the **assets** side; a **credit** balance on the **liabilities** side.
- Every **one-sided** error located later is rectified **through** the Suspense Account; every **two-sided** error is rectified **without** it.
- When all errors are found and rectified, the Suspense Account **automatically closes**. A residual balance means errors remain undetected.

Rectification after preparation of final accounts

If an error affecting a **nominal account** is discovered in the next accounting period, the nominal account of the previous year no longer exists — it has been closed to P&L. Such errors are rectified through a **Profit and Loss Adjustment Account** (also called Prior Period Adjustment), whose balance is transferred to Capital.

Thumb rule: Real and Personal accounts are rectified directly (their balances carry forward). Nominal accounts are rectified through P&L Adjustment A/c.

Q4. (EPFO APFC 2023)**Which of the following errors is not detected by the Trial Balance?**

- A credit purchase of ₹1,000 from Mr. Singh is credited wrongly to the account of Mr. Akash
- A credit purchase of ₹20,000 from Mr. Sandhu is recorded in the day book as ₹2,000
- Conversion of a temporary shed into a permanent building is recorded as repairs and maintenance expense
- Error in posting from the book of subsidiary record to the ledger

Answer: (c) — The official answer key marks (c) as the correct answer, treating it as an error of principle. However, the wording of the question is somewhat ambiguous because (a) and (b) can also be interpreted as errors that would not affect the agreement of the Trial Balance. Therefore, (c) should be treated as the intended answer based on the official key.

Practice questions

Q1. Error of Omission means:

- (a) Transaction recorded wrongly
- (b) Transaction completely or partially left out
- (c) Violation of accounting principle
- (d) Two errors cancelling each other

Q2. Complete omission is:

- (a) Detected by Trial Balance
- (b) Not detected by Trial Balance
- (c) Always one-sided
- (d) An error of principle

Q3. Error of Commission includes:

- (a) Wrong amount, wrong side, wrong account of same class, wrong casting
- (b) Complete omission
- (c) Capital treated as revenue
- (d) Only compensating errors

Q4. Error of Principle is:

- (a) Clerical mistake
- (b) Violation of an accounting principle (capital treated as revenue or vice versa)
- (c) Complete omission
- (d) Wrong casting only

Q5. A credit purchase of machinery recorded in the Purchases Book is an:

- (a) Error of omission
- (b) Error of commission
- (c) Error of principle
- (d) Compensating error

Q6. Which is NOT an error of commission?

- (a) Overcasting of sales book
- (b) Credit sales to Ramesh ₹5,000 credited to his account
- (c) Wrong balancing of machinery account
- (d) Cash sales not recorded in cash book

Q7. When purchase of an asset is treated as an expense, it is:

- (a) Error of principle
- (b) Error of omission
- (c) Error of commission
- (d) Compensating error

Q8. Compensating errors are:

- (a) Detected by Trial Balance
- (b) Never detected by Trial Balance
- (c) Always one-sided
- (d) Errors of principle

Q9. A tallied Trial Balance proves:

- (a) Books are completely free from error
- (b) Books add up arithmetically (but errors may remain)
- (c) Financial statements are correct
- (d) No fraud has occurred

Q10. Two-sided errors are rectified by:

- (a) Suspense Account

(b) Complete journal entry (no Suspense)

(c) Only narration

(d) Ignoring them

Q11. One-sided errors are rectified through:

- (a) Complete journal entry without Suspense
- (b) Suspense Account
- (c) Only Balance Sheet
- (d) Cash Book only

Q12. Suspense Account is opened when:

- (a) Trial Balance agrees
- (b) Trial Balance does not agree and difference cannot be located before final accounts
- (c) There are only two-sided errors
- (d) Books are perfect

Q13. Debit balance in Suspense Account appears on:

- (a) Liabilities side
- (b) Assets side
- (c) Neither
- (d) Capital side

Q14. The Sales Book was undercast by ₹4,000. What will be the effect before rectification?

- (a) Debit total of Trial Balance exceeds credit total by ₹4,000
- (b) Credit total of Trial Balance exceeds debit total by ₹4,000
- (c) Trial Balance will still agree
- (d) Difference of ₹8,000 will arise

Q15. Furniture purchased for ₹12,000 was wrongly recorded as purchases of goods. Which of the following is correct?

- (a) It is an error of omission
- (b) It is an error of principle
- (c) It is an error of commission and will necessarily affect the Trial Balance
- (d) It is a compensating error

Q16. ₹2,500 received from Ramesh was correctly recorded in the Cash Book but credited to Suresh's account. Which statement is correct?

- (a) Trial Balance will necessarily disagree
- (b) It is an error of principle
- (c) Trial Balance may still agree despite the error
- (d) It is an error of complete omission

Q17. Which of the following represents an **error of principle** that may remain undetected by the Trial Balance?

- (a) Credit purchase from Singh is credited to Akash
- (b) A purchase of ₹20,000 is recorded as ₹2,000 in the books
- (c) Expenditure incurred to convert a temporary shed into a permanent building is treated as repairs expense
- (d) An amount is posted only to the debit side of the relevant ledger accounts

Q18. A credit purchase of goods worth ₹20,000 is recorded in the Purchases Book as ₹2,000, and the same

amount is posted to the supplier's account. What is the likely result?

- (a) Trial Balance will disagree by ₹18,000
- (b) Trial Balance will agree, although both Purchases and the supplier's account are understated
- (c) Trial Balance will disagree by ₹2,000
- (d) It is an error of principle

Q19. A credit sale of ₹8,000 is completely omitted from the books. Which statement is correct?

- (a) Trial Balance will disagree by ₹8,000
- (b) Trial Balance will disagree by ₹16,000
- (c) Trial Balance may still agree
- (d) Suspense Account must be opened

Q20. Goods returned to a supplier for ₹6,000 are entered in the Purchase Returns Book, but the supplier's account is not posted. What is the likely effect?

- (a) Trial Balance will continue to agree
- (b) Trial Balance will disagree
- (c) It is an error of principle
- (d) It is a compensating error

Q21. The Purchases Book has been overcast by ₹3,000. Which statement correctly describes the error?

- (a) Purchases Account has been debited more than it should be
- (b) Purchases Account has been credited more than it should be
- (c) Both Purchases and supplier accounts are understated
- (d) The error cannot affect the Trial Balance

Q22. ₹10,000 paid for office furniture is wrongly debited to Office Expenses. Which statement best describes the error?

- (a) It is an error of omission
- (b) It is an error of principle and may remain undetected by the Trial Balance
- (c) It is an error of commission that must cause Trial Balance disagreement
- (d) It is a compensating error

Q23. Which of the following errors is **least likely to be detected merely by checking whether the Trial Balance agrees?**

- (a) Sales Book total is not posted to Sales Account
- (b) Purchase of machinery is treated as an ordinary revenue expense
- (c) One side of a ledger posting is completely omitted
- (d) A ledger account is wrongly totalled

Q24. The Trial Balance difference of ₹7,500 was placed in Suspense Account. Later, it was discovered that the Sales Account had been credited ₹7,500 less than required. What does this indicate?

- (a) Sales Account needs a further credit of ₹7,500
- (b) Sales Account needs a further debit of ₹7,500

- (c) The original sales transaction was completely omitted
- (d) It is an error of principle

Q25. Repairs expenditure of ₹4,000 incurred for an existing machine is wrongly treated as an addition to the Machinery Account. This is:

- (a) Error of omission
- (b) Error of commission
- (c) Error of principle
- (d) Compensating error

Q26. Wages Account is overcast by ₹2,000 while Salaries Account is undercast by ₹2,000. What type of error is illustrated?

- (a) Error of principle
- (b) Error of omission
- (c) Compensating error
- (d) Error of complete omission

Q27. After all errors discovered so far have been rectified, the Trial Balance agrees. Which conclusion is justified?

- (a) No accounting error can remain
- (b) All errors of principle have necessarily been detected
- (c) Some errors may still remain undetected
- (d) Financial statements must be completely accurate

Q28. An error relating to a nominal account is discovered in the following accounting year after the previous year's Profit & Loss Account has already been closed. Which account is generally used for adjustment?

- (a) Suspense Account
- (b) Profit & Loss Adjustment Account
- (c) Trading Account
- (d) Capital Account

Q29. Which of the following combinations is **correct?**

- (a) Complete omission — Trial Balance necessarily disagrees
- (b) Error of principle — Trial Balance necessarily disagrees
- (c) Compensating errors — Trial Balance may agree despite errors
- (d) Wrong posting to the opposite side — Trial Balance always agrees

Q30. A Trial Balance was prepared and found to agree. Which of the following errors **could still exist** in the books?

- (a) A transaction has been recorded only on the debit side
- (b) The total of the Sales Book has been posted twice to the Sales Account
- (c) A credit purchase has been completely omitted from the books
- (d) The debit side of an account has been overcast by ₹5,000

Answers & Explanations

Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.
1	b	2	b	3	a	4	b	5	c
6	d	7	a	8	b	9	b	10	b
11	b	12	b	13	b	14	a	15	b
16	c	17	c	18	b	19	c	20	b
21	a	22	b	23	b	24	a	25	c
26	c	27	c	28	b	29	c	30	c

Q1. Answer: (b) Transaction completely or partially left out

- An error of omission occurs when a transaction is **completely or partially omitted** from the books.
- Complete omission means the entire transaction is left unrecorded.
- Partial omission means some part of the recording/posting is omitted.

Q2. Answer: (b) Not detected by Trial Balance

- In complete omission, both the **debit and credit aspects** of a transaction are omitted.
- Therefore, the Trial Balance can still agree.
- Hence, complete omission is generally **not detected by Trial Balance**.

Q3. Answer: (a) Wrong amount, wrong side, wrong account of same class, wrong casting

- Error of commission arises from **clerical mistakes in recording or posting**.
- Examples include:
 - wrong amount
 - wrong side
 - wrong account of the same class
 - wrong casting or totaling

Q4. Answer: (b) Violation of an accounting principle (capital treated as revenue or vice versa)

- An error of principle occurs when an **accounting principle is violated**.
- A common example is treating:
 - capital expenditure as revenue expenditure, or
 - revenue expenditure as capital expenditure.
- Such errors may not affect the Trial Balance.

Q5. Answer: (c) Error of principle

- Machinery is a **capital asset**.
- Purchases Book is meant for goods purchased for resale.
- Recording machinery in the Purchases Book violates the **capital-revenue distinction**.
- Therefore, it is an error of principle.

Q6. Answer: (d) Cash sales not recorded in cash book

- Overcasting of Sales Book → error of commission.
- Wrong posting/balancing → error of commission.
- Completely failing to record cash sales → **error of omission**.
- Therefore, (d) is not an error of commission.

Q7. Answer: (a) Error of principle

- Purchase of an asset is a **capital expenditure**.
- Treating it as an expense treats a capital item as a revenue item.
- This violates the capital-revenue distinction.
- Therefore, it is an error of principle.

Q8. Answer: (b) Never detected by Trial Balance

- Compensating errors are errors whose effects **cancel each other**.
- The total debit and credit effects may therefore remain equal.
- As a result, the Trial Balance may agree despite the errors.

Q9. Answer: (b) Books add up arithmetically (but errors may remain)

- A tallied Trial Balance establishes **arithmetical agreement** between debit and credit totals.

- It does not establish that every transaction has been correctly recorded.
- Errors such as complete omission and errors of principle may remain undetected.

Q10. Answer: (b) Complete journal entry (no Suspense)

- A two-sided error affects **both the accounts involved**.
- Its rectification can therefore be made through the appropriate accounting entry.
- Suspense Account is generally required for **one-sided errors**, not two-sided errors.

Q11. Answer: (b) Suspense Account

- A one-sided error affects only **one ledger account**.
- If the Trial Balance difference has been temporarily placed in Suspense Account, it is used during rectification.
- Once the error is rectified, the Suspense Account is adjusted accordingly.

Q12. Answer: (b) Trial Balance does not agree and difference cannot be located before final accounts

- Suspense Account is a **temporary account**.
- It is opened when the Trial Balance does not agree.
- It helps temporarily accommodate the difference until the errors causing it are located.

Q13. Answer: (b) Assets side

- A debit balance represents a balance with a **debit nature**.
- A debit balance in Suspense Account is therefore shown on the **assets side** of the Balance Sheet.
- It remains there only until the underlying errors are rectified.

Q14. Answer: (a) Debit total of Trial Balance exceeds credit total by ₹4,000

- Sales Account normally has a **credit balance**.
- If the Sales Book is undercast by ₹4,000, Sales Account is credited ₹4,000 less.
- Therefore, the credit total of the Trial Balance is short by ₹4,000.
- Hence, the **debit total exceeds the credit total by ₹4,000**.

Q15. Answer: (b) It is an error of principle

- Furniture is a **capital asset**.
- Purchases of goods for resale are recorded through the Purchases Account.
- Recording furniture as purchases incorrectly classifies a capital item.
- Therefore, it is an **error of principle**.

Q16. Answer: (c) Trial Balance may still agree despite the error

- Cash received from Ramesh is correctly recorded in the Cash Book.
- However, Suresh's account is credited instead of Ramesh's.
- Both accounts are personal accounts and the amount of debit and credit remains equal.
- Therefore, the Trial Balance **may still agree**.

Q17. Answer: (c) Expenditure incurred to convert a temporary shed into a permanent building is treated as repairs expense

- Converting a temporary shed into a permanent building is **capital expenditure**.
- Treating this expenditure as repairs expense treats a capital item as a revenue expense.
- This violates the **capital-revenue distinction**.
- Therefore, it is an error of principle and may remain undetected by the Trial Balance.

Q18. Answer: (b) Trial Balance will agree, although both Purchases and the supplier's account are understated

- Actual purchase = ₹20,000.
- Recorded amount = ₹2,000.
- Both the Purchases Account and supplier's account are understated by **₹18,000**.
- Since both debit and credit are affected equally, the Trial Balance can still agree.

Q19. Answer: (c) Trial Balance may still agree

- The credit sale involves:
 - Debit → Debtor
 - Credit → Sales
- Since the entire transaction is omitted, **both sides are omitted**.
- Therefore, the Trial Balance may still agree.

Q20. Answer: (b) Trial Balance will disagree

- Purchase Returns Book records the return transaction.
- The corresponding posting to the supplier's account has been omitted.
- Thus, only one side of the ledger posting is missing.
- This is a **one-sided error**, which causes Trial Balance disagreement.

Q21. Answer: (a) Purchases Account has been debited more than it should be

- Purchases Book is used to determine the amount debited to Purchases Account.
- Overcasting means the total has been calculated **₹3,000 too high**.
- Therefore, Purchases Account has been **over-debited by ₹3,000**.
- This creates a difference in the Trial Balance.

Q22. Answer: (b) It is an error of principle and may remain undetected by the Trial Balance

- Installation expenditure is directly related to bringing machinery into working condition.
- It is therefore treated as part of the **capital cost of machinery**.
- Treating it as wages incorrectly treats capital expenditure as revenue expenditure.
- Hence, it is an error of principle.

Q23. Answer: (b) Purchase of machinery is treated as an ordinary revenue expense

- Machinery is a **capital asset**.
- Treating its purchase as an ordinary expense violates the capital-revenue distinction.
- Both debit and credit sides can remain equal.
- Therefore, the Trial Balance may still agree.

Q24. Answer: (a) Sales Account needs a further credit of ₹7,500

- Sales Account should have been credited with ₹7,500 more.
- Its credit balance is therefore understated by ₹7,500.
- Therefore, Sales Account requires a **further credit of ₹7,500**.
- The corresponding adjustment is made through Suspense Account.

Q25. Answer: (c) Error of principle

- Repairs expenditure on an existing machine is normally **revenue expenditure**.
- It should not ordinarily be added to the cost of the Machinery Account.
- Treating revenue expenditure as capital expenditure violates an accounting principle.
- Hence, it is an **error of principle**.

Q26. Answer: (c) Compensating error

- Wages Account is overcast by ₹2,000 → excess debit of ₹2,000.
- Salaries Account is undercast by ₹2,000 → shortage of debit of ₹2,000.
- The two errors **offset each other**.
- Therefore, it is a compensating error.

Q27. Answer: (c) Some errors may still remain undetected

- Agreement of the Trial Balance does not guarantee that all errors have been discovered.
- Errors such as:
 - complete omission
 - error of principle
 - compensating errors may remain undetected.
- Therefore, a tallied Trial Balance is **not conclusive proof of error-free books**.

Q28. Answer: (b) Profit & Loss Adjustment Account

- Nominal accounts affect the Profit & Loss Account.
- If an error relating to a nominal account is discovered in a subsequent accounting year after the previous year's Profit & Loss Account has been closed, the adjustment is generally made through the **Profit & Loss Adjustment Account**.

Q29. Answer: (c) Compensating errors — Trial Balance may agree despite errors

- Compensating errors have **offsetting effects**.
- One error may cancel the effect of another.
- Therefore, the debit and credit totals can remain equal.
- Hence, the Trial Balance may agree even though errors exist.

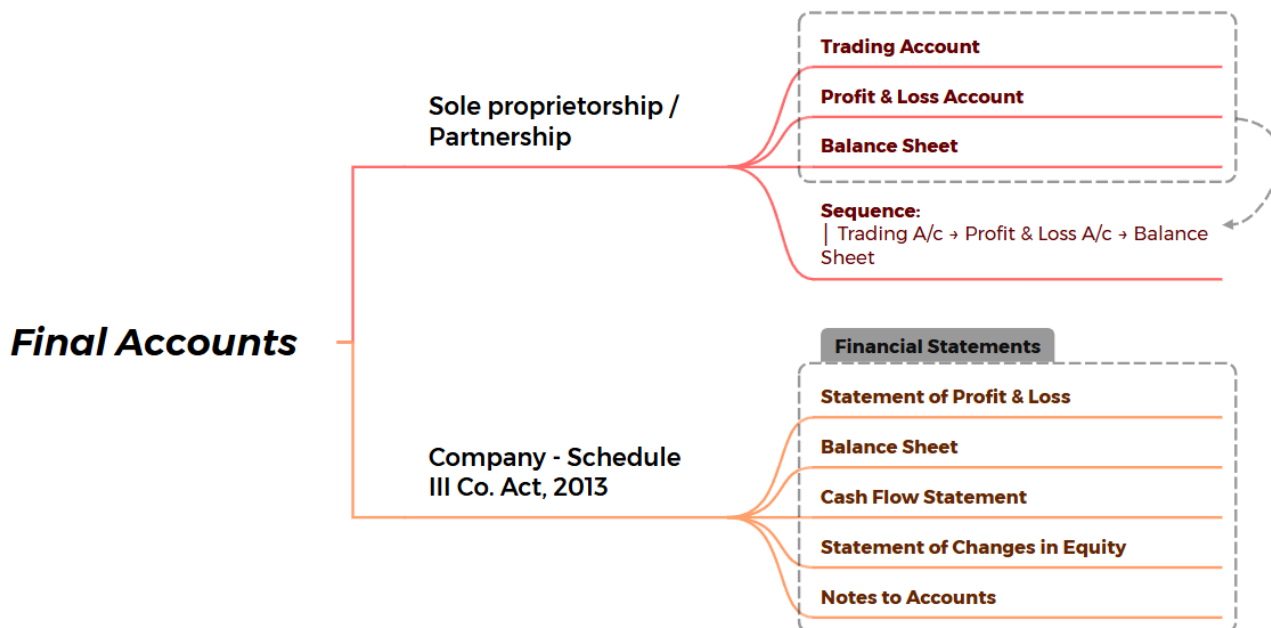
Q30. Answer: (c) A credit purchase has been completely omitted from the books

- A completely omitted credit purchase affects both:
 - Purchases Account → debit
 - Supplier's Account → credit
- If the entire transaction is omitted, **both debit and credit are absent**.
- Therefore, the Trial Balance can still agree.

Chapter 8: Final Accounts

Core Focus

- Final Accounts is the collective name for the statements prepared at the end of an accounting period to show the result of operations and the state of affairs of a business



The accounting flow remains the same, but the presentation and statutory requirements differ.

Trading Account

- The trading account is a nominal account which shows the result of buying and selling of goods for an accounting period.

Trading account for the year ended . . .					
Dr.					Cr.
Particulars	₹	₹	Particulars	₹	₹
To Opening stock		xxx	By Sales	xxx	
To Purchases	xxx		Less: Sales returns	xxx	xxx
Less: Purchases returns	xxx	xxx	By Closing stock		xxx
To Direct expenses:			By Gross loss c/d*		xxx
Carriage/Freight inwards		xxx			
Wages		xxx			
Dock charges		xxx			
Octroi		xxx			
Royalty		xxx			
Import duty		xxx			
To Cost of goods manufactured		xxx			
To Gross profit c/d*		xxx			
		xxx			xxx

Note: Wages and Salaries" → Trading Account (wages dominant, hence direct). "Salaries and Wages" → Profit & Loss Account (salaries dominant, hence indirect). The order of the words decides the destination. This is a classic one-mark discriminator.

Cost of goods sold = Opening stock + Net purchases + Direct expenses – Closing stock

If the amount of sales exceeds the cost of goods sold, the difference is gross profit. On the other hand, the excess of cost of goods sold over the amount of sales results in gross loss.

Sales – Cost of goods sold = Gross profit

Sales – Gross profit = Cost of goods sold

Example: From the following information, prepare Trading Account for the year ended 31.12.2016.

Particulars	₹
Opening Stock (1.1.2016)	10,000
Purchases	26,100
Sales	40,600
Closing Stock (31.12.2016)	13,500

Trading Account for the year ended 31st December, 2016

Particulars	Amount (₹)	Particulars	Amount (₹)
To Opening Stock	10,000	By Sales	40,600
To Purchases	26,100	By Closing Stock	13,500
To Gross Profit c/d	18,000		
Total	54,100	Total	54,100

Gross Profit

1. GP as a percentage of SALES:

GP = Sales × rate.

Cost of goods sold = Sales – GP.

2. GP as a percentage of COST: if GP is x% on cost, then on sales it is $x/(100+x)$. Take cost = 100, GP = x, sales = $100 + x$.

- 25% on COST = 20% on SALES. $33\frac{1}{3}\%$ on COST = 25% on SALES. 50% on COST = $33\frac{1}{3}\%$ on SALES. 20% on COST = $16\frac{2}{3}\%$ on SALES.
- On cost x% → on sales $x/(100+x)$; on sales y% → on cost $y/(100-y)$.

Q1. (EPFO EO/AO 2017)

Consider the following information: Rate of gross profit — 25% on cost of goods sold; Sales — ₹20,00,000. Which one of the following is the amount of gross profit?

- (a) ₹5,00,000
- (b) ₹6,25,000
- (c) ₹3,75,000
- (d) ₹4,00,000

Q2. (EPFO EO/AO 2021)

Which one of the following denotes Gross Profit?

- (a) Cost of goods sold + Opening stock
- (b) Sales less Cost of goods sold
- (c) Sales less Purchases
- (d) Net profit less Expenses of the period

Answers & Explanations

Q1. Answer: (d) ₹4,00,000

GP is 25% on cost, not on sales. Let cost = 100, then GP = 25 and sales = 125. $GP = \text{Sales} \times 25/125 = 20,00,000 \times 1/5 = ₹4,00,000$. Cost of goods sold = ₹16,00,000.

Q2. Answer: (b) Sales less Cost of goods sold

GP = Net Sales – COGS, where COGS = Opening Stock + Net Purchases + Direct Expenses – Closing Stock.

Option (c) is wrong because it ignores opening and closing stock and direct expenses.

Profit & Loss Account

Profit and Loss Account
(for the year ended)

Particulars	Amount	Particulars	Amount
To Gross Loss b/d	xxxx	By Gross Profit b/d	xxxx
To Salaries	xxxx	By Rent	xxxx
To Rent Rates and Taxes	xxxx	By Commission	xxxx
To Office Lighting	xxxx	By Interest on Drawings	xxxx
To Printing and Stationery	xxxx	By Interest on Investment	xxxx
To Insurance Premium	xxxx	By Discount Received	xxxx
To Postage	xxxx	By Profit on sale of Assets	xxxx
To General Expenses	xxxx	By Net Loss c/d	xxxx
To Miscellaneous Expenses	xxxx		
To Salary to staff	xxxx		
To Commission Charges	xxxx		
To Advertising Expenses	xxxx		
To Carriage Outward	xxxx		
To Bad Debts	xxxx		
To Packing Expenses	xxxx		
To Interest on loans	xxxx		
To Discount Allowed	xxxx		
To Depreciation	xxxx		
To Repairs and Maintenance	xxxx		
To Loss on sale of Assets	xxxx		
To Provision for Bad Debts	xxxx		
To Net Profit c/d	xxxx		
	xxxx		xxxx

Operating Profit vs Net profit

Operating profit is the profit generated by the core business activity, before non-operating incomes and expenses.

- **Operating Profit = Net Profit + Non-operating Expenses – Non-operating Incomes or**
- **Operating Profit = Gross Profit – Operating Expenses** (office, selling, distribution, depreciation)
- **Non-operating expenses:** interest on loans and debentures, loss on sale of fixed assets or investments, loss by fire, donations, preliminary expenses written off.
- **Non-operating incomes:** interest received on investments, dividend received, rent received (if not the main business), profit on sale of fixed assets or investments.

Q3. (UPSC EPFO, 2025)**Which one of the following is correct?**

- (a) Operating profit = Net profit – Non-operating expenses – Non-operating incomes
- (b) Operating profit = Net profit + Non-operating expenses – Non-operating incomes
- (c) Operating profit = Net profit + Non-operating expenses + Non-operating incomes
- (d) Operating profit = Net profit – Non-operating expenses + Non-operating incomes

Answer: (b) Operating profit = Net profit + Non-operating expenses – Non-operating incomes

- Pure sign discipline. All four options contain the same three terms; only the signs vary. Teach the logic rather than the formula, because a memorised formula is easy to reverse under exam pressure.

Balance Sheet**Classification of assets and liabilities**

Category	Definition	Examples
Current Assets	Expected to be realised, sold or consumed within twelve months or within the operating cycle, whichever is longer	Cash, bank, debtors, bills receivable, stock, prepaid expenses, accrued income, short-term investments
Non-Current Assets	All other assets	Land, building, plant, furniture, vehicles, goodwill, patents, long-term investments
Fictitious Assets	Debit balances that are not assets at all	Preliminary expenses, discount on issue of debentures, advertisement suspense, P&L (Dr.) balance
Wasting Assets	Assets that are depleted by extraction	Mines, quarries, oil wells
Current Liabilities	Payable within twelve months or within the operating cycle	Creditors, bills payable, bank overdraft, outstanding expenses, income received in advance, short-term provisions, current maturities of long-term debt
Non-Current Liabilities	Payable after twelve months	Debentures, long-term loans, deferred tax liability
Contingent Liabilities	Possible obligations dependent on an uncertain future event	Guarantees given, bills discounted not yet matured, disputed tax demands, claims not acknowledged as debts — disclosed by note, not recorded

Q4. (EPFO EO/AO 2021)**When are current liabilities payable?**

- (a) Within a year
- (b) After one year but within five years
- (c) Within five years
- (d) Subject to a contingency

Answer: (a) Within a year

- The twelve-month test. Option (d) describes a contingent liability, which is a different animal altogether — it is disclosed, not shown as a liability.

Schedule III of the Companies Act 2013

Schedule III to the Companies Act, 2013 prescribes the format of the Balance Sheet and the Statement of Profit and Loss for companies.

- **Division I** — for companies applying **AS**. **Division II** — for companies applying **Ind AS**. **Division III** — for NBFCs applying Ind AS.
- The Balance Sheet is presented in **vertical form only**; the horizontal form is not permitted.
- Structure: **Equity and Liabilities** (Shareholders' Funds → Share Application Money Pending Allotment → Non-Current Liabilities → Current Liabilities) and **Assets** (Non-Current Assets → Current Assets).
- Figures may be rounded off, and **corresponding previous-year figures must be given** for every item.

Q5. (EPFO EO-AO 2017)

Under which Schedule of the Companies Act, 2013 are the formats of financial statements prescribed?

- (a) Schedule I
- (b) Schedule II
- (c) Schedule III
- (d) Schedule IV

Answer: (c) Schedule III

- Learn the whole set, because the distractors are real schedules: Schedule I — Table F, model articles and memorandum; Schedule II — useful lives for depreciation; Schedule III — format of financial statements; Schedule V — managerial remuneration; Schedule VII — CSR activities.

Adjustment entries

- Adjustments are accounting entries made to ensure that **all incomes and expenses relating to the current accounting period are properly recognised** and that assets and liabilities are shown at their correct values. In the final accounts, an adjustment may affect the **Trading/P&L Account, Balance Sheet, or both**.

Adjustment	Journal Entry	Trading / P&L	Balance Sheet
Closing stock	Closing Stock A/c Dr. / To Trading A/c	Credit of Trading A/c	Current asset
Outstanding expense	Expense A/c Dr. / To Outstanding Expense A/c	Add to the expense	Current liability
Prepaid expense	Prepaid Expense A/c Dr. / To Expense A/c	Deduct from the expense	Current asset
Accrued income	Accrued Income A/c Dr. / To Income A/c	Add to the income	Current asset
Income received in advance	Income A/c Dr. / To Income Received in Advance A/c	Deduct from the income	Current liability
Depreciation	Depreciation A/c Dr. / To Asset A/c	Debit of P&L	Deduct from the asset
Further bad debts	Bad Debts A/c Dr. / To Debtors A/c	Debit of P&L	Deduct from debtors
Provision for doubtful debts	P&L A/c Dr. / To Provision for D/D A/c	Debit of P&L	Deduct from debtors
Interest on capital	Interest on Capital A/c Dr. / To Capital A/c	Debit of P&L	Add to capital
Interest on drawings	Drawings A/c Dr. / To Interest on Drawings A/c	Credit of P&L	Deduct from capital
Goods distributed as free samples	Advertisement A/c Dr. / To Purchases A/c	Deduct from purchases; debit P&L	—
Goods taken by proprietor	Drawings A/c Dr. / To Purchases A/c	Deduct from purchases	Deduct from capital
Abnormal loss of stock by fire (insured)	Insurance Claim A/c Dr. / Loss by Fire A/c Dr. / To Purchases (or Trading) A/c	Loss to P&L	Claim receivable as current asset
Manager's commission on net profit	Commission A/c Dr. / To Outstanding Commission A/c	Debit of P&L	Current liability

Note: Every adjustment given **OUTSIDE** the Trial Balance is posted **TWICE** — once in the Trading/P&L Account and once in the Balance Sheet. Every item given **INSIDE** the Trial Balance is posted **ONCE**.

Q6. (UPSC EPFO, 2025)

Which one of the following will be the adjustment journal entry if the rent received in advance is ₹2,000?

- (a) Debit profit and loss account and Credit rent account
- (b) Debit rent received account and Credit rent received in advance account
- (c) Debit rent received in advance account and Credit rent received account
- (d) Debit rent account and Credit profit and loss account

Answer: (b) Debit rent received account and Credit rent received in advance account

- ₹2,000 of the rent already credited to income does not belong to this year, so the income account is reduced by a debit, and the amount is parked in a liability account (Rent Received in Advance), which is credited.

Practice questions

Q1. Final Accounts collectively refer to:

- (a) Only Trading Account
- (b) Trading Account, Profit & Loss Account and Balance Sheet
- (c) Only Balance Sheet
- (d) Only Cash Flow Statement

Q2. “Wages and Salaries” is shown in:

- (a) Profit & Loss Account
- (b) Trading Account
- (c) Balance Sheet
- (d) Receipts and Payments Account

Q3. “Salaries and Wages” is shown in:

- (a) Trading Account
- (b) Profit & Loss Account
- (c) Balance Sheet as liability
- (d) Capital Account

Q4. Cost of Goods Sold =

- (a) Opening Stock + Net Purchases + Direct Expenses – Closing Stock
- (b) Sales – Gross Profit
- (c) Both (a) and (b)
- (d) Only Purchases

Q5. Gross Profit =

- (a) Sales – Cost of Goods Sold
- (b) Sales – Purchases
- (c) Net Profit – Expenses
- (d) Cost of Goods Sold + Opening Stock

Q6. If Gross Profit is 25% on cost, then on sales it is:

- (a) 25%
- (b) 20%
- (c) $33\frac{1}{3}\%$
- (d) $16\frac{2}{3}\%$

Q7. Operating Profit =

- (a) Net Profit – Non-operating expenses – Non-operating incomes
- (b) Net Profit + Non-operating expenses – Non-operating incomes
- (c) Gross Profit + Operating Expenses
- (d) Net Profit only

Q8. Current Assets are expected to be realised:

- (a) After twelve months
- (b) Within twelve months or operating cycle, whichever is longer
- (c) Only within operating cycle
- (d) Never

Q9. Contingent Liabilities are:

- (a) Recorded as liability
- (b) Disclosed by way of note
- (c) Shown as asset
- (d) Ignored completely

Q10. Formats of financial statements under Companies Act 2013 are prescribed in:

- (a) Schedule I
- (b) Schedule II
- (c) Schedule III
- (d) Schedule IV

Q11. Closing Stock adjustment entry is:

- (a) Trading A/c Dr. To Closing Stock A/c
- (b) Closing Stock A/c Dr. To Trading A/c
- (c) P&L A/c Dr. To Closing Stock A/c
- (d) No entry

Q12. Outstanding Expense is shown as:

- (a) Current Asset
- (b) Current Liability
- (c) Non-current Liability
- (d) Capital

Q13. Prepaid Expense is shown as:

- (a) Current Liability
- (b) Current Asset
- (c) Non-current Asset
- (d) Expense

Q14. Income received in advance is:

- (a) Current Asset
- (b) Current Liability
- (c) Income
- (d) Capital

Q15. Further Bad Debts are:

- (a) Added to Debtors
- (b) Deducted from Debtors and debited to P&L
- (c) Ignored
- (d) Credited to P&L

Q16. If closing stock is omitted from the final accounts, the effect will be:

- (a) Gross profit overstated and current assets overstated
- (b) Gross profit understated and current assets understated
- (c) Gross profit overstated and current assets understated
- (d) No effect on profit

Q17. Every adjustment given outside the Trial Balance is posted:

- (a) Once
- (b) Twice (once in Trading/P&L and once in Balance Sheet)
- (c) Three times
- (d) Never

Q18. Items given inside the Trial Balance are posted:

- (a) Twice
- (b) Once
- (c) Three times
- (d) Only in Balance Sheet

Q19. Interest on Capital is:

- (a) Debited to P&L and added to Capital
- (b) Credited to P&L
- (c) Ignored
- (d) Treated as liability

Q20. Interest on Drawings is:

- (a) Debited to P&L
- (b) Credited to P&L and deducted from Capital
- (c) Added to Capital
- (d) Ignored

Q21. Goods taken by proprietor are:

- (a) Added to Purchases
- (b) Deducted from Purchases and from Capital
- (c) Credited to Sales
- (d) Ignored

Q22. Goods distributed as free samples are:

- (a) Added to Purchases
- (b) Deducted from Purchases and debited to Advertisement (P&L)
- (c) Treated as sales
- (d) Capitalised

Q23. Abnormal loss of stock by fire (insured) is:

- (a) Fully charged to P&L
- (b) Insurance Claim A/c Dr. and Loss by Fire A/c Dr. To Purchases/Trading
- (c) Ignored
- (d) Treated as capital loss only

Q24. Outstanding wages at the end of the year will be:

- (a) Added to wages in Trading Account and shown as a current liability
- (b) Deducted from wages in Trading Account and shown as a current asset
- (c) Added to wages in Trading Account and shown as a current asset
- (d) Deducted from wages in Trading Account and shown as a current liability

Q25. Fictitious Assets include:

- (a) Goodwill
- (b) Preliminary expenses and P&L (Dr.) balance
- (c) Patents
- (d) Land

Q26. A provision for doubtful debts is created primarily to:

- (a) Increase the value of debtors
- (b) Provide for the expected loss from doubtful debts
- (c) Increase gross profit
- (d) Record cash received from debtors

Q27. Current Liabilities are payable:

- (a) After one year
- (b) Within a year (or operating cycle)
- (c) On contingency
- (d) Never

Q28. A business has Gross Profit of ₹2,00,000. It incurs operating expenses of ₹70,000 and earns interest on investments of ₹20,000. What is the **Operating Profit**?

- (a) ₹1,30,000
- (b) ₹1,50,000
- (c) ₹1,70,000
- (d) ₹90,000

Q29. Operating Profit is also known as:

- (a) Net Profit
- (b) Profit from core business activity before non-operating items
- (c) Gross Profit
- (d) Cash Profit

Q30. A prepaid expense appearing at the end of the accounting year is:

- (a) Added to the related expense and shown as a liability
- (b) Deducted from the related expense and shown as a current asset
- (c) Added to the related expense and shown as a current asset
- (d) Ignored while preparing final accounts

Answers & Explanations

Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.
1	b	2	b	3	b	4	c	5	a
6	b	7	b	8	b	9	b	10	c
11	b	12	b	13	b	14	b	15	b
16	b	17	b	18	b	19	a	20	b
21	b	22	b	23	b	24	a	25	b
26	b	27	b	28	a	29	b	30	b

Q1. Answer: (b) Trading Account, Profit & Loss Account and Balance Sheet

- Final Accounts collectively consist of the Trading Account, Profit & Loss Account and Balance Sheet.
- Trading Account determines Gross Profit/Loss, P&L Account determines Net Profit/Loss, and Balance Sheet shows financial position.

Q2. Answer: (b) Trading Account

- "Wages and Salaries" is treated as a direct expense.
- It is therefore shown in the Trading Account.

Q3. Answer: (b) Profit & Loss Account

- “Salaries and Wages” is treated as an indirect expense.
- It is therefore shown in the Profit & Loss Account.

Q4. Answer: (c) Both (a) and (b)

- $\text{COGS} = \text{Opening Stock} + \text{Net Purchases} + \text{Direct Expenses} - \text{Closing Stock}$.
- COGS can also be calculated as $\text{Sales} - \text{Gross Profit}$.

Q5. Answer: (a) Sales – Cost of Goods Sold

- $\text{Gross Profit} = \text{Sales} - \text{COGS}$.
- It represents the excess of sales over the cost of goods sold.

Q6. Answer: (b) 20%

- If cost = 100, Gross Profit = 25.
- Sales = 125.
- $\text{GP on Sales} = 25/125 \times 100 = 20\%$.

Q7. Answer: (b) Net Profit + Non-operating expenses – Non-operating incomes

- Operating Profit excludes non-operating incomes and expenses.
- $\text{Operating Profit} = \text{Net Profit} + \text{Non-operating Expenses} - \text{Non-operating Incomes}$.

Q8. Answer: (b) Within twelve months or operating cycle, whichever is longer

- Current Assets are expected to be realised within twelve months or the operating cycle, whichever is longer.

Q9. Answer: (b) Disclosed by way of note

- A contingent liability depends on an uncertain future event.
- It is generally disclosed by way of notes rather than recognised as an actual liability.

Q10. Answer: (c) Schedule III

- Schedule III of the Companies Act, 2013 prescribes the format of financial statements.

Q11. Answer: (b) Closing Stock A/c Dr. To Trading A/c

- Closing Stock is credited to the Trading Account.
- It is also shown as a current asset in the Balance Sheet.

Q12. Answer: (b) Current Liability

- Outstanding expenses are expenses incurred but not yet paid.
- They are therefore shown as current liabilities.

Q13. Answer: (b) Current Asset

- Prepaid expenses relate to a future period.
- They are therefore shown as current assets.

Q14. Answer: (b) Current Liability

- Income received in advance relates to a future period.
- It represents an obligation and is therefore shown as a current liability.

Q15. Answer: (b) Deducted from Debtors and debited to P&L

- Further bad debts are treated as an expense.
- They are deducted from Debtors and debited to the Profit & Loss Account.

Q16. Answer: (b) Gross profit understated and current assets understated

- Closing Stock is deducted while calculating COGS.
- It is also shown as a current asset.
- Its omission therefore understates both Gross Profit and Current Assets.

Q17. Answer: (b) Twice (once in Trading/P&L and once in Balance Sheet)

- An adjustment outside the Trial Balance affects two accounts.
- It is recorded once in the relevant Trading/P&L Account and once in the Balance Sheet.

Q18. Answer: (b) Once

- Items already appearing in the Trial Balance have already been recorded.
- They are therefore generally posted only once in the relevant final account.

Q19. Answer: (a) Debited to P&L and added to Capital

- Interest on Capital is an expense for the business.
- It is debited to P&L and added to the proprietor's Capital.

Q20. Answer: (b) Credited to P&L and deducted from Capital

- Interest on Drawings is income for the business.
- It is credited to P&L and deducted from the proprietor's Capital.

Q21. Answer: (b) Deducted from Purchases and from Capital

- Goods withdrawn by the proprietor are treated as Drawings.
- They reduce Purchases and the proprietor's Capital.

Q22. Answer: (b) Deducted from Purchases and debited to Advertisement (P&L)

- Goods distributed as free samples are treated as Advertisement expenditure.
- Purchases are reduced and Advertisement Account is debited.

Q23. Answer: (b) Insurance Claim A/c Dr. and Loss by Fire A/c Dr. To Purchases/Trading

- The insurance claim is recognised separately.
- The uninsured portion of the abnormal loss is transferred to the Profit & Loss Account.

Q24. Answer: (a) Added to wages in Trading Account and shown as a current liability

- Outstanding wages relate to the current accounting period.
- They are added to wages in the Trading Account.
- The outstanding amount is shown as a current liability.

Q25. Answer: (b) Preliminary expenses and P&L (Dr.) balance

- Fictitious assets are debit balances that do not represent actual assets.
- Examples include preliminary expenses and debit balance of the Profit & Loss Account.

Q26. Answer: (b) Provide for the expected loss from doubtful debts

- A provision for doubtful debts recognises the possibility that some debts may not be recovered.
- It provides for the expected loss from doubtful debts.

Q27. Answer: (b) Within a year (or operating cycle)

- Current liabilities are obligations expected to be settled within twelve months or the operating cycle, whichever is longer.

Q28. Answer: (a) ₹1,30,000

- Operating Profit = Gross Profit – Operating Expenses.
- = ₹2,00,000 – ₹70,000 = ₹1,30,000.
- Interest on investments is a non-operating income and is excluded.

Q29. Answer: (b) Profit from core business activity before non-operating items

- Operating Profit represents profit generated from the core business activity.
- It is calculated before considering non-operating incomes and expenses.

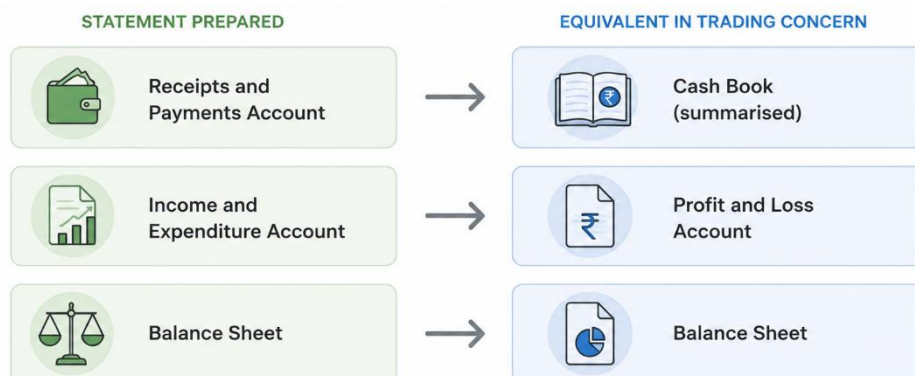
Q30. Answer: (b) Deducted from the related expense and shown as a current asset

- A prepaid expense relates to a future period.
- It is deducted from the current year's expense.
- It is shown as a current asset.

Chapter 9: Accounts of Non-Profit Organisations

Core Focus

- A Non-Profit Organisation is an entity whose objective is service rather than profit — a club, society, hospital, school, charitable trust, sports association or professional body.
- It has no owners and no capital; it has **members** and a **Capital Fund** (also called General Fund or Accumulated Fund).



Q1. (EPFO EO/AO 2021)

Which one of the following concerns prepares a Receipts and Payments Account?

- Trading concerns
- Non-trading concerns
- Manufacturing concerns
- Companies registered under the Companies Act

Answer: (b) Non-trading concerns

- The Receipts and Payments Account is the characteristic statement of a non-trading (not-for-profit) organisation. Trading and manufacturing concerns prepare a Cash Book and Trading/P&L Account instead.

Receipts & Payments vs Income & Expenditure

Example: Sunrise Club

Consider the following information for the year ended **31 March 2026**:

- Cash and Bank balance on 1 April 2025 = ₹20,000
- Subscription received during the year = ₹1,00,000
- Subscription relating to the current year = ₹1,20,000, of which ₹20,000 is still outstanding
- Life Membership Fees received = ₹25,000
- Donation received for Building Fund = ₹50,000
- Interest on Investments = ₹6,000 for the year, but only ₹5,000 received; ₹1,000 is outstanding
- Rent paid = ₹24,000
- Salaries paid = ₹36,000
- Other revenue expenses paid = ₹10,000
- Furniture purchased for cash = ₹15,000
- Depreciation on furniture = 10%
- Closing cash and bank balance = balancing figure

Receipts & Payments A/c

Receipts	₹	Payments	₹
To Opening Cash & Bank Balance	20,000	By Rent	24,000
To Subscriptions received	1,00,000	By Salaries	36,000
To Life Membership Fees	25,000	By Other Expenses	10,000
To Donation – Building Fund	50,000	By Furniture purchased	15,000
To Interest received	5,000	By Closing Cash & Bank Balance	1,15,000
Total	2,00,000	Total	2,00,000

Income & Expenditure Account

Expenditure	₹	Income	₹
To Rent	24,000	By Subscriptions	1,20,000
To Salaries	36,000	By Interest on Investments	6,000
To Other Expenses	10,000		
To Depreciation on Furniture	1,500		
To Surplus	54,500		
Total	1,26,000	Total	1,26,000

Point

Receipts and Payments Account

Income and Expenditure Account

Nature of account	Real account (a summary of the Cash Book)	Nominal account
Basis	Cash basis	Accrual basis
Records	All receipts and payments, capital and revenue , of all periods (previous, current, future)	Only revenue items of the current period
Opening/closing balances	Starts and ends with cash & bank balance	No opening balance; ends with Surplus or Deficit
Non-cash items (depreciation, provisions, outstanding, prepaid)	Not recorded	Fully recorded
Sides	Debit = Receipts; Credit = Payments	Debit = Expenditure; Credit = Income
Balancing figure	Closing cash and bank balance	Surplus (excess of income over expenditure) or Deficit
Purpose	Show cash position	Show operating result for the period
Balance carried to	Next period's Receipts & Payments	Capital Fund in the Balance Sheet

Q2. (EPFO EO/AO 2017)

Income and Expenditure Account is

- (a) Real Account
- (b) Personal Account
- (c) Nominal Account
- (d) Capital Account

Answer: (c) Nominal Account

Q3. The Receipts and Payments Account of a non-profit organisation is classified as:

- (a) Nominal Account
- (b) Personal Account
- (c) Real Account
- (d) Capital Account

Capital vs revenue items for an NPO

Revenue Items	Capital Items
1. Subscriptions → Revenue - Credited to the Income & Expenditure Account on an accrual basis. - It is recurring membership income.	6. Life Membership Fee → Capital - Added to the Capital Fund or, where appropriate, transferred to I&E over the estimated period of benefit. - It is a one-time payment for lifetime membership.
2. Entrance / Admission Fee → Usually Revenue - Normally credited to the Income & Expenditure Account. - May be capitalised if it is large, non-recurring, or the constitution so provides. - Treatment depends on its nature and established practice.	7. Legacy → Capital - Generally taken directly to the Balance Sheet / Capital Fund. - It is a non-recurring bequest received under a will.
3. General Donation → Revenue - Credited to the Income & Expenditure Account. - It is unrestricted and can be used for general purposes.	8. Specific / Special Donation → Capital - Credited to the specific fund and shown as part of the relevant fund until utilised. - The donor has earmarked it for a specific purpose.
	9. Endowment Fund → Capital - Added to the Endowment Fund; generally only the income from the fund is available for use. - The corpus is intended to remain intact.

4. Sale of Old Newspapers / Scrap → Revenue • Credited to the Income & Expenditure Account. • Generally treated as recurring/petty revenue income. 5. Honorarium Paid → Revenue Expenditure • Debited to the Income & Expenditure Account. • It is payment for services rendered.	10. Sale of a Fixed Asset → Capital • The sale proceeds are capital in nature; only the resulting profit or loss is transferred to the I&E Account. • It represents conversion of a capital asset into another form. 11. Government Grant for Construction → Capital • Generally credited to the relevant capital fund / asset-related fund. • It is linked to creation of a capital asset. 12. Tournament / Prize Fund → Capital / Specific Fund • Maintained as a specific fund; related expenses are normally adjusted against that fund rather than the general I&E Account. • The fund is earmarked for a particular purpose.
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The subscription computation

- Subscriptions are one of the main sources of income for an NPO, but the amount received during the year may not equal the income relating to that year. Therefore, exam questions often give you either the cash received and ask you to calculate subscription income, or give you the income and ask you to calculate the cash received. The same adjustment equation is used in both cases.

To find INCOME for the year (credit of I&E), start from CASH RECEIVED:

Cash received during the year	XXX
– Outstanding at the beginning (relates to last year)	XXX
+ Outstanding at the end (earned but not yet received)	XXX
+ Advance received at the beginning (relates to this year)	XXX
– Advance received at the end (relates to next year)	XXX
Subscription income for the year	XXX

To find CASH RECEIVED, start from INCOME and reverse every sign:

Income for the year + Opening outstanding – Closing outstanding – Opening advance + Closing advance = **Cash received**

Q4. A non-profit organisation received ₹80,000 as subscriptions during the year. Subscription outstanding was ₹10,000 at the beginning and ₹15,000 at the end of the year. Subscription received in advance was ₹5,000 at the beginning and ₹8,000 at the end. What amount should be credited to the Income & Expenditure Account as subscription income?

- (a) ₹72,000
 (b) ₹77,000
 (c) **₹82,000**
 (d) ₹87,000

Q5. A non-profit organisation's subscription income for the year was ₹1,20,000. Subscription outstanding was ₹15,000 at the beginning and ₹20,000 at the end. Subscription received in advance was ₹8,000 at the beginning and ₹5,000 at the end. What amount of subscription was actually received in cash during the year?

- (a) ₹1,08,000
 (b) **₹1,12,000**
 (c) ₹1,18,000
 (d) ₹1,22,000

Q6. (EPFO EO/AO 2023)

Following is the information relating to a club for the year ending 31.03.2022:

Subscription outstanding as on 31.03.2021: Rs. 16,000

Subscription outstanding as on 31.03.2022: Rs. 18,000

Subscription received in advance as on 31.03.2021: Rs. 12,000

Subscription received in advance as on 31.03.2022: Rs. 11,000

There are 70 members, each paying an annual subscription of Rs. 1,000.

Total subscription received during the year 2021–22 will be:

(a) Rs. 67,000

(b) Rs. 71,000

(c) Rs. 69,000

(d) Rs. 77,000

Cash received = Income + Opening Outstanding – Closing Outstanding – Opening Advance + Closing Advance

= ₹70,000 + ₹16,000 – ₹18,000 – ₹12,000 + ₹11,000

= **₹67,000**

Constructing the NPO Balance Sheet

- The **Opening Balance Sheet** is often not given and must be derived. **Capital Fund at the beginning = Opening assets – Opening liabilities.**
- **Capital Fund at the end = Opening Capital Fund + Surplus (or – Deficit) + Legacies + Life membership fees + Entrance fee capitalised.**
- **Specific funds** (Tournament Fund, Prize Fund, Building Fund) are shown on the liabilities side; related expenses are **deducted from the fund**, not charged to I&E; income earned on fund investments is **added to the fund**.
- **Consumables** such as sports material and stationery: consumption = Opening stock + Purchases – Closing stock, and only the **consumption** is debited to I&E.

Practice Questions

Q1. A Non-Profit Organisation prepares:

- (a) Trading Account
- (b) Receipts and Payments Account
- (c) Manufacturing Account
- (d) Only Balance Sheet

Q2. Receipts and Payments Account is a:

- (a) Nominal Account
- (b) Real Account
- (c) Personal Account
- (d) Capital Account

Q3. Income and Expenditure Account is a:

- (a) Real Account
- (b) Personal Account
- (c) Nominal Account
- (d) Capital Account

Q4. Receipts and Payments Account is prepared on:

- (a) Accrual basis
- (b) Cash basis
- (c) Hybrid basis
- (d) Mercantile basis only

Q5. Income and Expenditure Account is prepared on:

- (a) Cash basis
- (b) Accrual basis
- (c) Mixed basis
- (d) Only receipt basis

Q6. Receipts and Payments Account records:

- (a) Only revenue items of current period
- (b) All receipts and payments (capital and revenue) of all periods
- (c) Only capital items
- (d) Only outstanding items

Q7. Income and Expenditure Account records:

- (a) All capital and revenue items
- (b) Only revenue items of the current period
- (c) Only cash items
- (d) Only capital items

Q8. A Non-Profit Organisation purchased furniture for ₹50,000 during the year. Which statement correctly describes its treatment?

- (a) ₹50,000 is debited to Income & Expenditure Account
- (b) ₹50,000 is shown only in the Balance Sheet
- (c) ₹50,000 appears as a payment in Receipts & Payments Account and as an asset in the Balance Sheet
- (d) ₹50,000 is credited to Income & Expenditure Account

Q9. Which of the following would normally **not** affect the Receipts & Payments Account?

- (a) Subscription received in cash
- (b) Purchase of furniture for cash
- (c) Depreciation charged on furniture
- (d) Rent paid in cash

Q10. A club received ₹96,000 as subscriptions during the year. Subscription outstanding was ₹8,000 at the beginning and ₹12,000 at the end. Subscription received in advance was ₹4,000 at the beginning and ₹6,000 at the end. Subscription income for the year is:

- (a) ₹94,000
- (b) ₹96,000
- (c) ₹98,000
- (d) ₹1,02,000

Q11. Subscription income of a club for the year was ₹1,50,000. Outstanding subscription was ₹18,000 at the beginning and ₹25,000 at the end. Subscription received in advance was ₹10,000 at the beginning and ₹7,000 at the end. The amount actually received in cash was:

- (a) ₹1,40,000
- (b) ₹1,44,000
- (c) ₹1,50,000
- (d) ₹1,56,000

Q12. A sports club has 120 members, each paying an annual subscription of ₹1,500. Subscription outstanding was ₹24,000 at the beginning and ₹30,000 at the end. Subscription received in advance was ₹12,000 at the beginning and ₹9,000 at the end. The amount of subscription received in cash during the year is:

- (a) ₹1,65,000
- (b) ₹1,71,000
- (c) ₹1,77,000
- (d) ₹1,83,000

Q13. A charitable organisation receives ₹4,00,000 specifically for construction of a hospital building. The amount should generally be:

- (a) Credited to Income & Expenditure Account
- (b) Added to general income
- (c) Credited to Building Fund
- (d) Treated as subscription income

Q14. A club receives ₹3,00,000 as a legacy under the will of a deceased member. The amount is generally treated as:

- (a) Revenue income
- (b) Capital receipt added to Capital Fund
- (c) Current liability
- (d) Subscription income

Q15. A club receives ₹2,50,000 as life membership fees. Under the treatment generally followed for NPOs, the amount is:

- (a) Revenue income
- (b) Added to Capital Fund
- (c) Treated as subscription outstanding
- (d) Treated as a current liability

Q16. A club sells old newspapers and scrap for ₹7,500. The amount will normally be treated as:

- (a) Capital receipt
- (b) Revenue income
- (c) Specific fund receipt
- (d) Liability

Q17. The following information relates to a club:

Opening cash balance = ₹40,000
 Subscriptions received = ₹1,50,000
 General donation = ₹20,000
 Donation for Building Fund = ₹50,000
 Salaries paid = ₹60,000
 Rent paid = ₹30,000
 Furniture purchased = ₹40,000
 The closing cash balance will be:
 (a) ₹50,000
 (b) ₹70,000
 (c) ₹1,00,000
 (d) ₹1,30,000

Q18. A club has the following information for the year:

Subscription income = ₹2,00,000
 General donation = ₹30,000
 Interest income = ₹10,000
 Salaries = ₹90,000
 Rent = ₹40,000
 Depreciation = ₹15,000
 Honorarium = ₹20,000
 The surplus for the year is:
 (a) ₹55,000
 (b) ₹65,000
 (c) ₹75,000
 (d) ₹85,000

Answers & Explanations

Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.
1	b	2	b	3	c	4	b	5	b
6	b	7	b	8	c	9	c	10	c
11	a	12	b	13	c	14	b	15	b
16	b	17	d	18	c				

Q1. Answer: (b) Receipts and Payments Account

- A Non-Profit Organisation generally prepares a **Receipts and Payments Account** to summarise its cash and bank transactions.

Q2. Answer: (b) Real Account

- Receipts and Payments Account is treated as a **Real Account** because it is essentially a summary of the Cash Book.

Q3. Answer: (c) Nominal Account

- Income and Expenditure Account is a **Nominal Account**.
- It records revenue income and expenditure relating to the current accounting period.

Q4. Answer: (b) Cash basis

- Receipts and Payments Account records **actual cash receipts and payments**.
- Therefore, it is prepared on the **cash basis**.

Q5. Answer: (b) Accrual basis

- Income and Expenditure Account records income and expenditure **relating to the current period**, irrespective of whether cash has been received or paid.
- Hence, it follows the **accrual basis**.

Q6. Answer: (b) All receipts and payments (capital and revenue) of all periods

- Receipts and Payments Account records **all cash receipts and payments**, whether capital or revenue.
- It may also include transactions relating to past, current or future periods.

Q7. Answer: (b) Only revenue items of the current period

- Income and Expenditure Account records **revenue income and revenue expenditure relating to the current accounting period**.
- Capital receipts and capital payments are excluded.

Q8. Answer: (c) ₹50,000 appears as a payment in Receipts & Payments Account and as an asset in the Balance Sheet

- Purchase of furniture is a **capital expenditure**.
- The cash payment appears in Receipts & Payments Account.
- Furniture is shown as an **asset in the Balance Sheet**.

Q9. Answer: (c) Depreciation charged on furniture

- Depreciation is a **non-cash expense**.
- Therefore, it does not appear in the Receipts & Payments Account.

- It is charged to the Income and Expenditure Account.

Q10. Answer: (c) ₹98,000

- Subscription income = Cash received – Opening outstanding + Closing outstanding + Opening advance – Closing advance.
- = ₹96,000 – ₹8,000 + ₹12,000 + ₹4,000 – ₹6,000
- = **₹98,000.**

Q11. Answer: (a) ₹1,40,000

- Cash received = Income + Opening outstanding – Closing outstanding – Opening advance + Closing advance.
- = ₹1,50,000 + ₹18,000 – ₹25,000 – ₹10,000 + ₹7,000
- = **₹1,40,000.**

Q12. Answer: (b) ₹1,71,000

- Annual subscription income = $120 \times ₹1,500 = ₹1,80,000$.
- Cash received = ₹1,80,000 + ₹24,000 – ₹30,000 – ₹12,000 + ₹9,000.
- = **₹1,71,000.**

Q13. Answer: (c) Credited to Building Fund

- A donation specifically received for construction of a building is a **specific/capital receipt**.
- It is credited to the **Building Fund**, not treated as general income.

Q14. Answer: (b) Capital receipt added to Capital Fund

- A legacy is a non-recurring receipt received under a will.
- It is generally treated as a **capital receipt** and added to the **Capital Fund**.

Q15. Answer: (b) Added to Capital Fund

- Life membership fees are generally treated as a **capital receipt**.
- They are normally added to the **Capital Fund**.

Q16. Answer: (b) Revenue income

- Sale of old newspapers and scrap is normally treated as **revenue income**.
- It is credited to the **Income and Expenditure Account**.

Q17. Answer: (d) ₹1,30,000

- Total receipts = ₹1,50,000 + ₹20,000 + ₹50,000 = **₹2,20,000.**
- Total payments = ₹60,000 + ₹30,000 + ₹40,000 = **₹1,30,000.**
- Closing cash = ₹40,000 + ₹2,20,000 – ₹1,30,000
- = **₹1,30,000.**

Q18. Answer: (c) ₹75,000

- Total income = ₹2,00,000 + ₹30,000 + ₹10,000 = **₹2,40,000.**
- Total expenditure = ₹90,000 + ₹40,000 + ₹15,000 + ₹20,000 = **₹1,65,000.**
- Surplus = ₹2,40,000 – ₹1,65,000
- = **₹75,000.**

Chapter 10: Special Accounts

10.1 Consignment Accounts

A consignment is a despatch of goods by a consignor to an agent (the consignee) for sale on the consignor's behalf and at the consignor's risk. Ownership does **not** pass to the consignee; he is an agent, not a buyer.



Point	Consignment	Ordinary Sale
Ownership	Remains with the consignor until the goods are sold	Passes to the buyer immediately
Risk	Borne by the consignor	Borne by the buyer
Relationship	Principal and Agent	Seller and Buyer
Return of goods	Unsold goods may be returned freely	Only by agreement
Expenses	Ultimately borne by the consignor	Borne by the buyer after sale
Document	Account Sales sent by consignee	Invoice sent by seller

Example

A sends goods costing ₹50,000 to B on consignment.
 B pays ₹2,000 expenses and sells the goods for ₹60,000.
 B is entitled to ₹3,000 commission.
 B remits the balance to A.

Books of A — Consignor

Consignment A/c

Dr.	₹	Cr.	₹
To Goods Sent	50,000	By Sales	60,000
To Expenses	2,000		
To Commission	3,000		
To Profit transferred to P&L	5,000		
Total	60,000	Total	60,000

Books of B — Consignee

A's Account

Dr.	₹	Cr.	₹
To Commission	3,000	By Sales proceeds	60,000
To Expenses paid	2,000		
To Bank — amount remitted	55,000		
Total	60,000	Total	60,000

B's Account

Dr.	₹	Cr.	₹
To Sales	60,000	By Commission	3,000
		By Expenses	2,000
		By Bank — amount remitted	55,000
Total	60,000	Total	60,000

Normal Loss Vs. Abnormal Loss

Point	Normal Loss	Abnormal Loss
Cause	Inherent nature of the goods — evaporation, leakage, drying, breakage in transit as a routine	Accident, theft, fire, negligence
Predictable?	Yes, unavoidable	No, avoidable
Accounting treatment	No separate entry. The cost is absorbed by the surviving good units, raising the per-unit cost of the unsold stock	Valued at cost + proportionate expenses and removed from the Consignment Account
Entry	—	Abnormal Loss A/c Dr. / To Consignment A/c, then Abnormal Loss transferred (net of insurance claim) to the Profit & Loss Account
Effect on consignment profit	Reduces it indirectly	Removed so that the consignment result is not distorted

Why abnormal loss is CREDITED to the Consignment Account: The Consignment Account is debited with the cost of goods sent and all expenses. An abnormal loss is not a cost of *earning consignment revenue* — it is a separate misfortune. To take it out of the consignment result, it is **credited** to the Consignment Account (removing it) and **debited** to Abnormal Loss A/c, from where it goes to P&L.

Q1. (EPFO EO/AO 2017)

The abnormal loss on consignment is credited to

- (a) Profit and Loss Account
- (b) Consignee's Account
- (c) Consignment Account
- (d) Income and Expenditure Account

Answer: (c) Consignment Account

- The entry is Abnormal Loss A/c Dr. — To Consignment A/c. So the Consignment Account is credited, and the Abnormal Loss Account is debited.

Valuation of unsold consignment stock

- Unsold stock with the consignee is valued at cost to the consignor PLUS a proportionate share of all NON-RECURRING expenses.
- **Non-recurring expenses** (included in stock valuation): expenses incurred **up to the point the goods reach the consignee's godown** — packing, freight, loading, insurance in transit, customs duty, and the consignee's clearing charges and octroi.
- **Recurring expenses** (excluded): expenses incurred **after** the goods reach the godown — godown rent, insurance of godown, selling expenses, advertisement, salesmen's salaries, consignee's commission.
- The test: "**Did the expense help bring the goods to their present location and condition?**" If yes, include. This is the same logic as AS-2.

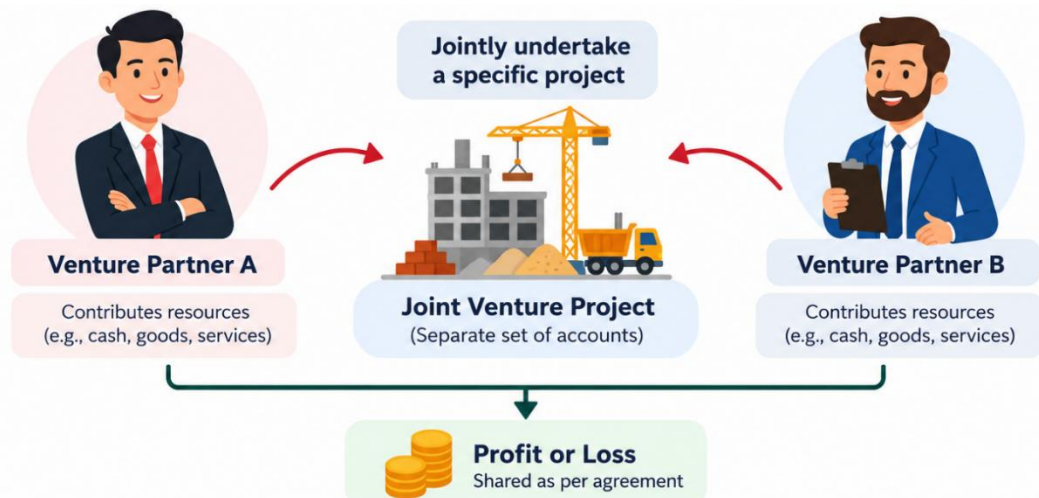
Types of commission

Commission	Payable for	Bears bad debts?
Ordinary commission	Simply effecting sales	No
Del credere commission	Guaranteeing the recovery of debts	Yes — the consignee bears the bad debts
Over-riding commission	Sales above a specified price, or introducing a new market/product	No

- Where del credere commission is paid, **bad debts are the consignee's loss**, not the consignor's, and are not debited to the Consignment Account.

10.2 Joint Venture Accounts

A joint venture is a temporary partnership between two or more persons for a specific, limited business purpose, dissolved as soon as that purpose is achieved.



Point	Joint Venture	Partnership	Consignment
Duration	Temporary, for one venture	Continuing	Continuing agency
Name	No firm name usually	Firm name	—
Relationship	Co-venturers, mutual agency for the venture	Partners	Principal–Agent
Governing law	Contract Act	Indian Partnership Act 1932	Contract Act — agency
Accounts	Closed at the end of the venture	Going concern	Ongoing
Profit sharing	As agreed for the venture	As per the deed	Consignee gets commission, not profit

Methods of recording

Method	How it works
Separate set of books	A Joint Bank A/c , a Joint Venture A/c and each Co-venturer's Capital A/c are opened. Purchases debited to Joint Venture A/c, sales credited; profit shared.
Each co-venturer keeps a record of all transactions	Each maintains a Joint Venture A/c and a personal account of the other co-venturer(s). Both sets show the same profit.
Each co-venturer records only his own transactions (Memorandum method)	A Memorandum Joint Venture A/c is prepared to find the total profit; each venturer's own books carry only a personal "Joint Venture with X" account.

The central entry: when goods are purchased for the joint venture, the cost is a cost *of the venture*, so it is debited to the **Joint Venture Account** — never to the buyer's own Purchases Account, which would contaminate his personal trading results.

Q1. (EPFO EO AO 2017)

When goods are purchased for the Joint Venture, the amount is debited to

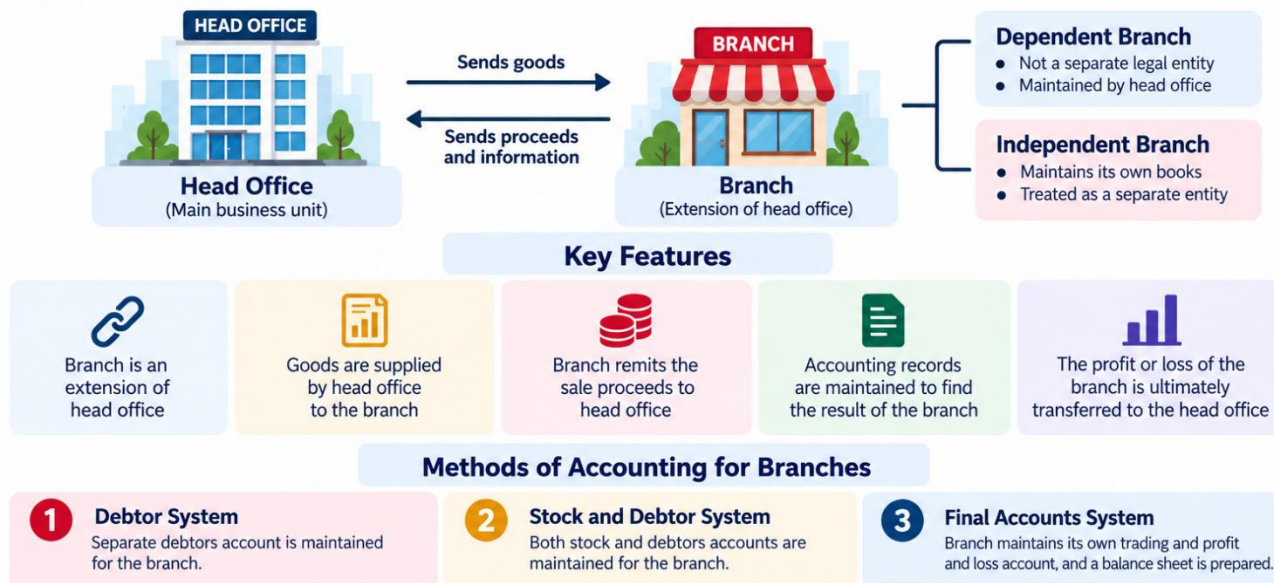
- Purchase Account
- Joint Venture Account
- Venturer's Capital Account
- Profit and Loss Account

Answer: (b) Joint Venture Account

- The Joint Venture Account is the venture's own Trading and P&L Account rolled into one. All venture costs are debited to it and all venture revenues credited; the balance is the venture's profit, shared in the agreed ratio.

10.3 Branch Accounts

Branch accounts refer to the system of accounting for the transactions of a branch, which is an extension of the head office.



System	When used	Nature of Branch A/c
Debtors System	Small branches; goods sent at cost or invoice price; branch keeps no full books	Nominal account — finds branch profit as a balancing figure
Stock and Debtors System	Goods sent at invoice price ; more analytical control	Several accounts: Branch Stock, Branch Debtors, Branch Expenses, Branch Adjustment, Branch P&L
Final Accounts System	Where a memorandum Trading and P&L Account is prepared for the branch	Memorandum
Wholesale Branch System	Where the branch is charged wholesale price to isolate the retailer's margin	—
Independent Branch	Large branches keeping complete double-entry books	Reciprocal accounts; Head Office A/c and Branch A/c reconciled
Foreign Branch	Independent branch abroad	Translation under AS-11

Q1. (EPFO EO/AO 2017)

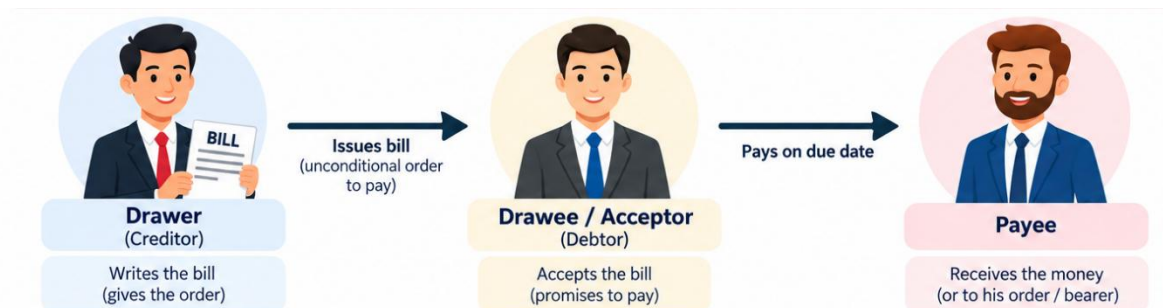
Branch Account under the Debtors System is

- Real Account
- Personal Account
- Nominal Account
- Liability Account

Answer: (c) Nominal Account

- Under the Debtors System the Branch Account is opened purely to compute the branch's profit or loss — opening stock, goods sent and expenses on the debit; sales, closing stock and returns on the credit; the balancing figure is profit. Any account whose balancing figure is a profit is a Nominal account.

10.4 Bills of Exchange



- **Section 5, Negotiable Instruments Act 1881:** a bill of exchange is an instrument in writing containing an **unconditional order**, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer.
- Three parties: **Drawer** (creditor who writes it), **Drawee/Acceptor** (debtor who accepts it), **Payee** (who receives the money).
- A **promissory note** contains an unconditional **promise** and has two parties: Maker and Payee.
- **Days of grace:** three days are added to the tenure to arrive at the due date, for time bills.
- **Discounting** a bill with a bank: discount is an expense of the drawer (**Discount A/c Dr.**), and the bank credits the net proceeds. On **dishonour**, the drawer must repay the bank the full amount plus **noting charges**.
- **Noting charges** are always ultimately borne by the **acceptor/drawee**.
- **Retiring a bill under rebate:** early payment; the **rebate is an income for the acceptor and an expense for the holder**.
- **Accommodation bill:** drawn and accepted without any underlying sale, purely to raise finance. Also called a kite or windmill.

Q1. Which of the following statements regarding a bill of exchange is correct?

- It contains an unconditional promise to pay and involves two parties.
- It contains an unconditional order to pay and normally involves three parties—drawer, drawee/acceptor and payee.
- It contains a conditional order to pay and involves two parties.
- It contains an unconditional promise to pay and normally involves three parties.

Q2. A bill of exchange is discounted with a bank before its due date and is subsequently dishonoured. Which of the following is correct?

- The acceptor is liable only for the net amount received by the drawer from the bank.
- The drawer must repay the bank the full amount of the bill plus noting charges.
- The bank bears the loss because it discounted the bill.
- The drawer is liable only for the discount charged by the bank.

Q1. Answer: (b)

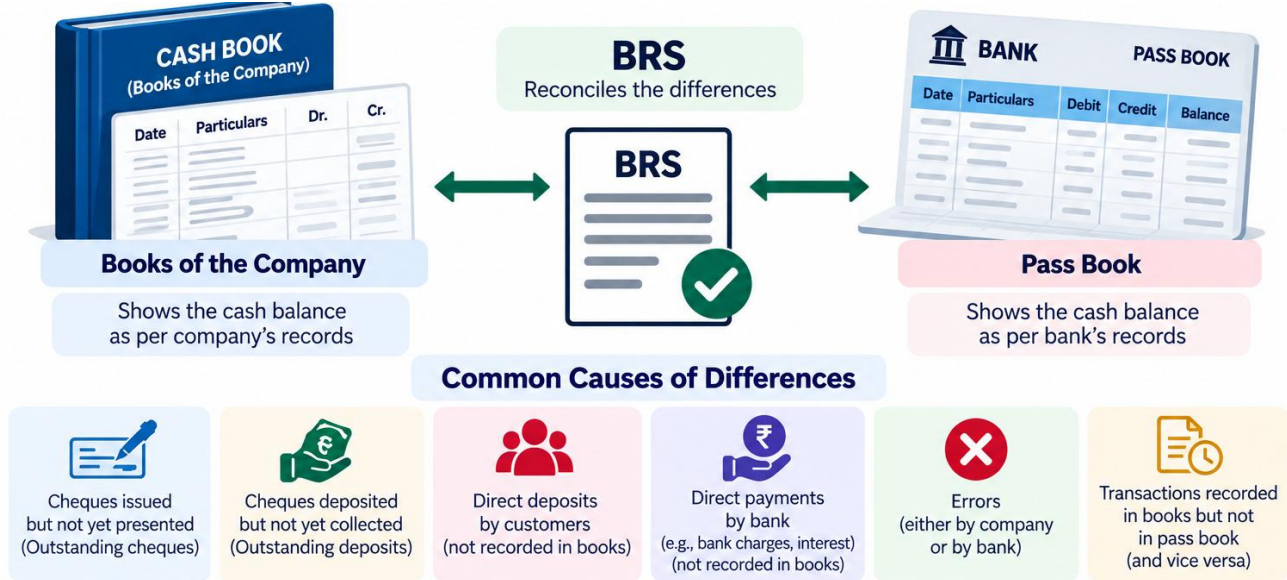
- Under Section 5 of the Negotiable Instruments Act, 1881, a bill of exchange contains an unconditional order to pay. It normally involves:
- Drawer → makes/sets out the order; Drawee/Acceptor → accepts the bill and undertakes to pay; Payee → receives the payment

Q2. Answer: (b) The drawer must repay the full amount of the bill plus noting charges.

- When a bill is discounted with a bank, the bank pays the drawer the amount after deducting the discount. If the bill is later dishonoured, the drawer must reimburse the bank for the full amount of the bill plus noting charges.

10.5 Bank Reconciliation Statement (BRS)

- A Bank Reconciliation Statement (BRS) is a statement prepared to reconcile the balance as per the Cash Book with the balance as per the Pass Book, by identifying the reasons for differences between the two balances.



- Important:** BRS does not itself record transactions. It is a statement prepared to explain and reconcile the difference between the Cash Book and Pass Book balances.

Q1. Which of the following transactions is likely to appear first in the Cash Book but not immediately in the Pass Book?

- Bank charges debited by the bank
- Interest credited by the bank
- Cheque deposited into the bank but not yet collected
- Direct deposit made by a customer into the firm's bank account

Q2. Which of the following transactions would normally cause a difference between the Cash Book and Pass Book balances until it is recorded by the bank?

- Cheque issued by the business but not yet presented for payment
- Cash purchase recorded immediately in the Cash Book
- Credit purchase of goods recorded in the Purchases Book
- Depreciation charged on machinery

10.6 Partnership Accounts

A partnership is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all — Section 4, Indian Partnership Act, 1932.

In the absence of a Partnership Deed — Section 13

Where there is no partnership deed, or the deed is silent, **Section 13 of the Indian Partnership Act, 1932** supplies the default rules. These are examined verbatim.

Matter	Rule in the absence of a deed
Profit and loss sharing	EQUALLY , irrespective of capital contributed, work done or experience
Interest on capital	NOT allowed
Interest on drawings	NOT charged
Salary or commission to a partner	NOT allowed
Interest on a loan advanced by a partner to the firm	Allowed at 6% per annum — and it is a charge against profit , payable even in a year of loss
Admission of a new partner	Requires the consent of all existing partners
Right to participate in management	Every partner has the right
Right to inspect books	Every partner has the right

Q1. (EPFO EO/AO 2017)

In the absence of any provision in the partnership agreement, profits and losses are shared by the partners

- (a) in the ratio of the capital of partners
- (b) equally
- (c) in the ratio of loans given by them to the partnership firm
- (d) in the ratio of the initial capital introduced by the partners

Q2. In the absence of a contract to the contrary, which of the following correctly states the rights and liabilities of partners under the Indian Partnership Act, 1932?

- (a) Interest on capital is allowed, interest on drawings is charged, salary/commission is allowed, and interest on a partner's loan is allowed at 6% p.a.
- (b) Interest on capital is not allowed, interest on drawings is not charged, salary or commission to a partner is not allowed, and interest on a loan advanced by a partner to the firm is allowed at 6% p.a.
- (c) Interest on capital is not allowed, interest on drawings is charged at 6% p.a., salary to a partner is allowed, and interest on a partner's loan is not allowed.
- (d) Interest on capital and salary to partners are allowed, interest on drawings is not charged, and interest on a partner's loan is allowed at 6% p.a.

Partnership essentials

- **Fixed vs Fluctuating Capital:** under the **fixed** method, two accounts are kept per partner — Capital A/c (unchanged except for introduction/withdrawal of capital) and **Current A/c** (all adjustments). Under the **fluctuating** method, one account absorbs everything. In the absence of instructions, **fluctuating** is assumed.
- **Goodwill on admission** is credited to the **old partners in their sacrificing ratio**. **Sacrificing ratio = Old ratio – New ratio**. **Gaining ratio = New ratio – Old ratio**.
- On **retirement or death**, goodwill is credited to the outgoing partner and debited to the continuing partners in their **gaining ratio**.
- **Garner v. Murray (1904):** on dissolution, a solvent partner's deficiency arising from an insolvent partner is borne by the solvent partners in the ratio of their **last agreed capitals**, not in the profit-sharing ratio.
- **Maximum number of partners:** 50, as prescribed under Rule 10 of the Companies (Miscellaneous) Rules, 2014 read with Section 464 of the Companies Act 2013.

10.7 Company Accounts

- **Categories of capital:** Authorised (Nominal/Registered) → Issued → Subscribed → **Called-up** → **Paid-up**. **Reserve Capital** is the part of uncalled capital reserved for winding up.
- **Securities Premium (Section 52)** may be used only for: issuing fully paid **bonus shares**; writing off **preliminary expenses**; writing off the expenses, commission or discount on issue of shares/debentures; providing the **premium on redemption** of preference shares or debentures; and **buy-back** of shares under Section 68.
- **Issue of shares at a discount is prohibited** by Section 53, except for **sweat equity shares** under Section 54.
- **Forfeiture:** on forfeiture, Share Capital A/c is debited with the **called-up** amount, Calls-in-Arrear credited, and Share Forfeiture A/c credited with the amount **already received**. On reissue, any balance in Share Forfeiture A/c is transferred to **Capital Reserve**.
- **Capital Redemption Reserve (Section 55):** where preference shares are redeemed out of profits, a sum equal to the nominal value redeemed must be transferred to CRR; CRR may be used **only** to issue fully paid bonus shares.
- **Dividend (Section 123):** may be declared only out of current profits, accumulated past profits, or money provided by the government — and only **after providing for depreciation**. Dividend must be deposited in a separate bank account within **5 days** and paid within **30 days** of declaration. Unpaid dividend goes to the **Unpaid Dividend Account** after 30 days, and to the **Investor Education and Protection Fund (IEPF)** after 7 years.

Practice questions

Consignment Accounts

Q1. In a consignment transaction, ownership of goods remains with the:

- (a) Consignor until the goods are sold
- (b) Consignee until the goods are sold
- (c) Consignee immediately after dispatch
- (d) Buyer from the date of dispatch

Q2. Which of the following expenses incurred by the consignee would ordinarily be included in the valuation of unsold consignment stock?

- (a) Godown rent after arrival of goods
- (b) Salesman's salary
- (c) Unloading and clearing charges incurred to bring goods to the godown
- (d) Advertisement expenses

Q3. A consignor sends 1,000 units costing ₹100 each. Freight and other non-recurring expenses amount to ₹10,000. Normal loss is 10% of the units sent. If 300 units remain unsold, their value will be:

- (a) ₹30,000
- (b) ₹33,333
- (c) ₹36,667
- (d) ₹40,000

Q4. The primary effect of a normal loss in consignment accounting is that:

- (a) A separate Normal Loss Account is debited
- (b) The cost is spread over the units remaining
- (c) The loss is transferred directly to Profit and Loss Account
- (d) The consignee bears the loss

Q5. Which commission specifically protects the consignor against bad debts arising from credit sales?

- (a) Ordinary commission
- (b) Overriding commission
- (c) Del credere commission
- (d) Special commission

Q6. A consignee is entitled to del credere commission. A customer subsequently defaults on a credit sale. In the absence of any special agreement, the bad debt is borne by:

- (a) Consignor
- (b) Consignee
- (c) Both equally
- (d) Insurance company

Q7. Goods costing ₹80,000 are consigned. The consignor incurs freight of ₹8,000. The consignee incurs unloading charges of ₹2,000 and selling expenses of ₹3,000. If 25% of the goods remain unsold, the amount included in closing stock for these expenses is:

- (a) ₹20,000
- (b) ₹22,500
- (c) ₹22,000
- (d) ₹23,000

Q8. An abnormal loss arising during consignment is initially recorded by:

- (a) Debiting Consignment Account and crediting Abnormal Loss Account
- (b) Debiting Abnormal Loss Account and crediting Consignment Account
- (c) Debiting Profit and Loss Account and crediting Consignment Account
- (d) Debiting Consignee Account and crediting Consignment Account

Q9. Goods costing ₹1,00,000 are sent on consignment. Freight ₹10,000 is incurred. During transit, 10% of the goods are destroyed abnormally. Assuming no other expenses, the value of abnormal loss is:

- (a) ₹10,000
- (b) ₹11,000
- (c) ₹9,000
- (d) ₹1,10,000

Q10. A consignee sells goods above the price specified by the consignor and receives an additional commission for achieving the specified price. Such commission is generally known as:

- (a) Del credere commission
- (b) Ordinary commission
- (c) Overriding commission
- (d) Trade discount

Joint Venture Accounts

Q11. A joint venture differs from an ordinary partnership primarily because a joint venture is generally:

- (a) Permanent in nature
- (b) Created for a specific business undertaking
- (c) Required to have a registered firm name
- (d) Always formed under the Companies Act

Q12. Under the separate-set-of-books method of joint venture accounting, which account is normally opened to record purchases, expenses and sales relating to the venture?

- (a) Joint Venture Account
- (b) Purchases Account
- (c) Trading Account
- (d) Profit and Loss Account

Q13. A and B undertake a joint venture. A purchases goods for ₹1,80,000 and incurs expenses of ₹20,000. B sells the goods for ₹3,00,000 and incurs selling expenses of ₹15,000. A further incurs ₹10,000 as administrative expenses relating to the venture. The profit of the venture is:

- (a) ₹65,000
- (b) ₹70,000
- (c) ₹75,000
- (d) ₹85,000

Q14. Under the separate-set-of-books method, cash contributed by a co-venturer is credited to:

- (a) Joint Venture Account
- (b) Co-venturer's Account

- (c) Joint Bank Account
- (d) Profit and Loss Account

Q15. In a joint venture where each co-venturer records only the transactions undertaken by him or her, the overall profit or loss of the venture is generally determined through:

- (a) Joint Venture Account maintained by any one co-venturer
- (b) Memorandum Joint Venture Account
- (c) Joint Bank Account
- (d) Co-venturer's Personal Account

Q16. If the profit-sharing ratio among A, B and C is 2 : 3 : 5 and the joint venture earns ₹1,00,000 profit, C's share will be:

- (a) ₹20,000
- (b) ₹30,000
- (c) ₹40,000
- (d) ₹50,000

Branch Accounts

Q17. Under the debtors system of branch accounting, the Branch Account is generally prepared to determine:

- (a) Gross profit only
- (b) Net profit or loss of the branch
- (c) Branch stock only
- (d) Branch debtors only

Q18. Under the debtors system, goods sent to a branch are generally recorded by:

- (a) Debiting Branch Account
- (b) Crediting Branch Account
- (c) Debiting Purchases Account
- (d) Crediting Sales Account

Q19. A branch has opening debtors of ₹40,000. Credit sales during the year are ₹80,000. Cash collected from debtors is ₹70,000 and returns from customers are ₹5,000. The closing debtors will be:

- (a) ₹35,000
- (b) ₹40,000
- (c) ₹45,000
- (d) ₹50,000

Q20. Under the debtors system, cash received by the branch from customers is:

- (a) Debited to Branch Account
- (b) Credited to Branch Account
- (c) Debited to Debtors Account
- (d) Credited to Sales Account

Q21. Which of the following is most appropriate for a branch where the head office wants to ascertain branch profit through a single Branch Account?

- (a) Debtors System
- (b) Stock and Debtors System
- (c) Wholesale Branch System only
- (d) Memorandum Branch System only

Q22. Under a stock and debtors system, which account is specifically maintained to control branch stock?

- (a) Branch Stock Account
- (b) Branch Adjustment Account
- (c) Branch Debtors Account
- (d) Branch Expenses Account

Bills of Exchange

Q23. A bill of exchange is essentially:

- (a) An unconditional promise to pay
- (b) An unconditional order to pay a certain sum of money
- (c) A conditional promise to pay
- (d) A receipt acknowledging debt

Q24. In a bill of exchange, the person who makes the order to pay is known as the:

- (a) Drawee
- (b) Payee
- (c) Drawer
- (d) Acceptor

Q25. The drawee becomes primarily liable on a bill after:

- (a) Drawing the bill
- (b) Endorsement
- (c) Acceptance
- (d) Discounting

Q26. What is the due date of a bill of exchange drawn on 30th January 2015 for a tenure of one month?

- (a) 28th February 2015
- (b) 2nd March 2015
- (c) 3rd March 2015
- (d) 4th March 2015

Q27. A bill of exchange is discounted with a bank before its due date. If the bill is subsequently dishonoured, who is ultimately responsible for reimbursing the bank for the amount due on the bill?

- (a) The drawee only
- (b) The drawer
- (c) The endorser only
- (d) The payee only

Q28. When a discounted bill is dishonoured, the drawee's liability towards the holder of the bill is:

- (a) Automatically extinguished
- (b) Transferred to the bank only
- (c) Enforced against the parties liable on the bill
- (d) Converted into a capital contribution

Q29. When the holder endorses a bill in favour of a creditor, the transaction is known as:

- (a) Discounting
- (b) Retirement
- (c) Endorsement
- (d) Renewal

Bank Reconciliation Statement

Q30. Which one of the following is the most appropriate reason for the difference between the bank balance

shown by the Cash Book and that shown by the Pass Book?

- (a) Differences arising only due to accounting errors
- (b) Timing differences and transactions recorded by one party but not yet recorded by the other
- (c) Differences arising only due to bank charges
- (d) Differences arising only due to cheques issued but not presented

Q31. The Cash Book shows a favourable bank balance of ₹25,000. Cheques issued but not yet presented amount to ₹4,000. Cheques deposited but not yet credited by the bank amount to ₹6,000. Bank charges of ₹500 have not been entered in the Cash Book, while a direct deposit of ₹2,000 by a customer has also not been recorded in the Cash Book. The balance as per Pass Book is:

- (a) ₹23,500
- (b) ₹24,000
- (c) ₹24,500
- (d) ₹25,500

Q32. If the bank charges are entered only in the Pass Book, then, while starting with a favourable Cash Book balance, the amount will generally be:

- (a) Added to arrive at Pass Book balance
- (b) Deducted to arrive at Pass Book balance
- (c) Ignored
- (d) Added twice

Q33. A cheque deposited into the bank is entered in the Cash Book but has not yet been credited by the bank. This difference will:

- (a) Increase Pass Book balance relative to Cash Book
- (b) Reduce Pass Book balance relative to Cash Book
- (c) Have no effect on reconciliation
- (d) Increase both balances

Q34. A cheque issued by the business has been recorded in the Cash Book but has not yet been presented for payment. Starting with the Cash Book's favourable balance, the amount should generally be:

- (a) Deducted to obtain Pass Book balance
- (b) Added to obtain Pass Book balance
- (c) Ignored
- (d) Deducted twice

Q35. The bank directly collects ₹5,000 from a customer on behalf of the business. The bank has credited the amount, but the Cash Book has not yet been updated. Starting with the Cash Book balance, the amount should be:

- (a) Added
- (b) Deducted
- (c) Ignored
- (d) Added only if the cheque was dishonoured

Q36. Which of the following would normally cause the Pass Book balance to be lower than the Cash Book balance?

- (a) Cheques issued but not presented
- (b) Direct deposit by a customer into the bank
- (c) Bank charges recorded only in Pass Book
- (d) Interest credited by bank

Q37. If a customer directly deposits ₹10,000 into the bank account and the entry has not yet been made in the Cash Book, the Cash Book balance is:

- (a) Higher than Pass Book balance by ₹10,000
- (b) Lower than Pass Book balance by ₹10,000
- (c) Equal to Pass Book balance
- (d) Higher by ₹20,000

Partnership Accounts

Q38. In the absence of an agreement to the contrary, partners are entitled to share profits:

- (a) In proportion to their capital
- (b) In proportion to their drawings
- (c) Equally
- (d) In proportion to their seniority

Q39. In the absence of an agreement to the contrary, a partner is:

- (a) Entitled to salary for conducting the firm's business
- (b) Not entitled to remuneration for taking part in the conduct of business
- (c) Entitled to commission but not salary
- (d) Entitled to salary only if profits are earned

Q40. In the absence of a contrary agreement, interest on capital is payable:

- (a) At 6% irrespective of profit
- (b) At 12% irrespective of profit
- (c) Only out of profits
- (d) Always out of capital

Q41. A partner advances ₹60,000 to the firm beyond the amount of capital he agreed to contribute. In the absence of an agreement to the contrary, the annual interest on such advance is:

- (a) ₹2,400
- (b) ₹3,000
- (c) ₹3,600
- (d) ₹6,000

Q42. A and B are partners without any partnership agreement. The firm earns ₹90,000 profit. A contributed ₹8 lakh capital and B ₹2 lakh. The profit will ordinarily be divided:

- (a) ₹72,000 to A and ₹18,000 to B
- (b) ₹45,000 each
- (c) ₹60,000 to A and ₹30,000 to B
- (d) ₹80,000 to A and ₹10,000 to B

Q43. If a partner makes an advance to the firm beyond the amount of capital agreed to be contributed, the statutory rate of interest in the absence of a contrary agreement is:

- (a) 4% p.a.
- (b) 5% p.a.
- (c) 6% p.a.
- (d) 8% p.a.

Q44. A partner has a right to take part in the conduct of the business of the firm:

- (a) Only if he contributes the highest capital
- (b) Subject to the partnership agreement and statutory provisions
- (c) Only if he is a working partner
- (d) Only with court permission

Company Accounts

Q45. Under Schedule III to the Companies Act, 2013, the prescribed format primarily relates to:

- (a) Cash Book and Ledger
- (b) Balance Sheet and Statement of Profit and Loss
- (c) Trial Balance and Cash Flow only
- (d) Cost Sheet and Production Account

Q46. Securities premium arising on issue of shares at a premium is generally credited to:

- (a) General Reserve
- (b) Securities Premium Account
- (c) Capital Redemption Reserve only
- (d) Statement of Profit and Loss

Q47. Which one of the following statements regarding Securities Premium is correct?

- (a) It is treated as revenue profit available for distribution as dividend
- (b) It can be used for any purpose for which General Reserve may be used

(c) It can be utilised only for purposes specifically permitted under the Companies Act

(d) It is transferred to the Statement of Profit and Loss immediately after receipt

Q48. Which of the following is a characteristic feature of a debenture?

- (a) It represents ownership capital
- (b) It ordinarily represents borrowed capital
- (c) It necessarily carries voting rights equivalent to equity shares
- (d) It is always issued at par

Q49. A company issues shares of ₹10 each at ₹12 per share. The ₹2 excess over the nominal value represents:

- (a) Discount
- (b) Capital reserve
- (c) Securities premium
- (d) Revenue profit

Q50. Which statement about company financial statements is correct?

- (a) They need not comply with applicable accounting standards
- (b) They are required to give a true and fair view and comply with applicable accounting standards, subject to the Companies Act framework
- (c) Schedule III applies only to partnership firms
- (d) Financial statements are prepared only when the company makes a profit

Answer Key

Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.
1	a	2	c	3	c	4	b	5	c
6	b	7	b	8	b	9	b	10	c
11	b	12	a	13	c	14	b	15	b
16	d	17	b	18	a	19	c	20	b
21	a	22	a	23	b	24	c	25	c
26	c	27	b	28	c	29	c	30	b
31	c	32	b	33	b	34	b	35	a
36	c	37	b	38	c	39	b	40	c
41	c	42	b	43	c	44	b	45	b
46	b	47	c	48	b	49	c	50	b

Q1. Answer: (a) Consignor until the goods are sold

- In a consignment, ownership of goods remains with the consignor until the goods are sold to customers.

Q2. Answer: (c) Unloading and clearing charges incurred to bring goods to the godown

- Non-recurring expenses necessary to bring goods to their present location and condition are included in the value of unsold stock.

Q3. Answer: (c) ₹36,667

- Cost = ₹1,00,000 and freight = ₹10,000. After 10% normal loss, 900 units remain. Cost per unit = ₹1,10,000 ÷ 900 = ₹122.22. Value of 300 units = ₹36,667.

Q4. Answer: (b) The cost is spread over the units remaining

- Normal loss is unavoidable, so its cost is absorbed by the units remaining after the normal loss.

Q5. Answer: (c) Del credere commission

- Del credere commission compensates the consignee for assuming the risk of bad debts arising from credit sales.

Q6. Answer: (b) Consignee

- When del credere commission is allowed, the consignee bears the risk of bad debts arising from credit sales.

Q7. Answer: (b) ₹22,500

- Expenses included = ₹80,000 + ₹8,000 + ₹2,000 = ₹90,000. Selling expenses are excluded. Unsold stock = 25%; therefore, ₹90,000 × 25% = ₹22,500.

Q8. Answer: (b) Debiting Abnormal Loss Account and crediting Consignment Account

- Abnormal loss is separately identified and transferred from the Consignment Account to the Abnormal Loss Account.

Q9. Answer: (b) ₹11,000

- Cost of goods = ₹1,00,000 and freight = ₹10,000. Total cost = ₹1,10,000. Abnormal loss = 10% × ₹1,10,000 = ₹11,000.

Q10. Answer: (c) Overriding commission

- Overriding commission is an additional commission paid for achieving specified sales conditions or selling at a price above the specified price.

Q11. Answer: (b) Created for a specific business undertaking

- A joint venture is generally a temporary arrangement formed for a specific business undertaking, unlike an ordinary partnership which may continue indefinitely.

Q12. Answer: (a) Joint Venture Account

- Under the separate-set-of-books method, the Joint Venture Account records purchases, expenses and sales relating to the venture.

Q13. Answer: (c) ₹75,000

- Total cost = ₹1,80,000 + ₹20,000 + ₹15,000 + ₹10,000 = ₹2,25,000. Profit = ₹3,00,000 – ₹2,25,000 = ₹75,000.

Q14. Answer: (b) Co-venturer's Account

- When a co-venturer contributes cash, Joint Bank Account is debited and the respective Co-venturer's Account is credited.

Q15. Answer: (b) Memorandum Joint Venture Account

- A Memorandum Joint Venture Account is prepared to ascertain the overall profit or loss when each co-venturer records only their own transactions. It is a memorandum account and does not form part of the double-entry system.

Q16. Answer: (d) ₹50,000

- Total ratio = 2 + 3 + 5 = 10. C's share = 5/10 × ₹1,00,000 = ₹50,000.

Q17. Answer: (b) Net profit or loss of the branch

- Under the Debtors System, a single Branch Account is prepared to ascertain the net profit or loss of the branch.

Q18. Answer: (a) Debiting Branch Account

- Goods sent by the head office to the branch are debited to the Branch Account because they represent goods supplied to the branch.

Q19. Answer: (c) ₹45,000

- Closing debtors = Opening debtors + Credit sales – Cash collected – Returns = ₹40,000 + ₹80,000 – ₹70,000 – ₹5,000 = ₹45,000.

Q20. Answer: (b) Credited to Branch Account

- Cash collected from branch customers reduces branch debtors and is therefore credited to the Branch Account under the Debtors System.

Q21. Answer: (a) Debtors System

- The Debtors System uses a single Branch Account to determine the overall profit or loss of the branch.

Q22. Answer: (a) Branch Stock Account

- Under the Stock and Debtors System, the Branch Stock Account is specifically maintained to record and control the movement of goods at the branch.

Q23. Answer: (b) An unconditional order to pay a certain sum of money

- A bill of exchange is an unconditional written order directing a specified person to pay a certain sum of money to a specified person or to his order.

Q24. Answer: (c) Drawer

- The drawer is the person who makes or draws the bill and gives the order to the drawee to make payment.

Q25. Answer: (c) Acceptance

- The drawee becomes the acceptor after accepting the bill and thereby becomes primarily liable for its payment.

Q26. Answer: (c) 3rd March 2015

- When a bill is drawn on the last days of a month for a set number of months, and the target month doesn't have a matching date (like February 30th), the period ends on the last day of that target month. One month from January 30th ends on February 28th. Adding 3 days of grace (March 1, 2, and 3) brings the maturity date to March 3rd.

Q27. Answer: (b) The drawer

- On discounting, the bank becomes the holder of the bill. If the bill is dishonoured, the bank can recover the amount due, along with applicable charges, from the parties liable on the bill; the drawer is ultimately liable subject to the rights of recourse.

Q28. Answer: (c) Enforced against the parties liable on the bill

- Dishonour does not extinguish the liability. The holder can proceed against the parties liable on the bill according to the applicable rules.

Q29. Answer: (c) Endorsement

- When the holder transfers the rights in a bill to another person by signing on the bill, it is known as endorsement.

Q30. Answer: (b) Timing differences and transactions recorded by one party but not yet recorded by the other

- Differences between the Cash Book and Pass Book generally arise because transactions may be recorded at different times by the business and the bank, along with certain items directly recorded by the bank.

Q31. Answer: (c) ₹24,500

- Pass Book balance = ₹25,000 + ₹4,000 – ₹6,000 – ₹500 + ₹2,000 = **₹24,500**.

Q32. Answer: (b) Deducted to arrive at Pass Book balance

- Bank charges reduce the Pass Book balance but are not yet recorded in the Cash Book. Therefore, they are deducted when starting with the favourable Cash Book balance.

Q33. Answer: (b) Reduce Pass Book balance relative to Cash Book

- The cheque has already increased the Cash Book balance, but until the bank credits it, the Pass Book remains lower.

Q34. Answer: (b) Added to obtain Pass Book balance

- A cheque issued is immediately recorded in the Cash Book, reducing its balance. Until presented, the bank has not made the corresponding payment, so the Pass Book balance is higher.

Q35. Answer: (a) Added

- Since the bank has already credited the amount but the Cash Book has not recorded it, the amount is added to the Cash Book balance.

Q36. Answer: (c) Bank charges recorded only in Pass Book

- Bank charges reduce the Pass Book balance while the Cash Book remains unchanged until the charges are recorded.

Q37. Answer: (b) Lower than Pass Book balance by ₹10,000

- The bank has recorded the direct deposit, but the Cash Book has not. Hence, the Pass Book balance exceeds the Cash Book balance by ₹10,000.

Q38. Answer: (c) Equally

- In the absence of an agreement, partners share profits and losses equally, irrespective of their capital contributions.

Q39. Answer: (b) Not entitled to remuneration for taking part in the conduct of business

- In the absence of an agreement to the contrary, a partner is not entitled to remuneration for participating in the conduct of the firm's business.

Q40. Answer: (c) Only out of profits

- In the absence of an agreement, interest on capital is payable only out of profits.

Q41. Answer: (c) ₹3,600

- Interest on a partner's advance is 6% p.a. $₹60,000 \times 6\% = ₹3,600$.

Q42. Answer: (b) ₹45,000 each

- In the absence of an agreement, profits are shared equally. Capital contribution does not determine the profit-sharing ratio.

Q43. Answer: (c) 6% p.a.

- A partner is entitled to interest at **6% per annum** on an advance made beyond the capital agreed to be contributed, in the absence of an agreement to the contrary.

Q44. Answer: (b) Subject to the partnership agreement and statutory provisions

- Every partner has a right to take part in the conduct of the firm's business, subject to the terms of the partnership agreement and applicable law.

Q45. Answer: (b) Balance Sheet and Statement of Profit and Loss

- Schedule III prescribes the form and minimum presentation requirements for the financial statements covered by the Companies Act framework.

Q46. Answer: (b) Securities Premium Account

- The premium received on the issue of shares is credited to the Securities Premium Account.

Q47. Answer: (c) It can be utilised only for purposes specifically permitted under the Companies Act

- Securities Premium is a capital receipt and its utilisation is restricted to the purposes specified under the Companies Act, 2013.

Q48. Answer: (b) It ordinarily represents borrowed capital

- Debentures generally represent debt or borrowed capital of the company and carry an obligation to pay interest and repay the principal according to their terms.

Q49. Answer: (c) Securities premium

- The excess of the issue price over the nominal value of a share is called securities premium. Here, $₹12 - ₹10 = ₹2$ per share.

Q50. Answer: (b) They are required to give a true and fair view and comply with applicable accounting standards, subject to the Companies Act framework

- Company financial statements are prepared within the Companies Act framework and must comply with applicable accounting requirements and present a true and fair view.

Chapter 11: Cost and Management Accounting

Cost concepts and classification

Basis of classification	Categories
By element	Material · Labour · Expenses (each further split into Direct and Indirect)
By traceability	Direct costs (traceable to a cost object) · Indirect cost / Overheads
By behaviour	Fixed (total constant, per unit falls) · Variable (total varies, per unit constant) · Semi-variable / Mixed
By function	Production · Administration · Selling · Distribution · Research & Development
By controllability	Controllable · Uncontrollable
By normality	Normal · Abnormal
By decision relevance	Relevant · Irrelevant; Sunk cost · Opportunity cost · Marginal cost · Differential cost · Imputed cost · Replacement cost

The cost sheet

Stage	Composition
Prime Cost	Direct Material + Direct Labour + Direct Expenses
Factory / Works Cost	Prime Cost + Factory Overheads (+ Opening WIP – Closing WIP)
Cost of Production	Works Cost + Administration Overheads
Cost of Goods Sold	Cost of Production + Opening Finished Goods – Closing Finished Goods
Cost of Sales (Total Cost)	Cost of Goods Sold + Selling and Distribution Overheads
Sales	Cost of Sales + Profit

Overheads — allocation, apportionment and absorption – *High Yield*

1. Allocation → Entire overhead is charged to **one department** because it is wholly identifiable with that department.

Example: Salary of a departmental foreman.

2. Apportionment → A common overhead is **divided among several departments** on an equitable basis.

Example: Rent distributed according to floor area.

3. Re-apportionment → Costs of **service departments** are transferred to **production departments**.

Methods: Direct, Step-ladder, Reciprocal, Repeated Distribution, Simultaneous Equations.

4. Absorption → Departmental overhead is finally **charged to products/units** passing through the department using an overhead rate.

The bases of apportionment

Overhead	Basis of Apportionment
Rent, rates, taxes, building repairs & insurance	Floor area occupied
Lighting	Number of light points / floor area
Electric / motive power	HP of motors × machine hours
Depreciation & insurance of plant	Capital value of plant
Supervision, canteen, welfare, timekeeping, personnel, ESI & PF	Number of employees
Stores & material handling	Value / weight of materials issued
Delivery & transport	Weight × distance / tonne-km
Steam, gas & water	Technical estimate / actual consumption
General overheads	Direct wages / direct labour hours

Q1. (EPFO EO/AO 2017)

The cost of electric power should be apportioned over different departments according to

- (a) horsepower of motors
- (b) number of light points
- (c) horsepower multiplied by machine hours
- (d) machine hours

Answer: (c) Horsepower multiplied by machine hours

- Power consumed = rate of consumption (horsepower) × duration of consumption (machine hours). Option (a) ignores how long the motor ran; option (d) ignores how large the motor is; option (b) is the basis for lighting, not power.

Overhead absorption rates – *High Yield*

<i>Overhead Rate</i>	<i>Uses</i>
% of Direct Material Cost	OH ÷ Direct Material Cost × 100 → Material prices are stable and materials are the dominant element.
% of Direct Wages	OH ÷ Direct Wages × 100 → Labour rates are fairly uniform and production is labour-intensive.
% of Prime Cost	OH ÷ Prime Cost × 100 → Simple method, but combines material and labour bases.
Direct Labour Hour Rate	OH ÷ Direct Labour Hours → Labour-intensive production; more accurate than % of wages when labour hours are a better measure of effort.
Machine Hour Rate	OH ÷ Machine Hours → Machine-intensive production; best where machine usage drives overhead.
Rate per Unit of Output	OH ÷ Units Produced → Suitable when output is single and uniform .

- **Under-absorption** — actual overhead exceeds absorbed overhead; **over-absorption** — the reverse. The difference is disposed of by a **supplementary rate**, by transfer to the **Costing P&L Account**, or by carry-forward.
- **Fixed overhead rate is computed on NORMAL CAPACITY**, not on actual output — using actual output would make the unit cost fluctuate with volume. This is also the AS-2 rule.

Q2. (EPFO APFC 2015)

Consider an industry with the following features:

Budgeted monthly fixed cost = ₹2,20,000;

Normal monthly output = 12,000 per standard labour hours;

Standard variable overhead rate = ₹25 per labour hour.

What would be the total factory overhead rate?

- (a) ₹40.33 per labour hour
- (b) ₹41.67 per labour hour
- (c) ₹42.67 per labour hour
- (d) ₹43.33 per labour hour

Answer: (d) ₹43.33 per labour hour

- Step 1 — Fixed overhead rate = Budgeted fixed cost ÷ Normal output = 2,20,000 ÷ 12,000 = ₹18.33 per labour hour.
- Step 2 — Total factory overhead rate = Fixed rate + Variable rate = 18.33 + 25 = ₹43.33 per labour hour.

Marginal costing and break-even analysis

Marginal costing is a technique that classifies costs into variable and fixed costs and uses contribution to analyse profit and output decisions. Break-even analysis determines the level of sales at which total revenue equals total cost, resulting in no profit and no loss.

- **Contribution** = Sales – Variable Cost = Fixed Cost + Profit.
- **P/V Ratio** = $(\text{Contribution} \div \text{Sales}) \times 100 = (\text{Change in Profit} \div \text{Change in Sales}) \times 100$.
- **Break-Even Point (units)** = Fixed Cost $\div$ Contribution per unit.
- **Break-Even Point (₹)** = Fixed Cost $\div$ P/V Ratio.
- **Margin of Safety** = Actual Sales – Break-Even Sales = Profit $\div$ P/V Ratio.
- **Required Sales for a target profit** = $(\text{Fixed Cost} + \text{Target Profit}) \div \text{P/V Ratio}$.
- **Absorption costing vs Marginal costing:** absorption costing treats fixed factory overhead as a **product** cost (carried in inventory); marginal costing treats it as a **period** cost (written off in full). Profits under the two differ whenever inventory levels change.

Standard costing

Standard costing is a technique in which predetermined standard costs are established for materials, labour and overheads and compared with actual costs. The resulting variances help management identify deviations and exercise cost control.

<i>Variance</i>	Formula
Material Cost Variance	$(\text{Std Qty} \times \text{Std Price}) - (\text{Actual Qty} \times \text{Actual Price})$
Material Price Variance	$\text{Actual Qty} \times (\text{Std Price} - \text{Actual Price})$
Material Usage Variance	$\text{Std Price} \times (\text{Std Qty} - \text{Actual Qty})$
Labour Cost Variance	$(\text{Std Hours} \times \text{Std Rate}) - (\text{Actual Hours} \times \text{Actual Rate})$
Labour Rate Variance	$\text{Actual Hours} \times (\text{Std Rate} - \text{Actual Rate})$
Labour Efficiency Variance	$\text{Std Rate} \times (\text{Std Hours} - \text{Actual Hours})$

Practice questions

Q1. Which of the following is not a direct cost merely because it is incurred in the production department?

- (a) Direct material
- (b) Direct labour
- (c) Factory rent
- (d) Direct expenses

Q2. A product requires Direct Material ₹1,20,000, Direct Labour ₹80,000 and Direct Expenses ₹20,000. The Prime Cost is:

- (a) ₹1,80,000
- (b) ₹2,00,000
- (c) ₹2,20,000
- (d) ₹2,40,000

Q3. From the following information, calculate the Works Cost: Prime Cost ₹2,20,000; Factory Overheads ₹60,000; Opening WIP ₹30,000; Closing WIP ₹20,000.

- (a) ₹2,70,000
- (b) ₹2,80,000
- (c) ₹2,90,000
- (d) ₹3,10,000

Q4. If Works Cost is ₹2,90,000 and Administration Overheads are ₹40,000, the Cost of Production is:

- (a) ₹2,50,000
- (b) ₹2,90,000
- (c) ₹3,30,000
- (d) ₹3,70,000

Q5. Cost of Production is ₹3,30,000. Opening Finished Goods are ₹50,000 and Closing Finished Goods are ₹30,000. The Cost of Goods Sold is:

- (a) ₹3,10,000
- (b) ₹3,30,000
- (c) ₹3,50,000
- (d) ₹4,10,000

Q6. A departmental manager's salary is identifiable entirely with one particular department. This overhead should normally be:

- (a) Apportioned
- (b) Allocated
- (c) Re-apportioned
- (d) Absorbed on machine hours

Q7. Factory rent is common to several departments. The most appropriate basis of apportionment is generally:

- (a) Number of employees
- (b) Direct wages
- (c) Floor area occupied
- (d) Machine hours

Q8. Where production is highly machine-intensive and machine usage is the principal cause of overhead, the most appropriate absorption base is generally:

- (a) Percentage of direct wages
- (b) Machine-hour rate
- (c) Percentage of material cost
- (d) Number of employees

Q9. Actual factory overhead is ₹5,40,000 while overhead absorbed in production is ₹5,00,000. The situation represents:

- (a) Over-absorption of ₹40,000
- (b) Under-absorption of ₹40,000
- (c) No difference
- (d) Under-absorption of ₹5,00,000

Q10. Budgeted fixed factory overhead is ₹2,40,000 and normal capacity is 12,000 labour hours. The fixed overhead rate per labour hour is:

- (a) ₹15
- (b) ₹20
- (c) ₹24
- (d) ₹30

Q11. A company sells 10,000 units at ₹50 each. Variable cost is ₹30 per unit. The total contribution is:

- (a) ₹1,00,000
- (b) ₹2,00,000
- (c) ₹3,00,000
- (d) ₹5,00,000

Q12. Sales are ₹8,00,000 and variable cost is ₹5,20,000. The P/V ratio is:

- (a) 30%
- (b) 35%
- (c) 40%
- (d) 65%

Q13. Fixed cost is ₹2,40,000 and contribution per unit is ₹80. The break-even point in units is:

- (a) 2,000 units
- (b) 2,500 units
- (c) 3,000 units
- (d) 3,500 units

Q14. Fixed cost is ₹1,80,000 and the P/V ratio is 30%. The break-even sales are:

- (a) ₹4,50,000
- (b) ₹5,40,000
- (c) ₹6,00,000
- (d) ₹6,60,000

Q15. Actual sales are ₹12,00,000 and break-even sales are ₹9,00,000. The Margin of Safety is:

- (a) ₹2,00,000
- (b) ₹3,00,000
- (c) ₹9,00,000
- (d) ₹21,00,000

Q16. A business has fixed costs of ₹3,00,000, a target profit of ₹1,20,000 and a P/V ratio of 40%. Sales required to earn the target profit are:

- (a) ₹7,50,000
- (b) ₹8,00,000
- (c) ₹10,50,000
- (d) ₹12,00,000

Q17. A product sells for ₹10 per unit and has variable cost of ₹6 per unit. If selling price rises to ₹12 while

variable cost remains ₹6, the new P/V ratio will be:

- (a) 40%
- (b) 50%
- (c) 60%
- (d) 66⅔%

Q18. Contribution per unit is ₹50. If fixed costs increase by ₹20,000, the break-even point will increase by:

- (a) 200 units
- (b) 300 units
- (c) 400 units
- (d) 500 units

Q19. When closing inventory increases, other things remaining unchanged, profit under absorption costing compared with marginal costing will generally be:

- (a) Lower
- (b) Higher
- (c) E
- Qual in all cases
- (d) Nil

Q20. A company has spare production capacity. A special order offers a selling price of ₹70 per unit. Variable cost is ₹50 per unit and there is no additional fixed cost. Ignoring Qualitative factors, accepting the order would:

- (a) Reduce profit by ₹20 per unit
- (b) Increase contribution by ₹20 per unit
- (c) Have no effect on profit
- (d) Increase fixed cost by ₹20 per unit

Q21. A component can be manufactured for Variable Cost ₹60 per unit and Avoidable Fixed Cost ₹20 per unit. The component can alternatively be purchased for ₹75 per unit. Assuming sufficient capacity is available, the economically relevant comparison indicates that the company should:

- (a) Buy, because ₹75 < ₹80
- (b) Make, because relevant make cost is ₹60
- (c) Buy, because fixed cost is irrelevant
- (d) Make only if selling price exceeds ₹100

Q22. A company uses a building for Product A that could alternatively be rented out for ₹30,000 per month. If the building is used for Product A, the ₹30,000 forgone rent represents:

- (a) Sunk cost
- (b) Historical cost
- (c) Opportunity cost
- (d) Marginal cost

Q23. Standard material requirement is 1,000 kg at ₹10 per kg. Actual consumption is 1,100 kg at ₹9 per kg. The Material Cost Variance is:

- (a) ₹100 Favourable

- (b) ₹100 Adverse
- (c) ₹1,100 Favourable
- (d) ₹1,000 Adverse

Q24. Using the information in Q23, the Material Price Variance is:

- (a) ₹1,100 Favourable
- (b) ₹1,000 Favourable
- (c) ₹100 Adverse
- (d) ₹1,100 Adverse

Q25. Using the information in Q23, the Material Usage Variance is:

- (a) ₹1,000 Favourable
- (b) ₹1,000 Adverse
- (c) ₹100 Favourable
- (d) ₹100 Adverse

Q26. Standard labour requirement is 200 hours at ₹50 per hour. Actual labour is 220 hours at ₹48 per hour. The Labour Cost Variance is:

- (a) ₹560 Favourable
- (b) ₹560 Adverse
- (c) ₹1,440 Favourable
- (d) ₹1,000 Adverse

Q27. Using the information in Q26, the Labour Rate Variance is:

- (a) ₹440 Favourable
- (b) ₹440 Adverse
- (c) ₹1,000 Favourable
- (d) ₹1,000 Adverse

Q28. Using the information in Q26, the Labour Efficiency Variance is:

- (a) ₹1,000 Favourable
- (b) ₹1,000 Adverse
- (c) ₹440 Favourable
- (d) ₹560 Adverse

Q29. The primary purpose of standard costing is to:

- (a) Eliminate all fixed costs
- (b) Compare predetermined costs with actual costs and analyse variances
- (c) Calculate only financial accounting profit
- (d) Replace the need for budgeting

Q30. Budgeted fixed factory overhead is ₹1,80,000, normal capacity is 20,000 labour hours and variable overhead is ₹12 per labour hour. The total factory overhead rate per labour hour is:

- (a) ₹12
- (b) ₹18
- (c) ₹21
- (d) ₹30

Answer Key

Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.
1	c	2	c	3	c	4	c	5	c
6	b	7	c	8	b	9	b	10	b
11	b	12	b	13	c	14	c	15	b
16	c	17	b	18	c	19	b	20	b
21	a	22	c	23	a	24	a	25	b
26	b	27	a	28	b	29	b	30	c

Q1. Answer: (c) Factory rent

- Factory rent is an indirect cost because it cannot normally be directly traced to a specific unit of product.
- Direct material, direct labour and direct expenses can be specifically identified with the product.

Q2. Answer: (c) ₹2,20,000

- Prime Cost = Direct Material + Direct Labour + Direct Expenses.
- Prime Cost = ₹1,20,000 + ₹80,000 + ₹20,000 = **₹2,20,000**.

Q3. Answer: (c) ₹2,90,000

- Works Cost = Prime Cost + Factory Overheads + Opening WIP – Closing WIP.
- Works Cost = ₹2,20,000 + ₹60,000 + ₹30,000 – ₹20,000 = **₹2,90,000**.

Q4. Answer: (c) ₹3,30,000

- Cost of Production = Works Cost + Administration Overheads.
- Cost of Production = ₹2,90,000 + ₹40,000 = **₹3,30,000**.

Q5. Answer: (c) ₹3,50,000

- Cost of Goods Sold = Cost of Production + Opening Finished Goods – Closing Finished Goods.
- COGS = ₹3,30,000 + ₹50,000 – ₹30,000 = **₹3,50,000**.

Q6. Answer: (b) Allocated

- Allocation means charging an entire cost to a particular cost centre when it can be specifically identified with that centre.
- Since the manager's salary relates entirely to one department, it is **allocated** to that department.

Q7. Answer: (c) Floor area occupied

- Factory rent is a common overhead for different departments.
- Floor area occupied is generally an appropriate basis for apportioning rent.

Q8. Answer: (b) Machine-hour rate

- Machine-hour rate is appropriate where machine usage is the major factor causing overhead costs.
- It provides a logical relationship between machine usage and overhead absorption.

Q9. Answer: (b) Under-absorption of ₹40,000

- Under-absorption occurs when actual overhead is greater than overhead absorbed.
- Under-absorption = ₹5,40,000 – ₹5,00,000 = **₹40,000**.

Q10. Answer: (b) ₹20

- Fixed Overhead Rate = Budgeted Fixed Overhead ÷ Normal Capacity.
- = ₹2,40,000 ÷ 12,000 hours = **₹20 per labour hour**.

Q11. Answer: (b) ₹2,00,000

- Contribution per unit = Selling Price – Variable Cost.
- Contribution per unit = ₹50 – ₹30 = ₹20.
- Total Contribution = 10,000 × ₹20 = **₹2,00,000**.

Q12. Answer: (b) 35%

- Contribution = Sales – Variable Cost.
- Contribution = ₹8,00,000 – ₹5,20,000 = ₹2,80,000.
- P/V Ratio = ₹2,80,000 ÷ ₹8,00,000 × 100 = **35%**.

Q13. Answer: (c) 3,000 units

- Break-even Point (Units) = Fixed Cost ÷ Contribution per Unit.
- = ₹2,40,000 ÷ ₹80 = **3,000 units**.

Q14. Answer: (c) ₹6,00,000

- Break-even Sales = Fixed Cost ÷ P/V Ratio.
- = ₹1,80,000 ÷ 30% = **₹6,00,000**.

Q15. Answer: (b) ₹3,00,000

- Margin of Safety = Actual Sales – Break-even Sales.
- = ₹12,00,000 – ₹9,00,000 = **₹3,00,000**.

Q16. Answer: (c) ₹10,50,000

- Required Contribution = Fixed Cost + Target Profit.
- = ₹3,00,000 + ₹1,20,000 = ₹4,20,000.
- Required Sales = ₹4,20,000 ÷ 40% = **₹10,50,000**.

Q17. Answer: (b) 50%

- New Contribution per unit = ₹12 – ₹6 = ₹6.
- P/V Ratio = Contribution ÷ Sales × 100.
- = ₹6 ÷ ₹12 × 100 = **50%**.

Q18. Answer: (c) 400 units

- Increase in Break-even Point = Increase in Fixed Cost ÷ Contribution per Unit.
- = ₹20,000 ÷ ₹50 = **400 units**.

Q19. Answer: (b) Higher

- Under absorption costing, a portion of fixed production overhead is included in closing inventory.
- Therefore, when closing inventory increases, profit under absorption costing is generally **higher** than under marginal costing.

Q20. Answer: (b) Increase contribution by ₹20 per unit

- Since spare capacity is available, the additional fixed cost is nil.
- Incremental contribution = ₹70 – ₹50 = **₹20 per unit**.

Q21. Answer: (a) Buy, because ₹75 < ₹80

- Relevant cost of making = Variable Cost + Avoidable Fixed Cost.
- = ₹60 + ₹20 = **₹80 per unit**. Since the purchase price is ₹75, buying is preferable.

Q22. Answer: (c) Opportunity cost

- Opportunity cost is the benefit sacrificed by choosing one alternative instead of another.
- The company sacrifices ₹30,000 rent by using the building itself, making it an **opportunity cost**.

Q23. Answer: (a) ₹100 Favourable

- Material Cost Variance = Standard Cost – Actual Cost.
- Standard Cost = 1,000 × ₹10 = ₹10,000; Actual Cost = 1,100 × ₹9 = ₹9,900.
- MCV = ₹10,000 – ₹9,900 = **₹100 Favourable**.

Q24. Answer: (a) ₹1,100 Favourable

- Material Price Variance = Actual Quantity × (Standard Price – Actual Price).
- = 1,100 × (₹10 – ₹9) = **₹1,100 Favourable**.

Q25. Answer: (b) ₹1,000 Adverse

- Material Usage Variance = Standard Price × (Standard Quantity – Actual Quantity).
- = ₹10 × (1,000 – 1,100) = **₹1,000 Adverse**.

Q26. Answer: (b) ₹560 Adverse

- Labour Cost Variance = Standard Labour Cost – Actual Labour Cost.
- Standard Cost = 200 × ₹50 = ₹10,000; Actual Cost = 220 × ₹48 = ₹10,560.
- LCV = ₹10,000 – ₹10,560 = **₹560 Adverse**.

Q27. Answer: (a) ₹440 Favourable

- Labour Rate Variance = Actual Hours × (Standard Rate – Actual Rate).
- = 220 × (₹50 – ₹48) = **₹440 Favourable**.

Q28. Answer: (b) ₹1,000 Adverse

- Labour Efficiency Variance = Standard Rate $\times$ (Standard Hours – Actual Hours).
- = ₹50 $\times$ (200 – 220) = **₹1,000 Adverse.**

Q29. Answer: (b) Compare predetermined costs with actual costs and analyse variances

- Standard costing establishes predetermined or standard costs.
- Actual performance is compared with these standards and the resulting variances are analysed.

Q30. Answer: (c) ₹21

- Fixed Overhead Rate = ₹1,80,000 $\div$ 20,000 hours = **₹9 per hour.**
- Variable Overhead Rate = **₹12 per hour.**
- Total Factory Overhead Rate = ₹9 + ₹12 = **₹21 per hour.**

Chapter 12: Financial Statement Analysis

Ratio analysis

- Ratio Analysis is the process of evaluating a firm's financial performance by comparing figures from the financial statements.
- Ratios help assess liquidity, solvency, profitability, efficiency, and market performance.
- A single ratio should never be interpreted in isolation; comparison with previous years, industry averages, or competitors is essential.

Liquidity ratios

- Liquidity ratios measure a firm's ability to meet short-term obligations using current assets.
- A higher liquidity ratio generally indicates a stronger short-term financial position, but an excessively high ratio may suggest inefficient use of working capital.

Ratio	Formula	Ideal
Current Ratio	Current Assets ÷ Current Liabilities	2 : 1
Quick / Acid Test / Liquid Ratio	(Current Assets – Stock – Prepaid Expenses) ÷ Current Liabilities	1 : 1
Absolute Liquid / Cash Ratio	(Cash + Bank + Marketable Securities) ÷ Current Liabilities	0.5 : 1

Solvency ratios

- Solvency ratios evaluate the firm's long-term financial stability and debt-paying capacity.

Ratio	Formula	Ideal
Debt–Equity Ratio	Long-term Debt ÷ Shareholders' Funds	2 : 1
Proprietary Ratio	Shareholders' Funds ÷ Total Assets	Higher is safer
Interest Coverage Ratio	Profit before Interest and Tax ÷ Interest	> 6 times
Total Assets to Debt Ratio	Total Assets ÷ Long-term Debt	Higher is safer

Activity / Turnover ratios

- Activity (Turnover) ratios measure how efficiently a business utilizes its assets and resources.

Ratio	Formula
Inventory Turnover	Cost of Goods Sold ÷ Average Inventory
Debtors (Receivables) Turnover	Net Credit Sales ÷ Average Debtors
Average Collection Period	365 ÷ Debtors Turnover
Creditors (Payables) Turnover	Net Credit Purchases ÷ Average Creditors
Average Payment Period	365 ÷ Creditors Turnover
Working Capital Turnover	Net Sales ÷ Working Capital
Fixed Assets Turnover	Net Sales ÷ Net Fixed Assets

Profitability ratios

- Profitability ratios measure the firm's ability to generate profit from sales, assets, or shareholders' funds.

Ratio	Formula
Gross Profit Ratio	(Gross Profit ÷ Net Sales) × 100
Net Profit Ratio	(Net Profit ÷ Net Sales) × 100
Operating Ratio	((COGS + Operating Expenses) ÷ Net Sales) × 100
Operating Profit Ratio	(Operating Profit ÷ Net Sales) × 100 = 100 – Operating Ratio
Return on Capital Employed (ROCE)	(PBIT ÷ Capital Employed) × 100
Return on Equity (ROE)	(Profit after Tax and Preference Dividend ÷ Equity Shareholders' Funds) × 100
Earnings Per Share (EPS)	(PAT – Preference Dividend) ÷ Number of Equity Shares
Price–Earnings Ratio	Market Price per Share ÷ EPS
Dividend Payout Ratio	(Dividend per Share ÷ EPS) × 100

- Capital Employed** = Shareholders' Funds + Long-term Debt = Fixed Assets + Working Capital.
- Working Capital** = Current Assets – Current Liabilities.

Limitations of ratio analysis: based on historical data; ignores price-level changes; ignores qualitative factors; comparability suffers from differing accounting policies; a single ratio in isolation is meaningless; window dressing can distort them.

Cash Flow Statement — AS-3 / Ind AS 7

- Cash Flow Statement (CFS) shows the actual inflow and outflow of cash and cash equivalents during an accounting period.

Activity	Includes
Operating	Cash from principal revenue-producing activities — receipts from customers, payments to suppliers and employees, taxes paid (unless identifiable with investing/financing)
Investing	Purchase and sale of fixed assets and investments , interest and dividend received (for a non-financial enterprise), loans given
Financing	Issue and redemption of shares and debentures , long-term borrowings and repayments, dividend and interest paid

- Two methods for operating activities:** the **Direct Method** (gross receipts and payments) and the **Indirect Method** (start with net profit before tax and extraordinary items, adjust for non-cash and non-operating items, then for working-capital changes).
- Standard indirect-method adjustments: **add back** depreciation, amortisation, loss on sale of assets, interest paid, preliminary expenses written off; **deduct** interest and dividend received, profit on sale of assets.
- Cash equivalents** are short-term, highly liquid investments readily convertible into known amounts of cash and subject to insignificant risk of change in value — generally an original maturity of **three months or less**.
- Non-cash transactions** (issue of shares for the purchase of a business, conversion of debentures into shares) are **excluded** from the cash flow statement and disclosed separately.

Fund Flow vs Cash Flow

Point	Fund Flow Statement	Cash Flow Statement
Basis	Change in working capital	Change in cash and cash equivalents
Concept	Accrual	Cash
Statement of changes	Schedule of Changes in Working Capital is prepared	Not required
Statutory requirement	None	Mandatory under AS-3 / Ind AS 7 for specified companies
Usefulness	Long-term financial planning	Short-term liquidity planning

Practice Questions

Q1. A company has Current Assets of ₹6,00,000 and Current Liabilities of ₹3,00,000. Its Current Ratio is:

- (a) 0.5 : 1
- (b) 1 : 1
- (c) 2 : 1
- (d) 3 : 1

Q2. Current Assets are ₹5,00,000, including Inventory of ₹1,20,000 and Prepaid Expenses of ₹20,000. Current Liabilities are ₹1,80,000. The Quick Ratio is:

- (a) 1 : 1
- (b) 1.5 : 1
- (c) 2 : 1
- (d) 2.5 : 1

Q3. Cash ₹40,000, Bank Balance ₹30,000 and Marketable Securities ₹20,000 constitute the absolute liquid assets. Current Liabilities are ₹1,80,000. The Absolute Liquid Ratio is:

- (a) 0.25 : 1
- (b) 0.50 : 1
- (c) 0.75 : 1
- (d) 1 : 1

Q4. Long-term debt is ₹4,00,000 and shareholders' funds are ₹8,00,000. The Debt-Equity Ratio is:

- (a) 0.5 : 1
- (b) 1 : 1
- (c) 2 : 1
- (d) 4 : 1

Q5. Shareholders' funds are ₹6,00,000 and total assets are ₹10,00,000. The Proprietary Ratio is:

- (a) 0.4
- (b) 0.5
- (c) 0.6
- (d) 1.67

Q6. Profit Before Interest and Tax is ₹1,80,000 and interest expense is ₹30,000. The Interest Coverage Ratio is:

- (a) 3 times
- (b) 4 times
- (c) 6 times
- (d) 9 times

Q7. Cost of Goods Sold is ₹9,00,000 and average inventory is ₹1,50,000. The Inventory Turnover Ratio is:

- (a) 4 times
- (b) 5 times
- (c) 6 times

(d) 7 times

Q8. Net Credit Sales are ₹12,00,000 and average receivables are ₹2,00,000. The Receivables Turnover Ratio is:

- (a) 4 times
- (b) 5 times
- (c) 6 times
- (d) 8 times

Q9. If Receivables Turnover Ratio is 6 times, using a 365-day year, the average collection period is approximately:

- (a) 30.4 days
- (b) 45.8 days
- (c) 60.8 days
- (d) 73 days

Q10. Net Credit Purchases are ₹9,00,000 and average Trade Payables are ₹1,50,000. The Creditors Turnover Ratio is:

- (a) 4 times
- (b) 5 times
- (c) 6 times
- (d) 8 times

Q11. If Creditors Turnover Ratio is 6 times, the average payment period using a 365-day year is approximately:

- (a) 30.4 days
- (b) 45.8 days
- (c) 60.8 days
- (d) 91.25 days

Q12. Net Sales are ₹12,00,000 and working capital is ₹2,00,000. The Working Capital Turnover Ratio is:

- (a) 4 times
- (b) 5 times
- (c) 6 times
- (d) 8 times

Q13. Net Sales are ₹15,00,000 and Gross Profit is ₹3,00,000. The Gross Profit Ratio is:

- (a) 10%
- (b) 15%
- (c) 20%
- (d) 25%

Q14. Net Sales are ₹15,00,000 and Net Profit is ₹1,50,000. The Net Profit Ratio is:

- (a) 5%
- (b) 10%

- (c) 15%
(d) 20%

Q15. Cost of Goods Sold is ₹9,00,000 and operating expenses are ₹3,00,000. Net Sales are ₹15,00,000. The Operating Ratio is:

- (a) 60%
(b) 70%
(c) 80%
(d) 90%

Q16. Based on the information in Q15, the Operating Profit Ratio is:

- (a) 10%
(b) 20%
(c) 30%
(d) 80%

Q17. Profit Before Interest and Tax is ₹2,40,000 and capital employed is ₹12,00,000. The ROCE is:

- (a) 10%
(b) 15%
(c) 20%
(d) 25%

Q18. A company purchases additional inventory entirely on credit, with no immediate payment. Other things remaining unchanged, what happens immediately?

- (a) Current Ratio increases and Quick Ratio increases
(b) Current Ratio decreases and Quick Ratio increases
(c) Current Ratio may increase while Quick Ratio decreases
(d) Both ratios necessarily remain unchanged

Q19. Which statement regarding ratio analysis is most appropriate?

- (a) A single ratio is sufficient to judge overall financial performance
(b) Ratios should be interpreted in isolation
(c) Ratios become more meaningful when compared with relevant previous periods or benchmarks
(d) A higher value of every ratio is always desirable

Q20. A very high Current Ratio may sometimes indicate:

- (a) Efficient utilisation of all current assets
(b) Excessive investment in working capital
(c) Absence of current liabilities
(d) Guaranteed profitability

Q21. Under AS-3, for a non-financial enterprise, cash received from customers is generally classified as:

- (a) Investing Activity

- (b) Financing Activity
(c) Operating Activity
(d) Non-cash Activity

Q22. Under AS-3, purchase of machinery for cash is classified as:

- (a) Operating Activity
(b) Investing Activity
(c) Financing Activity
(d) Extraordinary Activity

Q23. Under AS-3, proceeds from issue of equity shares for cash are classified as:

- (a) Operating Activity
(b) Investing Activity
(c) Financing Activity
(d) Non-cash Activity

Q24. Under AS-3, for a non-financial enterprise, interest paid is generally classified as:

- (a) Operating Activity
(b) Investing Activity
(c) Financing Activity
(d) Non-cash Activity

Q25. Under AS-3, for a non-financial enterprise, interest received and dividends received are generally classified as:

- (a) Operating Activities
(b) Investing Activities
(c) Financing Activities
(d) Non-cash Activities

Q26. Dividend paid by a non-financial enterprise under AS-3 is generally classified as:

- (a) Operating Activity
(b) Investing Activity
(c) Financing Activity
(d) Non-cash Activity

Q27. A cash equivalent generally has an original maturity of:

- (a) Three months or less
(b) Six months or less
(c) One year or less
(d) More than one year

Q28. Which of the following is a non-cash transaction and therefore is not included as a cash flow in the Cash Flow Statement?

- (a) Purchase of machinery for cash
(b) Issue of shares for cash
(c) Conversion of debentures into equity shares

(d) Repayment of a bank loan in cash

Q29. Under the indirect method of determining cash flow from operating activities, depreciation is generally:

- (a) Deducted from profit
- (b) Added back to profit
- (c) Treated as financing cash flow
- (d) Treated as investing cash flow

Q30. A company reports Cash Flow from Operating Activities of ₹2,00,000, Cash Flow from Investing Activities of ₹1,20,000 outflow and Cash Flow from Financing Activities of ₹50,000 inflow. Ignoring other adjustments, the net increase in cash and cash equivalents is:

- (a) ₹30,000
- (b) ₹70,000
- (c) ₹1,30,000
- (d) ₹3,70,000

Answers & Explanations

Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.
1	c	2	c	3	b	4	a	5	c
6	c	7	c	8	c	9	c	10	c
11	c	12	c	13	c	14	b	15	c
16	b	17	c	18	c	19	c	20	b
21	c	22	b	23	c	24	c	25	b
26	c	27	a	28	c	29	b	30	c

Q1. Answer: (c) 2 : 1

- Current Ratio = Current Assets ÷ Current Liabilities.
= ₹6,00,000 ÷ ₹3,00,000 = **2 : 1**.

Q2. Answer: (c) 2 : 1

- Quick Assets = Current Assets – Inventory – Prepaid Expenses.
= ₹5,00,000 – ₹1,20,000 – ₹20,000 = ₹3,60,000.
- Quick Ratio = ₹3,60,000 ÷ ₹1,80,000 = **2 : 1**.

Q3. Answer: (b) 0.50 : 1

- Absolute Liquid Assets = Cash + Bank Balance + Marketable Securities.
= ₹40,000 + ₹30,000 + ₹20,000 = ₹90,000.
- Absolute Liquid Ratio = ₹90,000 ÷ ₹1,80,000 = **0.50 : 1**.

Q4. Answer: (a) 0.5 : 1

- Debt-Equity Ratio = Long-term Debt ÷ Shareholders' Funds.
= ₹4,00,000 ÷ ₹8,00,000 = **0.5 : 1**.

Q5. Answer: (c) 0.6

- Proprietary Ratio = Shareholders' Funds ÷ Total Assets.
= ₹6,00,000 ÷ ₹10,00,000 = **0.6**.

Q6. Answer: (c) 6 times

- Interest Coverage Ratio = EBIT ÷ Interest.
= ₹1,80,000 ÷ ₹30,000 = **6 times**.

Q7. Answer: (c) 6 times

- Inventory Turnover Ratio = Cost of Goods Sold ÷ Average Inventory.
= ₹9,00,000 ÷ ₹1,50,000 = **6 times**.

Q8. Answer: (c) 6 times

- Receivables Turnover Ratio = Net Credit Sales ÷ Average Receivables.
= ₹12,00,000 ÷ ₹2,00,000 = **6 times**.

Q9. Answer: (c) 60.8 days

- Average Collection Period = 365 ÷ Receivables Turnover Ratio.
= 365 ÷ 6 = **60.83 days**, approximately **60.8 days**.

Q10. Answer: (c) 6 times

- Creditors Turnover Ratio = Net Credit Purchases ÷ Average Trade Payables.
= ₹9,00,000 ÷ ₹1,50,000 = **6 times**.

Q11. Answer: (c) 60.8 days

- Average Payment Period = 365 ÷ Creditors Turnover Ratio.
= 365 ÷ 6 = **60.83 days**, approximately **60.8 days**.

Q12. Answer: (c) 6 times

- Working Capital Turnover Ratio = Net Sales ÷ Working Capital.
= ₹12,00,000 ÷ ₹2,00,000 = **6 times**.

Q13. Answer: (c) 20%

- Gross Profit Ratio = Gross Profit ÷ Net Sales × 100.
= ₹3,00,000 ÷ ₹15,00,000 × 100 = **20%**.

Q14. Answer: (b) 10%

- Net Profit Ratio = Net Profit ÷ Net Sales × 100.
= ₹1,50,000 ÷ ₹15,00,000 × 100 = **10%**.

Q15. Answer: (c) 80%

- Operating Ratio = (COGS + Operating Expenses) ÷ Net Sales × 100.
= (₹9,00,000 + ₹3,00,000) ÷ ₹15,00,000 × 100 = **80%**.

Q16. Answer: (b) 20%

- Operating Profit Ratio = 100% – Operating Ratio.
= 100% – 80% = **20%**.

Q17. Answer: (c) 20%

- ROCE = EBIT ÷ Capital Employed × 100.
= ₹2,40,000 ÷ ₹12,00,000 × 100 = **20%**.

Q18. Answer: (c) Current Ratio may increase while Quick Ratio decreases

- Purchase of inventory on credit increases both Current Assets and Current Liabilities.
- Inventory is not included in Quick Assets.
- Therefore, the Quick Ratio decreases, while the effect on the Current Ratio depends on the existing ratio.

Q19. Answer: (c) Ratios become more meaningful when compared with relevant previous periods or benchmarks

- Ratio analysis becomes useful when ratios are compared with previous years, industry standards or appropriate benchmarks.
- A single ratio in isolation may not provide a complete picture.

Q20. Answer: (b) Excessive investment in working capital

- A very high Current Ratio does not necessarily indicate better financial performance.
- It may indicate that excessive funds are tied up in current assets.
- Therefore, both liquidity and efficient utilisation of resources should be considered.

Q21. Answer: (c) Operating Activity

- Cash received from customers arises from the entity's principal revenue-producing activities.
- Therefore, under AS-3, it is classified as a **cash flow from operating activities**.

Q22. Answer: (b) Investing Activity

- Purchase of machinery represents acquisition of a long-term asset.
- Cash flows relating to acquisition or disposal of long-term assets are classified as **investing activities**.

Q23. Answer: (c) Financing Activity

- Issue of equity shares results in an inflow of funds from the owners of the enterprise.
- Therefore, proceeds from issue of shares are classified as a **financing activity**.

Q24. Answer: (c) Financing Activity

- Under AS-3, for a non-financial enterprise, interest paid is classified as a **financing activity** because it represents a cost of obtaining financial resources.

Q25. Answer: (b) Investing Activities

- Interest received and dividends received represent returns on investments.
- Under AS-3 for a non-financial enterprise, they are classified as **investing activities**.

Q26. Answer: (c) Financing Activity

- Dividend paid represents a distribution of returns to the owners of the enterprise.
- Under AS-3, dividend paid is classified as a **financing activity**.

Q27. Answer: (a) Three months or less

- Cash equivalents are short-term, highly liquid investments that are readily convertible into known amounts of cash.
- An investment normally qualifies when its original maturity is **three months or less** from the date of acquisition.

Q28. Answer: (c) Conversion of debentures into equity shares

- Conversion of debentures into equity shares does not involve an actual movement of cash.
- It is therefore a **non-cash transaction** and is not included as a cash flow in the Cash Flow Statement.

Q29. Answer: (b) Added back to profit

- Depreciation is a non-cash expense.
- Under the indirect method, it reduces accounting profit but does not involve a cash outflow.
- Therefore, depreciation is **added back to profit** while calculating cash flow from operating activities.

Q30. Answer: (c) ₹1,30,000

- Net Cash Flow = Operating Cash Flow + Investing Cash Flow + Financing Cash Flow.
= ₹2,00,000 – ₹1,20,000 + ₹50,000.
- Net increase in cash = **₹1,30,000**.

Chapter 13: Auditing

- An audit is the **independent** examination of financial information of **any entity**, whether profit-oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an **opinion** thereon

Objectives

Objective	Content
Primary objective	To express an opinion on whether the financial statements give a true and fair view and are prepared in accordance with the applicable financial reporting framework
Secondary / incidental objectives	Detection and prevention of errors and frauds

- An auditor is a watchdog, not a bloodhound** — *Kingston Cotton Mill Co. (1896)*. He is justified in relying on trusted officials in the absence of suspicion, but must investigate once suspicion is aroused.
- Audit provides **reasonable assurance**, not absolute assurance, because of **inherent limitations**: the use of test checking and sampling, the fact that most evidence is persuasive rather than conclusive, the presence of management judgement and estimates, the possibility of collusion, and the risk of management override of controls.

Scope of audit - **Core Focus**

Within the scope of audit	Outside the scope of audit
Examination of the system of accounting and internal control	Preparation of the books of account — that is management's responsibility
Verification of the authenticity and validity of transactions	Management functions and decision-making
Vouching, verification and valuation of assets and liabilities	Guaranteeing the accuracy of every single figure
Checking arithmetical accuracy and compliance with law and standards	Certifying the future viability of the business
Reporting to the appropriate person or body (shareholders, trustees, government)	Detecting every fraud, however concealed

Q1. (EPFO APFC 2023)

Which one of the following aspects is not covered in audit?

- Examination of the system of accounting and internal control
- Preparation of books of accounts
- Reporting to the appropriate person/body
- Verification of the authenticity and validity of transactions

Q2. An audit is an independent examination of financial information of an entity, whether profit-oriented or not, irrespective of its size or legal form, when such examination is conducted with a view to:

- Preparing the financial statements
- Expressing an opinion thereon
- Detecting every error and fraud
- Guaranteeing the financial position of the entity

Q3. Which of the following is a basic objective of auditing?

- Verifying the authenticity and validity of transactions
- Preparing the books of account
- Taking management decisions
- Guaranteeing the future profitability of the entity

Q1. Answer: (b) Preparation of books of accounts

- Preparing the books is a management function. An auditor who prepares the accounts cannot independently audit them — and under Section 144 of the Companies Act 2013 he is barred from doing so.

Q2. Answer: (b) Expressing an opinion thereon

- The primary objective of an audit is to express an independent opinion on the financial statements based on examination of financial information.

Q3. Answer: (a) Verifying the authenticity and validity of transactions

- Verification of the authenticity and validity of transactions is a basic objective of auditing.

Types of audits

- Internal audit and statutory (external) audit differ mainly in their purpose, appointment, reporting relationship and legal requirements.

Point	Internal Audit	Statutory (External) Audit
Appointed by	Management	Shareholders (Section 139)
Reports to	Management / Audit Committee	Shareholders
Scope decided by	Management	Statute — cannot be restricted by management
Continuity	Continuous throughout the year	Usually at year end
Qualification	Not necessarily a Chartered Accountant (Section 138 permits a CA, CMA or such other professional as the Board decides)	Must be a practising Chartered Accountant (Section 141)
Removal	By management	Only by special resolution with Central Government approval (Section 140)

Audit planning — SA 300 - *Core Focus*

- SA 300, "Planning an Audit of Financial Statements", requires the auditor to establish an **OVERALL AUDIT STRATEGY** that sets the scope, timing and direction of the audit, and that **GUIDES** the development of the more detailed **AUDIT PLAN**.

Term	What it is	Level
Overall Audit Strategy	Sets the scope, timing and direction of the audit; determines resources, materiality, reliance on internal controls	Broad / strategic — comes FIRST
Audit Plan	More detailed than the strategy; describes the nature, timing and extent of planned risk assessment procedures and further audit procedures	Detailed — developed from the strategy
Audit Programme	A written list of the specific procedures to be performed by the audit staff on each area, with assignments and sign-offs	Operational — the working instrument
Completion Memorandum	A summary prepared at the end of the audit recording significant matters and their resolution	Concluding

Q4. (EPFO APFC 2023) Which of the following sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan?

- Audit program
- Overall audit strategy
- Completion memorandum
- Audit plan

Q5. Which of the following is prepared first in the audit planning process?

- Audit programme
- Audit plan
- Overall audit strategy
- Audit report

Q6. Which of the following correctly distinguishes an audit plan from an audit programme?

- (a) Audit plan is prepared by management, whereas audit programme is prepared by shareholders.
- (b) Audit plan describes the nature, timing and extent of planned procedures, whereas audit programme lists specific procedures to be performed by audit staff.
- (c) Audit programme is broader than audit strategy.
- (d) Audit plan is prepared after the audit report.

Q4. Answer: (b) Overall audit strategy

- The overall audit strategy sets the scope, timing and direction of the audit and provides the basis for developing the more detailed audit plan.

Q5. Answer: (c) Overall audit strategy

- The overall audit strategy is prepared first in the audit planning process.
- It provides the framework for preparing the audit plan, which is then translated into specific procedures through the audit programme.

Q6. Answer: (b) Audit plan describes the nature, timing and extent of planned procedures, whereas audit programme lists specific procedures to be performed by audit staff.

- The audit plan provides details about the nature, timing and extent of planned audit procedures.
- The audit programme is more specific and contains the individual procedures to be performed by the audit staff.

Audit documentation — SA 230 - *High Yield*

- Audit documentation is the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (also referred to as "working papers"). SA 230 governs it.

Point	Rule
What it includes	Audit programmes, analyses, issues memoranda, summaries of significant matters , letters of confirmation and representation, checklists, correspondence, abstracts of significant contracts
What it does NOT include	Superseded drafts, preliminary thinking, notes reflecting incomplete reasoning, duplicates
Audit File vs Audit Documentation	They are NOT the same. The audit file is the folder or storage medium — physical or electronic — that <i>contains</i> the documentation. Documentation is the content; the file is the container
Form	May be on paper, electronic or other media
Ownership	The auditor's property — <i>Chantrey Martin & Co. v. Martin</i> — though the auditor may release extracts at his discretion
Assembly of the final audit file	To be completed within 60 days after the date of the auditor's report (SQC 1)
Retention	Not less than seven years from the date of the auditor's report (SQC 1)
Permanent file	MOA/AOA, organisation structure, copies of long-term contracts, prior years' analyses, history of the entity
Current file	Correspondence, audit programme, working papers and evidence relating to the current year

Q7. (UPSC EPFO, 2025)

Which one of the following statements about audit documentation is not correct?

- (a) Audit documentation includes audit programmes.
- (b) Audit file and audit documentation are the same.
- (c) Audit documentation includes summaries of significant matters.
- (d) Audit documentation may be recorded on paper or in electronic form.

Answer: (b) Audit file and audit documentation are the same.

- SA 230 defines the two separately: audit documentation is the record; the audit file is the folder or storage medium in which that record is assembled. A container is not its contents. (a), (c) and (d) are all correct statements from the same standard.

Vouching, Verification and Valuation - *Core Focus*

VOUCHING Checks the authenticity of transactions recorded in the books.  VS VERIFICATION Confirms the existence, ownership and value of assets and liabilities. 		
Point	VOUCHING	VERIFICATION
Relates to	Transactions — entries in the books	Assets and liabilities — items in the Balance Sheet
Object	To establish the authenticity, validity and accuracy of a recorded transaction	To confirm existence, ownership, possession, valuation, and freedom from charge
Timing	Throughout the year / during the audit	At the end of the year
Evidence	Vouchers — invoices, receipts, agreements, minutes	Physical inspection, title deeds, certificates, confirmations
Performed by	Usually audit assistants	Usually, the senior auditor or the auditor himself
Covers valuation?	No	Yes — valuation is part of verification

- **The five objectives of verification** — remember them as **E-O-P-V-C**: Existence, Ownership, Possession, proper Valuation, and freedom from Charge or encumbrance.
- **Valuation** means satisfying oneself that the value attached to an asset is fair and reasonable and in accordance with generally accepted accounting principles. Valuation is the auditor's *responsibility to verify*; the *valuation itself* is management's responsibility. *Kingston Cotton Mill*: "an auditor is not a valuer."

Q8. (UPSC EPFO, 2025)

In the context of auditing, the primary objective of vouching is

- (a) To detect errors in financial statements
- (b) To evaluate internal controls
- (c) To verify the authenticity of transactions
- (d) To assess management performance

Q9. (UPSC EPFO, 2025)

Which one of the following is not the objective of verification in auditing?

- (a) Checking the historical accuracy of accounts
- (b) Verification of the existence of the assets
- (c) Verification of the valuation of the assets

- (d) Verification of the authority of the acquisition of the assets

Q10. An auditor examines invoices, receipts and purchase agreements to establish that transactions recorded in the books are genuine and properly supported. This procedure is primarily known as:

- (a) Verification
- (b) Valuation
- (c) Vouching
- (d) Internal audit

Q11. Which of the following correctly represents the objectives of verification of assets?

(a) Accuracy, completeness, classification and disclosure

(b) Existence, ownership, possession, valuation and freedom from charge

(c) Authenticity, validity, accuracy, authorization and classification

(d) Occurrence, completeness, valuation, cut-off and disclosure

Q12. With regard to valuation of assets, which one of the following statements is correct?

(a) The auditor is responsible for determining the value of the assets.

(b) Valuation is exclusively a management function and the auditor has no responsibility regarding it.

(c) The auditor verifies whether the valuation made by management is reasonable and in accordance with applicable accounting principles.

(d) Valuation is part of vouching because it concerns the amount recorded in the books.

Q8. Answer: (c) To verify the authenticity of transactions

- Vouching is the examination of documentary evidence supporting transactions. Detecting errors (a) is an incidental benefit, not the primary object; (b) belongs to the evaluation of internal control; (d) belongs to management audit.

Q9. Answer: (a) Checking the historical accuracy of accounts

- Historical accuracy of recorded entries is the object of vouching. Verification is concerned with the state of the asset at the balance sheet date — existence, ownership, valuation and authority.

Q10. Answer: (c) Vouching

- Vouching examines documentary evidence to establish the authenticity and validity of transactions recorded in the books.

Q11. Answer: (b) Existence, ownership, possession, valuation and freedom from charge

- These are the five objectives of verification, remembered as E-O-P-V-C.

Q12. Answer: (c) The auditor verifies whether the valuation made by management is reasonable and in accordance with applicable accounting principles

- Management is responsible for valuation; the auditor verifies its reasonableness and compliance with applicable accounting principles.

Internal control, internal check and internal audit

Point	Internal Control	Internal Check	Internal Audit
Meaning	The whole system of controls — financial and otherwise — established by management to carry on business in an orderly manner, safeguard assets and secure the accuracy and reliability of records	An arrangement of duties such that no one person handles a transaction from beginning to end ; the work of one is automatically checked by another	An independent appraisal activity within the organisation, reviewing operations as a service to management
Nature	The umbrella concept	A part of internal control	A part of internal control, and a review of it
Cost	Built into the system	No extra cost — it is a division of work	Requires a separate staff/department
Timing	Continuous	Simultaneous with the work	After the transaction

- The **components of internal control** (SA 315): **Control Environment · Risk Assessment Process · Information System and Communication · Control Activities · Monitoring of Controls.**
- Section 138, Companies Act 2013** — internal audit is mandatory for every listed company, and for prescribed classes of unlisted public and private companies based on turnover, paid-up capital, borrowings and deposits.

- **Section 134(5)(e)** requires the directors of a listed company to state in the Directors' Responsibility Statement that **internal financial controls** are adequate and operating effectively; **Section 143(3)(i)** requires the auditor to report on the adequacy of internal financial controls over financial reporting.

Fraud and error — SA 240 and reporting under the Companies Act

- **Primary responsibility for the prevention and detection of fraud rests with those charged with governance and with management — not with the auditor.** The auditor's responsibility is to obtain **reasonable assurance** that the financial statements as a whole are free from material misstatement, whether caused by fraud or error.
- **Window dressing** is the presentation of accounts to show a **better** position than the reality; **secret reserves** show a **worse** position than the reality. Both are forms of fraudulent financial reporting.

Fraud reporting thresholds — Section 143(12)

- Where an auditor of a company, in the course of performance of his duties, has reason to believe that an offence of fraud involving an amount of ₹1 CRORE OR ABOVE is being or has been committed against the company by its officers or employees, he shall report the matter to the CENTRAL GOVERNMENT.

<i>Amount of fraud</i>	Report to	Time limits
₹1 crore or above	Central Government (Secretary, Ministry of Corporate Affairs)	Report to the Board or Audit Committee within 2 days of knowledge, seeking reply within 45 days ; then forward to the Central Government within 15 days of receiving the reply (or on expiry of 45 days), in Form ADT-4 by registered post with acknowledgement due and by e-mail
Below ₹1 crore	Audit Committee or the Board	Within 2 days of knowledge; disclosed in the Board's Report

- The same obligation applies to a **cost auditor** and a **secretarial auditor**.
- **Section 447** defines fraud and prescribes punishment — imprisonment of six months to ten years and a fine of one to three times the amount involved; where the fraud involves public interest, the minimum imprisonment is three years.

Q13. (EPFO EO/AO 2023)

Reporting on fraud is to be made by an auditor to the Central Government when the sums involved in the fraud

- exceed ₹20 lakh
- exceed ₹50 lakh
- exceed ₹75 lakh
- are ₹1 crore or above

Audit report and company auditor - *High Yield*

Types of audit opinion — SA 700 series

 Unmodified (Clean) When issued The financial statements give a true and fair view in all material respects.	 Qualified When issued Misstatements are material but not pervasive, or the auditor cannot obtain sufficient evidence but the possible effects are material but not pervasive — “except for ...”.	 Adverse When issued Misstatements are both material and pervasive — the statements do not give a true and fair view.	 Disclaimer of Opinion When issued The auditor cannot obtain sufficient appropriate evidence and the possible effects are both material and pervasive — the auditor does not express an opinion.
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The company auditor — Companies Act 2013

Section	Key Provision
139(1)	Auditor appointed at AGM for 5 consecutive years . Ratification removed by Companies (Amendment) Act, 2017.
139(6)	First auditor: Board appoints within 30 days of registration; failing which, members appoint in an EGM within 90 days .
139(2) — Rotation	Listed & prescribed companies: Individual → 1 term (5 years) ; Firm → 2 terms (10 years) ; followed by 5-year cooling-off .
140	Removal before expiry: Special resolution + prior Central Government approval .
141	Qualifications & disqualifications — includes body corporate (except LLP), officer/employee, person indebted beyond ₹5 lakh , security holder, and person convicted of fraud within 10 years .
143	Powers & duties: access to books, obtain information/explanations, attend general meetings, and report.
144	Prohibited non-audit services: bookkeeping, internal audit, actuarial services, investment advisory, investment banking, outsourced financial services, management services.
147	Punishment for contravention.

CARO 2020 and Government audit

- **CARO 2020** (Companies (Auditor's Report) Order, 2020) requires the auditor to report on 21 specified matters. It does **not** apply to banking companies, insurance companies, Section 8 companies, one-person companies, or small companies.
- **Comptroller and Auditor General of India (CAG)** — a constitutional authority under **Article 148**; duties and powers under the **CAG (DPC) Act, 1971**. Article 149 defines duties; Article 151 requires the reports to be laid before Parliament or the State Legislature.
- Government audit types: **Propriety audit** (wisdom, faithfulness and economy of expenditure), **Regularity/Compliance audit**, **Performance audit** (economy, efficiency, effectiveness — the "3 Es"), **Audit of receipts**, and **Audit of stores and stock**.
- Under **Section 139(5)**, the auditor of a **Government company** is appointed by the **CAG**, and under **Section 143(6)** the CAG has the right to conduct a **supplementary audit**.

Practice Questions

Q1. The primary objective of an audit is to:

- (a) Detect every fraud
- (b) Express an opinion on the financial statements
- (c) Prepare the books of account
- (d) Guarantee future viability

Q2. The basic objective of an audit with reference to the nature, size or form of an entity:

- (a) May change
- (b) Does not change
- (c) Must change
- (d) Always changes

Q3. Which of the following is outside the normal scope of statutory audit?

- (a) Examination of the accounting and internal control system
- (b) Verification of the authenticity and validity of transactions
- (c) Preparation of the books of account
- (d) Reporting on the financial statements

Q4. Which statement best describes the reasonable assurance provided by an audit?

- (a) It guarantees that the financial statements contain no errors or frauds
- (b) It ensures that every transaction has been examined by the auditor
- (c) It provides a high, but not absolute, level of assurance regarding material misstatements
- (d) It guarantees the future profitability of the business

Q5. An auditor is traditionally described as a:

- (a) Bloodhound
- (b) Watchdog
- (c) Manager
- (d) Valuer

Q6. The Overall Audit Strategy primarily determines the:

- (a) Detailed audit procedures only
- (b) Scope, timing and direction of the audit
- (c) Materiality level only
- (d) Sample size only

Q7. Which of the following correctly distinguishes an audit plan from an audit programme?

- (a) Audit plan is prepared by management, whereas audit programme is prepared by shareholders
- (b) Audit plan describes the nature, timing and extent of planned procedures, whereas audit programme lists specific procedures to be performed
- (c) Audit programme is broader than the overall audit strategy
- (d) Audit plan is prepared after the audit report

Q8. Which of the following statements regarding audit documentation under SA 230 is correct?

- (a) Audit documentation and audit file mean exactly the same thing

- (b) Audit documentation can be maintained only in physical form
- (c) Audit documentation records the procedures performed, evidence obtained and conclusions reached by the auditor
- (d) Audit documentation is owned by the company's shareholders

Q9. The final audit file is required to be assembled within:

- (a) 30 days after the auditor's report
- (b) 60 days after the auditor's report
- (c) 90 days after the auditor's report
- (d) One year after the auditor's report

Q10. The retention period for audit documentation under the applicable quality-control requirements is not less than:

- (a) 5 years
- (b) 7 years
- (c) 8 years
- (d) 10 years

Q11. The primary objective of vouching is to establish the:

- (a) Existence and ownership of assets
- (b) Authenticity, validity and accuracy of recorded transactions
- (c) Valuation of assets and liabilities
- (d) Going concern status of the entity

Q12. Verification of assets and liabilities primarily involves determining their:

- (a) Arithmetical accuracy only
- (b) Existence, ownership, possession, valuation and freedom from charge
- (c) Documentary support only
- (d) Market value only

Q13. Which of the following correctly distinguishes vouching from verification?

- (a) Vouching deals mainly with transactions, while verification deals mainly with assets and liabilities
- (b) Vouching deals only with assets, while verification deals only with transactions
- (c) Both vouching and verification deal exclusively with vouchers
- (d) Both are identical audit procedures

Q14. Which of the following is an essential feature of an effective internal check?

- (a) One employee handles a transaction from beginning to end
- (b) Duties are arranged so that the work of one employee is automatically checked by another
- (c) All accounting functions are performed by the chief accountant
- (d) Transactions are checked only at the end of the year

Q15. Which statement correctly distinguishes internal check from internal audit?

- (a) Internal check requires a separate audit department, whereas internal audit does not
- (b) Internal check is built into the division of duties, whereas internal audit is an independent review of activities and controls
- (c) Internal audit is performed continuously with every transaction, whereas internal check is performed annually
- (d) Both terms refer to the same arrangement

Q16. Under Section 138 of the Companies Act, 2013, internal audit is mandatory for:

- (a) Every company without exception
- (b) Listed companies and prescribed classes of companies
- (c) Only private companies
- (d) Only Section 8 companies

Q17. Where an auditor has reason to believe that fraud involving ₹1 crore or more has been committed against the company by its officers or employees, the matter is required to be reported to:

- (a) The shareholders only
- (b) The Audit Committee only
- (c) The Central Government
- (d) SEBI

Q18. Which of the following correctly describes window dressing?

- (a) Deliberately presenting the financial position as worse than it actually is
- (b) Presenting financial statements in a manner that shows a better position than the underlying reality
- (c) Creating a provision for doubtful debts
- (d) Correcting an accounting error before finalisation

Q19. An auditor identifies a misstatement that is material but not pervasive to the financial statements. The appropriate opinion is generally:

- (a) Unmodified opinion
- (b) Qualified opinion
- (c) Adverse opinion
- (d) Disclaimer of opinion

Q20. An auditor concludes that misstatements are both material and pervasive, and the financial statements therefore do not present a true and fair view. The auditor should express:

- (a) Qualified opinion
- (b) Unmodified opinion
- (c) Adverse opinion
- (d) Disclaimer of opinion

Q21. Which of the following statements about an auditor's responsibility is correct?

- (a) The auditor is primarily responsible for preparing the financial statements
- (b) The auditor is responsible for guaranteeing that no fraud exists
- (c) Management is responsible for preparing the financial statements, while the auditor expresses an

opinion on them

- (d) Shareholders are responsible for preparing the financial statements

Q22. Under the Companies Act, 2013, the first auditor of a company, other than a Government company, is generally appointed by the:

- (a) Shareholders at the first AGM
- (b) Board of Directors within 30 days of registration
- (c) Central Government within 60 days of registration
- (d) CAG within 30 days of registration

Q23. Under the auditor rotation provisions applicable to prescribed companies, an audit firm may generally serve for:

- (a) One term of 5 years
- (b) Two consecutive terms of 5 years each
- (c) Three consecutive terms of 5 years each
- (d) An unlimited number of terms

Q24. Which of the following is a prohibited non-audit service for a statutory auditor under Section 144 of the Companies Act, 2013?

- (a) Audit of financial statements
- (b) Book-keeping services
- (c) Reporting to shareholders
- (d) Verification of assets

Q25. The auditor of a Government company is appointed by the:

- (a) Board of Directors
- (b) Shareholders in the AGM
- (c) Comptroller and Auditor General of India
- (d) Central Government

Q26. Which of the following is not generally exempt from the applicability of CARO 2020?

- (a) Banking company
- (b) Insurance company
- (c) Section 8 company
- (d) Listed public company

Q27. The auditor's report on the financial statements of a company is primarily addressed to the:

- (a) Management
- (b) Shareholders
- (c) Creditors
- (d) Stock exchange

Q28. Which of the following statements about audit documentation is not correct?

- (a) It may contain audit programmes and working papers
- (b) It may be maintained in electronic form
- (c) Audit documentation and the audit file are exactly the same thing
- (d) It records significant matters and the conclusions reached by the auditor

Q29. Which of the following statements correctly describes the responsibility for valuation of assets?

- (a) The auditor determines the value of every asset
- (b) Management is responsible for making the

accounting estimates and valuations, while the auditor evaluates whether they are reasonable and appropriately presented

- (c) Shareholders determine the value of assets
- (d) The auditor guarantees that all assets are stated at market value

Q30. Which sequence correctly represents the broad progression in audit planning?

- (a) Audit programme → Overall audit strategy → Audit plan
- (b) Audit report → Audit plan → Audit programme
- (c) Overall audit strategy → Audit plan → Audit programme
- (d) Audit plan → Audit report → Overall audit strategy

Answer Key

Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.
1	b	2	b	3	c	4	c	5	b
6	b	7	b	8	c	9	b	10	b
11	b	12	b	13	a	14	b	15	b
16	b	17	c	18	b	19	b	20	c
21	c	22	b	23	b	24	b	25	c
26	d	27	b	28	c	29	b	30	c

Q1. Answer: (b) Express an opinion on the financial statements

- The primary objective of an audit is to enable the auditor to express an opinion on the financial statements.

Q2. Answer: (b) Does not change

- The basic objective of an audit remains the same irrespective of the nature, size or form of the entity.

Q3. Answer: (c) Preparation of the books of account

- Preparation of books of account is the responsibility of management and is not the normal responsibility of the statutory auditor.

Q4. Answer: (c) It provides a high, but not absolute, level of assurance regarding material misstatements

- Reasonable assurance provides a high level of assurance, but it does not guarantee that all errors or frauds will be detected.

Q5. Answer: (b) Watchdog

- An auditor is traditionally described as a watchdog because the auditor examines the financial records and reports on the financial statements.

Q6. Answer: (b) Scope, timing and direction of the audit

- The overall audit strategy determines the scope, timing and direction of the audit.

Q7. Answer: (b) Audit plan describes the nature, timing and extent of planned procedures, whereas audit programme lists specific procedures to be performed

- The audit plan provides the framework for the audit, while the audit programme contains detailed audit procedures.

Q8. Answer: (c) Audit documentation records the procedures performed, evidence obtained and conclusions reached by the auditor

- Audit documentation provides a record of the audit procedures performed, evidence obtained and conclusions reached.

Q9. Answer: (b) 60 days after the auditor's report

- The final audit file should ordinarily be assembled within 60 days after the date of the auditor's report.

Q10. Answer: (b) 7 years

- Audit documentation is generally required to be retained for a period of not less than seven years.

Q11. Answer: (b) Authenticity, validity and accuracy of recorded transactions

- Vouching involves examining documentary evidence to establish the authenticity and validity of transactions.

Q12. Answer: (b) Existence, ownership, possession, valuation and freedom from charge

- Verification involves determining the existence, ownership, possession and proper valuation of assets and liabilities.

Q13. Answer: (a) Vouching deals mainly with transactions, while verification deals mainly with assets and liabilities

- Vouching examines transactions, whereas verification mainly relates to assets and liabilities.

Q14. Answer: (b) Duties are arranged so that the work of one employee is automatically checked by another

- Internal check is based on division of duties so that the work of one employee is automatically checked by another.

Q15. Answer: (b) Internal check is built into the division of duties, whereas internal audit is an independent review of activities and controls

- Internal check is part of the routine system of control, while internal audit involves systematic examination of activities and controls.

Q16. Answer: (b) Listed companies and prescribed classes of companies

- Section 138 requires internal audit for listed companies and other prescribed classes of companies.

Q17. Answer: (c) The Central Government

- Fraud involving ₹1 crore or more committed by officers or employees is required to be reported to the Central Government as prescribed.

Q18. Answer: (b) Presenting financial statements in a manner that shows a better position than the underlying reality

- Window dressing involves presenting financial statements in a way that makes the financial position appear better than it actually is.

Q19. Answer: (b) Qualified opinion

- A material but non-pervasive misstatement generally results in a qualified opinion.

Q20. Answer: (c) Adverse opinion

- When misstatements are both material and pervasive, the auditor expresses an adverse opinion.

Q21. Answer: (c) Management is responsible for preparing the financial statements, while the auditor expresses an opinion on them

- Management prepares the financial statements, whereas the auditor examines them and expresses an independent opinion.

Q22. Answer: (b) Board of Directors within 30 days of registration

- The first auditor of a company other than a Government company is generally appointed by the Board within 30 days of registration.

Q23. Answer: (b) Two consecutive terms of 5 years each

- An audit firm may generally serve for two consecutive terms of five years each under the auditor rotation provisions.

Q24. Answer: (b) Book-keeping services

- Book-keeping services are prohibited non-audit services for a statutory auditor under Section 144.

Q25. Answer: (c) Comptroller and Auditor General of India

- The auditor of a Government company is appointed by the Comptroller and Auditor General of India.

Q26. Answer: (d) Listed public company

- Banking companies, insurance companies and certain other specified entities are exempt from CARO 2020, whereas a listed public company is not generally exempt.

Q27. Answer: (b) Shareholders

- The auditor's report on the financial statements of a company is primarily addressed to its members or shareholders.

Q28. Answer: (c) Audit documentation and the audit file are exactly the same thing

- Audit documentation consists of records prepared or obtained by the auditor, while the audit file is the organized collection of such documentation.

Q29. Answer: (b) Management is responsible for making the accounting estimates and valuations, while the auditor evaluates whether they are reasonable and appropriately presented

- Management is responsible for accounting estimates and valuations, while the auditor evaluates their reasonableness and presentation.

Q30. Answer: (c) Overall audit strategy → Audit plan → Audit programme

- Audit planning broadly proceeds from the overall audit strategy to the audit plan and then to the detailed audit programme.

Chapter 14: Insurance

- A contract of insurance is a contract whereby the insurer, in consideration of a premium, undertakes to indemnify the insured against loss arising from an uncertain event, or to pay a fixed sum on the happening of a specified event.

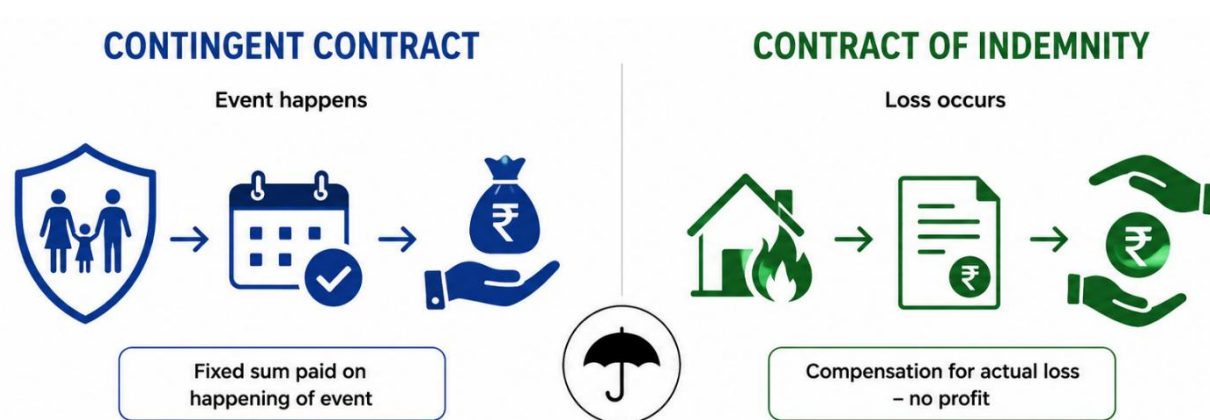
Why Insurance Exists

- **Risk Management** — reduces the financial impact of uncertain events.
- **Economic Stability** — encourages trade/business by protecting against catastrophic loss.
- **Savings + Investment** — many life products combine protection with returns.
- **Social Security** — government uses insurance for welfare (PMJJBY, PMJAY, etc.).
- **Financial Intermediation** — insurers mobilise long-term premium into G-Secs, bonds, infrastructure and equity, channelling household savings into the economy.

Important Terms

- **Insurer / Underwriter** — the company providing insurance (e.g., LIC, ICICI Lombard).
- **Policyholder** — the person or entity in whose name the policy is issued and who holds the contractual rights under the policy.
- **Insured** — the person, property or interest covered by the insurance policy.
- **Premium** — the price paid for coverage — annual/monthly/single.
- **Sum Assured** — the maximum guaranteed payout under the policy.
- **Policy** — the written contract with terms & conditions.
- **Claim** — a formal request to the insurer for payment after a loss.
- **Indemnification** — the process of compensating for an actual loss.

Contingent Contract	Contract of Indemnity
A contingent contract is a contract to do or not do something depending on the happening or non-happening of an uncertain future event, which is collateral to the contract. • Life insurance • Personal accident insurance • Other agreements dependent on an uncertain future event	A contract of indemnity is an agreement where one party promises to save the other from financial loss caused by the conduct of the promisor or another person. • The purpose is to place the insured/person in approximately the same financial position as before the loss. • Fire insurance • Marine insurance • Motor insurance



- Life insurance is a **CONTINGENCY** contract, not a contract of **INDEMNITY** because human life has no monetary value that can be measured, so the insurer pays an **agreed sum assured** rather than compensating a measured loss.
- This also explains why **life policies have no principle of subrogation and no average clause**. Fire, marine and motor are all indemnity contracts.

Q1. (UPSC EPFO, 2025)**Which one of the following is not a Contract of Indemnity?**

- (a) Contract of Fire Insurance
- (b) Contract of Life Insurance
- (c) Contract of Marine Insurance
- (d) Contract of Motor Insurance

Answer: (b) Contract of Life Insurance

- Life insurance pays a fixed sum assured on the happening of a contingency, because the loss of a life cannot be measured in money. Fire, marine and motor insurance all indemnify a measured loss and are therefore contracts of indemnity.

History of Insurance

Global Origins

- Babylon (c. 1750 BC) — Hammurabi's Code: loan cancelled if goods lost at sea/to piracy (early marine risk transfer).
- China (from ~3000 BC) — merchants spread cargo across multiple vessels to diversify shipwreck risk.
- India (ancient) — Dharmashastra/Manusmriti mention community assistance after loss; Kautilya's Arthashastra (4th c. BCE) references resource-pooling for disaster relief.
- Lloyd's of London (late 17th c.) — began in a coffeehouse; became the world's first organised insurance market.
- Life insurance — developed in 18th-century England, initially for military officers, later the general public.

History of Insurance in India — Three Phases

Colonial period → Nationalisation era → Post-liberalisation phase:

- **1818** — Oriental Life Insurance Co. (Kolkata) — first life insurer in India; served Europeans only, charged Indians higher (racially-biased) premiums.
- **1870** — Bombay Mutual Life Assurance Society — first Indian-owned/Swadeshi life insurer; fair premiums for Indians.
- **1907** — Indian Mercantile Insurance Ltd. — first general (non-life) insurance company.
- **1912** — Indian Life Assurance Companies Act — first legislation regulating life insurance (premium rates, reserves).
- **1928** — Indian Insurance Companies Act — empowered govt to collect statistical data on life & non-life insurers.
- **1938** — Insurance Act, 1938 — consolidated all earlier laws; still the principal insurance legislation (heavily amended since, including 2025).
- **1956** — Life Insurance Nationalisation Act — 245 private life insurers merged into LIC.
- **1972** — General Insurance Business (Nationalisation) Act — 107 general insurers merged into GIC + 4 subsidiaries (National, New India, Oriental, United India).
- **1993** — Malhotra Committee — recommended ending the LIC/GIC monopoly; private & foreign entry; an independent regulator.
- **1999** — IRDA Act — established IRDAI; opened the sector to private players.
- **2000 onwards** — Private insurers launch (ICICI Prudential, HDFC Life, etc.); FDI cap raised over time: 26% (2000) → 49% (2015) → 74% (2021) → 100% (2025 Act, notified Feb 2026).

Why both banking & insurance were nationalised

- Pre-nationalisation problems: many small, weak insurers; insolvency, fraud, mismanagement; low public confidence.
- Banking parallel: 1948-49 RBI nationalised → 1955 SBI nationalised → 1969/1980 private bank nationalisation waves.
- Insurance parallel: 1956 LIC Act (life) → 1972 GIC Act (general) — nationalised to serve financial inclusion & Five-Year Plan goals.
- Reform parallel: Narasimham Committee (banking) ↔ Malhotra Committee, 1993 (insurance) — both recommended liberalisations.

The Principles of Insurance – *Core Focus*

Principle	Meaning	Applies to
Utmost Good Faith (Uberrimae Fidei)	Both parties must disclose all material facts fully and truthfully. Non-disclosure may make the contract voidable. Example: A person hides a serious illness while taking a life policy.	All insurance
Insurable Interest	The insured must have a financial or legally recognised interest in the subject matter. Example: A person can insure their house because its destruction would cause financial loss. Life: at policy inception; Fire: at time of loss; Marine: at both times.	All insurance
Indemnity	Compensation is limited to the actual loss ; the insured cannot make a profit. Example: If a car suffers a ₹1 lakh loss, the insurer pays ₹1 lakh, subject to policy terms.	General insurance
Subrogation	After paying the claim, the insurer steps into the shoes of the insured and can recover from the third party responsible for the loss. Example: If a third party damages your insured car, the insurer can recover the amount from that third party after settling your claim.	General insurance
Contribution	If the same risk is insured with multiple insurers , each insurer contributes rateably ; total recovery cannot exceed the actual loss. Example: A ₹4 lakh loss covered by two insurers is shared between them according to their respective liability.	General insurance
Proximate Cause (Causa Proxima)	The insurer is liable when the nearest, dominant and effective cause of the loss is an insured peril. Example: If an insured storm is the effective cause of damage to a house, the resulting loss may be covered.	All insurance
Mitigation of Loss / Loss Minimisation	The insured must take reasonable steps to minimise the loss , as a prudent uninsured person would. Example: After a fire starts, the owner should call the fire brigade and take reasonable steps to prevent further damage.	All insurance

Q2. (UPSC EPFO, 2025)

In the case of a contract of insurance, the principle which states that it is the duty of the insured to take reasonable steps to minimize the loss or damage to the insured property is called

- (a) Principle of Subrogation
- (b) Principle of Utmost Good Faith
- (c) Principle of Co-operation
- (d) Principle of Mitigation

Q3. (EPFO APFC 2023)

The principle of subrogation in insurance allows

- (a) investment of policy amount
- (b) refund for insured and insured's insurance company
- (c) auto-renewal of policy
- (d) indemnification of the insured

Q4. Which of the following principles of insurance requires the insured to disclose all material facts relating to the risk to the insurer?

- (a) Principle of Indemnity
- (b) Principle of Utmost Good Faith
- (c) Principle of Contribution
- (d) Principle of Subrogation

Q5. Which one of the following correctly explains the principle of insurable interest in a contract of insurance?

- (a) The insured must have a financial or legally recognised interest in the subject matter insured.
- (b) The insured must always own the property being insured.
- (c) The insurer must have an interest in the financial condition of the insured.
- (d) The insured must insure the property for its full market value.

Q2. Answer: (d) Principle of Mitigation

- Also called the principle of loss minimisation. The insured must behave as a prudent uninsured person would — he cannot let the fire burn because the property is insured.

Q3. Answer: (b) refund for insured and insured's insurance company (official key)

- subrogation means that once the insurer has paid the claim in full, it succeeds to all the rights and remedies of the insured against any third party responsible for the loss — so the insurer can recover from that third party.

Q4. Answer: (b) Principle of Utmost Good Faith

- Also called **Uberrimae Fidei**, this principle requires the insured and insurer to disclose all **material facts** relating to the risk honestly and completely.
- Non-disclosure or misrepresentation of a **material fact** may make the insurance contract voidable at the option of the insurer.

Q5. Answer: (a) The insured must have a financial or legally recognised interest in the subject matter insured.

- **Insurable interest** means that the insured must stand to suffer a **financial or legally recognised loss** if the insured subject matter is damaged or destroyed.
- **Ownership is not always necessary**; what is essential is the existence of a legally recognised interest in the subject matter of insurance.

Insurance Act, 1938

Enacted after weak regulation of general insurance under the 1912 Act caused instability; consolidated life & non-life regulation into one comprehensive law. Still the principal Act — amended most recently and most substantially by the Sabka Bima Sabki Raksha (Amendment of Insurance Laws) Act, 2025.

Objectives

- Protect policyholders' interests.
- Regulate and control the insurance business in India.
- Ensure financial soundness of insurers.
- Prevent frauds and malpractices.
- Prescribe minimum standards for insurance operations.

Key Provisions (as amended)

- **Registration of Insurers (Ss. 2C, 3, 3A)** — compulsory registration with IRDAI. Minimum paid-up capital: Life ₹100 cr, General ₹100 cr, Reinsurance ₹200 cr (the 2025 Act empowers IRDAI to prescribe/relax capital norms, including removing the ₹100 cr floor for insurance co-operative societies). Deposit with RBI required as security.
- **Prohibition on Rebates (S. 41)** — no insurer/agent may offer premium rebates as an inducement. Penalty up to ₹10 lakh.
- **Accounts & Audit (Ss. 10-16)** — annual accounts, balance sheets, returns to IRDAI; mandatory qualified audit.
- **Investments (S. 27)** — prescribes the % of assets to be invested in approved (safe, liquid) securities.
- **Solvency Margin (S. 64VA)** — Life insurers: higher of ₹50 cr or 1% of sum at risk. General insurers: higher of ₹50 cr or 20% of net premium income. (IRDAI is moving toward a Risk-Based Capital (RBC) framework to replace this formula-based regime — see Section 12.)
- **Control over Management (Ss. 34A-C)** — IRDAI's prior approval is needed to appoint the MD/CEO/Principal Officer.
- **Licensing of Agents/Intermediaries** — mandatory IRDAI licensing; minimum training/qualification prescribed.
- **Protection of Policyholders (S. 45)** — life policies cannot be questioned after 3 years for misstatement, except fraud.
- **Penalties (Ss. 102-105, 119)** — fines + imprisonment for false statements, unregistered operation, etc. The 2025 Act raised maximum penalties and gave IRDAI disgorgement power (to claw back wrongful gains).

IRDAI — The Insurance Sector Regulator

- **Organisation** — 1996: IRDA set up (non-statutory) → 1999: given statutory status under the IRDA Act, 1999 → 2014: renamed Insurance Regulatory and Development Authority of India (IRDAI).
- **HQ** — Hyderabad, Telangana (since 2001; earlier Delhi). [RBI & SEBI are headquartered in Mumbai.]
- **Structure** — 1 Chairperson (age limit 65, term up to 5 yrs) + up to 5 whole-time + 4 part-time members = a statutory ceiling of 10; re-appointment is possible. Current Chairman (2026): Ajay Seth

Functions & Powers (Section 14)

- Regulation of insurers — issue, renew, modify, suspend or cancel registration; separate licences for life, general & re-insurance business.
- Policyholder protection — claims settlement norms, nomination/assignment, surrender value, transparent policy terms.
- Investment oversight — directs the proportion of assets insurers must hold in approved securities.
- Tariff/pricing regulation to prevent predatory pricing in specific segments.
- Intermediary regulation — licensing of agents, brokers, surveyors/loss-assessors, Third-Party Administrators (TPAs), bancassurance.
- Monitoring financial soundness — solvency margins, periodic returns, inspections & audits.
- Dispute settlement — Insurance Ombudsman scheme for consumer grievance redressal.
- Member of the Financial Stability & Development Council (FSDC).
- Appeals against IRDAI orders lie with the *Securities Appellate Tribunal (SAT)*.

Domestic Systemically Important Insurers (D-SIIs)

- IRDAI designates certain insurers as “*too big to fail*” and subjects them to enhanced regulation/monitoring. Current list: (1) LIC, (2) GIC Re, (3) The New India Assurance Co. Ltd. (NIACL).

Insurance Intermediaries

- **Insurance Agent** — sells policies of a SINGLE insurer (e.g., an LIC agent).
- **Insurance/Direct Broker** — sells life/general/health policies of MULTIPLE companies (e.g., Policybazaar.com).
- **Reinsurance Broker** — places reinsurance business with multiple reinsurers.
- **Composite Broker** — does both direct broking and reinsurance broking.
- **Bancassurance** — a bank sells insurance products on behalf of an insurer (French-origin term).
- **Surveyor / Loss Assessor** — independently assesses the quantum of loss for claims.
- **Third-Party Administrator (TPA)** — e.g., a hospital or agency handling health-insurance claim processing/cashless treatment.
- **Bima Vahak (2023-24 reform)** — village-level individual/company salesperson — can sell multiple insurers' products at the Gram Panchayat level; helps with KYC and claims.
- **LIC Bima Sakhi** — women agents (age 18-70, passed 10th std) recruited by LIC to sell policies in villages; stipend ₹7,000/₹6,000/₹5,000 in years 1/2/3 plus commission; can progress to LIC Development Officer.

IRDAI Reforms — “Insurance for All by 2047” & the Bima Trinity



Bima Sugam	Bima Vistaar	Bima Vahak
Digital marketplace	Composite micro-insurance	Last-mile distribution
One platform for multiple insurers	Life + Accident + Property + Hospitalisation	Village-level, women-led
Compare • Buy • Renew • Manage • Claim	₹2 lakh per coverage line	Multiple insurers' policies
Platform	Product	Distributor

Q6. Consider the following statements regarding Bima Sugam, Bima Vistaar and Bima Vahak:

1. Bima Sugam is a digital marketplace intended to facilitate access to insurance products offered by multiple insurers.
2. Bima Vistaar is a standardised composite insurance product covering multiple risks under a single policy.
3. Bima Vahak is an insurance distribution initiative operating primarily through urban-based agents.

Which of the statements given above is/are correct?

- (a) 1 and 2 only
 (b) 2 and 3 only
 (c) 1 and 3 only
 (d) 1, 2 and 3

Insurance Progress Indicators

- **Insurance Penetration:** Reflects the percentage of GDP spent on insurance premium
- **Insurance Density:** Indicates premium per capita

Metric	FY2001–02	FY2012–22	FY2024–25
Insurance Penetration (%)	2.70%	4.20%	3.7 %
Insurance Density (USD)	\$11	\$91	\$97=

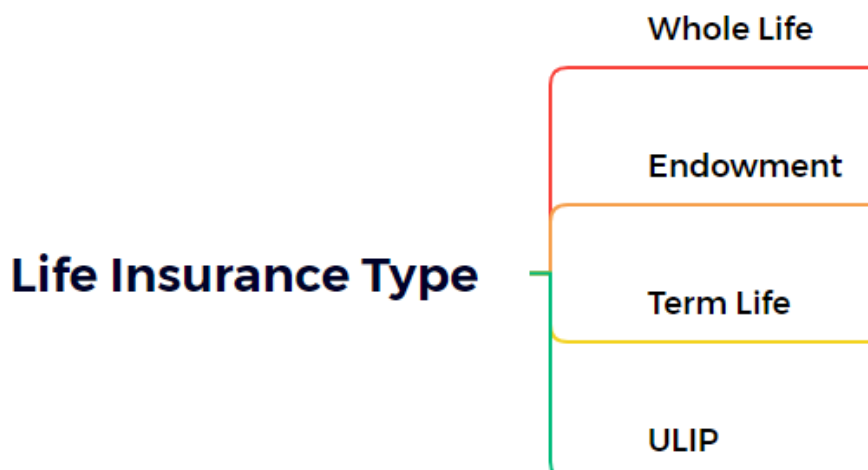
Q7. Consider the following statements

1. The Insurance Penetration is measured as ratio of Insurance Premium to Population in a country
2. The Insurance Density is measured as ratio of Insurance Premium to GDP of a country

Which among the statements given above is/are correct?

- (a) 1 only (b) 2 only (c) Both 1 and 2 (d) Neither 1 nor 2

Insurance → Life Insurance



Life Insurance Type	Policy Duration	Features	Outcome at Maturity	Outcome at Death
Whole Life	Longer policy (e.g. 35-40 yrs)	Savings returned with interest at maturity	✓ Saving + Interest	
Endowment	Shorter policy (e.g. 10-20 yrs)	Savings returned with interest at maturity	✓ Saving + Interest	
Term Life	Short policy, Low premium	No return if no death (e.g. PM Jeevan Jyoti Bima)	✗	
ULIP (Unit Linked Insurance Plans)	Varies	Part of money in insurance, part in mutual fund	✓ Saving + Interest	

Life Insurance Corporation of India (LIC) – 1956

- ❖ LIC was established under the LIC Act, 1956, by nationalizing private life insurance companies
- ❖ It is a **statutory corporation**
- ❖ Govt sold 5% of its 100% shareholding through IPO in 2022

Regulation: LIC is governed under three key legislations:

- LIC Act, 1956
- Insurance Act, 1938
- IRDAI Act, 1999



Pradhan Mantri Bima Yojanas (PMSBY vs. PMJJBY)

Feature	PMSBY (Suraksha Bima Yojana)	PMJJBY (Jeevan Jyoti Bima Yojana)
Scope	Accident Insurance (Death/Disability)	Life Insurance (Death due to any reason)
Eligibility	Bank/Post Office Account	Bank/Post Office Account
Age Group	18-70 years	18-50 years
Annual Premium	₹12 (Auto-debit)	₹330 (Auto-debit)
Benefits	- ₹2 lakh for accidental death/full disability - ₹1 lakh for partial disability	- ₹2 lakh for death (any cause)
Insurance Period	1st June – 31st May (Annual Renewal)	1st June – 31st May (Annual Renewal)
Ministry	Ministry of Finance	Ministry of Finance

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Insurance → General Insurance → Health Insurance**Ayushman Bharat / PM Jan Arogya Yojana (PMJAY)**

Feature	Details
Launch	Budget 2018, part of Ayushman Bharat. Two components: Health & Wellness Centres (HWC) and PM Jan Arogya Yojana (PMJAY).
Coverage	Free insurance cover of ₹5 lakh per family per year for secondary and tertiary hospitalization.
Beneficiaries	10 crore families (50 crore people) identified using Socio-Economic Caste Census (SECC). - All senior citizens aged 70 years and above
Pre-existing Disease	All pre-existing diseases covered from day 1.
Pre/post-hospitalization	Covers 3 days before and 15 days after hospitalization expenses.
Cashless & Paperless	Access through empanelled public/private hospitals. Operated via NHA's web portal.
No Limits	No cap on family size or age.

PMJAY Governance

1. National Health Authority (NHA) Overlooks PMJAY implementation,
2. State Health Agency (SHA) Each state forms an agency for local implementation.
3. Cost Sharing
 - Special Category States: 90:10 (Union: State)
 - Other States: 60:40
 - UTs without legislature: 100% Union.

Sub-Schemes

1. **PM SEHAT** - For all residents of J&K; provides ₹5 lakh insurance even outside J&K.
2. **Ayushman CAPF** - Health cover for personnel and families of CAPFs like BSF, CRPF, CISF, etc.

Q11. (UPSC CDS, 2019-I)

Which are the benefits of the Pradhan Mantri Jan Arogya Yojana (PMJAY)?

1. Free treatment available at all public and empanelled private hospitals.
2. Cashless and paperless access to quality health care services.
3. Govt provides health insurance up to ₹5 lakh per family per year.
4. Pre-existing diseases are not covered.

Codes:

- a) 1 and 3 only b) 1, 2, and 3
c) 2 and 4 only d) 2, 3, and 4

Q12. (UPSC CSE, 2020)

Ayushman Bharat is a national health insurance system for:

- a) Women
- b) Every citizen
- c) old age people
- d) Poor and vulnerable.

Q13. (UPSC CDS, 2020-I)

Which is not a feature of the Ayushman Bharat Scheme?

- a) There is no cap on family size and age.
- b) The scheme includes pre- and post-hospitalization expenses.
- c) A defined transport allowance per hospitalization will also be paid to the beneficiary.
- d) The scheme provides a benefit cover of ₹10 lakh per family.

Q14. Which of the following is not a feature of PM Jan Arogya Yojana (PMJAY)?

1. No cap on family size and age.
2. Free treatment in both public and private hospitals.
3. Health insurance cover of ₹10 lakh per family per year.
4. Pre-existing diseases covered from day 1.

Q15. Consider the following statements regarding Ayushman Bharat:

1. PMJAY covers only rural families.
2. It includes pre-hospitalization and post-hospitalization expenses.
3. Cashless and paperless services are available.

Which of the above statements are correct?

- a) 1 and 2 only b) 2 and 3 only
c) 1 and 3 only d) All of the above

Q16. Ayushman Bharat Digital Mission is implemented by:

- a) Ministry of Health & Family Welfare
- b) National Health Authority
- c) NITI Aayog
- d) Ministry of Skill Development

Q17. Who serves as the Chairperson of the Governing Board of the National Health Authority (NHA)?

- a) Minister of Health and Family Welfare
- b) Prime Minister of India
- c) CEO of NITI Aayog
- d) Secretary of Health and Family Welfare

Q18. Which of the following statements about the National Health Authority (NHA) is correct?

1. NHA has been granted statutory status.
2. NHA is an attached office under the Ministry of Labour and Employment.
3. NHA oversees the implementation of the Ayushman Bharat Digital Mission.

Select the correct answer using the codes below:

- a) 1 and 2 only b) 3 only
c) 2 and 3 only d) 1, 2, and 3

Q19. With reference to PM Jan Arogya Yojana (PM-JAY), consider the following statements:

1. The scheme provides health insurance coverage of up to ₹5 lakh for BPL (Below Poverty Line) families only.
2. Under this scheme, identified beneficiaries can get treatment in government hospitals and empanelled private hospitals anywhere in India.
3. It is a centrally sponsored scheme implemented by the Ministry of Finance.

Which among the statements given above is/are incorrect?

- (a) 1 and 2 only (b) 1 and 3 only
(c) 2 only (d) 1, 2, and 3

Q11. Answer: (b) 1, 2, and 3

Q12. Answer: (d) Poor and vulnerable

Q13. Answer: (d) The scheme provides a benefit cover of ₹10 lakh per family

Explanation:

- PM-JAY provides health cover of **₹5 lakh per family per year**, not ₹10 lakh.
- There is no restriction on family size or age.
- Pre- and post-hospitalization expenses are covered.
- A defined transport allowance per hospitalization is also provided.

Q14. Answer: (c) 3 only

Q15. Answer: (b) 2 and 3 only

- PM-JAY is not restricted to rural families; it covers eligible families in both rural and urban areas.

Q16. Answer: (b) National Health Authority

- The **National Health Authority (NHA)** is the implementing agency for the Ayushman Bharat Digital Mission (ABDM).

Q17. Answer: (a) Minister of Health and Family Welfare

- The **Minister of Health and Family Welfare** serves as the Chairperson of the Governing Board of the National Health Authority.

Q18. Answer: (b) 3 only

- NHA is an **attached office under the Ministry of Health and Family Welfare**, not the Ministry of Labour and Employment.
- NHA does **not have statutory status**; it is an executive body.
- NHA oversees the implementation of the **Ayushman Bharat Digital Mission (ABDM)**.

Q19. Answer: (b) 1 and 3 only

Employees' State Insurance Corporation (ESIC)

Establishment:

1948: Enacted under the Employees' State Insurance Act.

1952: ESIC Corporation set up under the Ministry of Labour and Employment.

Applicability:

1. Non-seasonal establishments ≥ 10 : Mandatory enrolment.
2. Hazardous industries < 10 workers: Compulsory coverage.
3. Non-hazardous industries < 10 : Voluntary participation.

Seasonal vs. Temporary (Casual) Workers in ESIC

1. Seasonal industries $\rightarrow$ Operate only during specific times of the year (Farm labourers sugarcane harvesting) $\rightarrow$ Not covered under ESIC.
2. Workers employed on a temporary or short-term basis $\rightarrow$ Eligible for ESIC

Eligibility: Employees earning less than ₹21,000/month in eligible establishments.

Benefits of ESIC:

- Medical Insurance
- Maternity Benefits
- Pension for Family in case of death/Injury
- Sickness Benefits: Partial wages during medical leave.

Contributions: Premium shared by Employer + Employee

Q20. (UPSC CSE, 2012)

Consider the following

1. Hotels and restaurants
2. Motor transport undertakings
3. Newspaper establishments
4. Private medical institutions

The employees of which of the above can have coverage under ESIC?

- a) 1, 2, and 3 only b) 4 only c) 1, 3, and 4 only **d) 1, 2, 3, and 4**

Investment Policy:

Up to 15% of funds invested in equities, with 85% in debt instruments. This aims to enhance returns and ensure sustainability.

General Insurance $\rightarrow$ Other than Health Insurance

CROP Insurance $\rightarrow$ PM Fasal Bima Yojana

- ❖ It was launched by MoA&FW
- ❖ It gives insurance against all non-preventable natural risks from pre-sowing to post-harvest stage.

Not Covered: Losses arising out of war and nuclear risks, malicious damage and other preventable risks shall be excluded.

- ❖ All farmers (including sharecroppers and tenant farmers) growing notified crops in notified areas are eligible for this scheme.
- ❖ Earlier the scheme was compulsory $\rightarrow$ now Optional

Note:

- Limit on premium charged by insurance companies: No
- Limit on premium paid by farmer

Rabi crops	1.5%
Kharif crops	2%
Commercial/ Horticulture	5%
- Remaining premium is paid equally by Centre and States 50:50 normally 90:10 for N-E states

Q21. (UPSC CSE, 2016)

With reference to 'Pradhan Mantri Fasal Bima Yojana', consider the following statements

1. Under this scheme, farmers will have to pay a uniform premium of two percent for any crop they cultivate in any season of the year.
 2. This scheme covers post-harvest losses arising out of cyclones and unseasonal rains.
- Which of the statements given above is/are correct?

- (a) 1 only (b) 2 only (c) Both 1 and 2 (d) Neither 1 nor 2

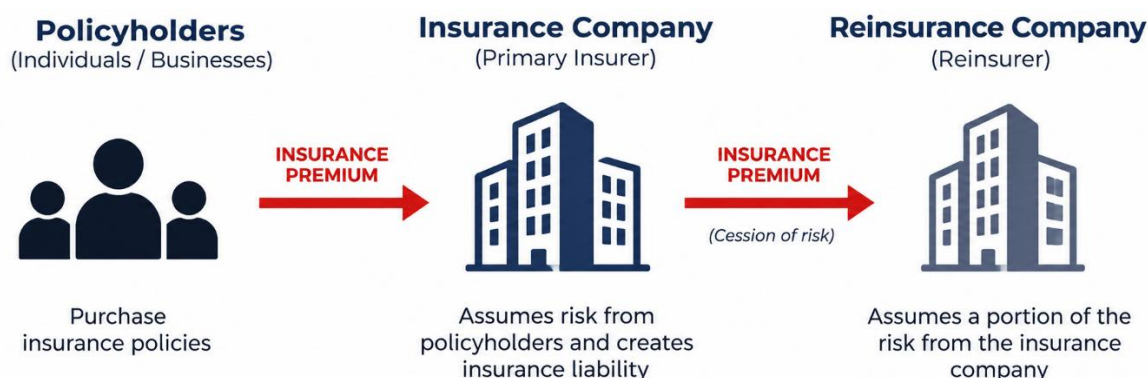
Q22. Which among the following types of risks can be covered under the Pradhan Mantri Fasal Bima Yojana (PMFBY)?

1. Drought and Floods
2. Crop loss due to attack by wild animals
3. Losses arising out of war

Select the correct answer using the code given below:

- (a) 1 only (b) 1 and 2 only (c) 2 and 3 only (d) 1, 2, and 3

Reinsurance - *High Yield*



Reinsurance is “insurance for insurance companies” — an insurer (cedant) transfers part of its risk portfolio to another insurer (the reinsurer), to avoid a single large claim threatening its solvency.

Purpose & Need

- Spread risk globally/across companies; stabilise profits.
- Capacity enhancement — lets insurers accept larger risks.
- Catastrophe protection (earthquakes, floods) & financial stability.
- Access to the reinsurer's technical/actuarial expertise.

Types of Reinsurance

- **Facultative Reinsurance** — case-by-case; a separate agreement per policy; suited to large/unusual risks. E.g., a large refinery insured under a specific facultative contract.
- **Treaty Reinsurance** — covers a whole portfolio; automatic acceptance within agreed limits; an ongoing relationship. E.g., all fire policies below ₹100 crore sum assured ceded under treaty.

Methods

- **Proportional (Pro Rata)** — Quota Share (fixed % of risk/premium shared) or Surplus Share (cession above the insurer's retention limit).
- **Non-Proportional (Excess of Loss)** — reinsurer pays only once the loss crosses a defined threshold; common for catastrophe cover.

Reinsurance in India

- **GIC Re** — India's national/public-sector reinsurer; historically enjoyed “right of first refusal” on domestic cessions under the IRDAI (Reinsurance) Regulations, 2018.
- Liberalised in 2015 — private reinsurers now permitted, e.g., India's ITI Reinsurance Ltd.; foreign reinsurers (Swiss Re, Munich Re, General Reinsurance/Warren Buffett-USA, Lloyd's-UK) permitted via Indian branches.
- The 2025 Amendment Act cut the net-owned-fund requirement for foreign reinsurance branches from ₹5,000 crore to ₹1,000 crore — easing entry for global reinsurers, especially at GIFT City.
- **Pandemic Risk Pool** (proposed by IRDAI) — insurers + Government jointly fund a pool to absorb future pandemic-related claim shocks.

Co-insurance

- **Co-insurance** — multiple insurers directly cover the same insured; there IS a direct relationship with the insured; purpose is sharing risk directly with the insured.
- DICGC Act, 1961 — parallel concept: banks must buy DEPOSIT insurance from DICGC, just as insurers must reinsure under the Insurance Act, 1938.

The Sabka Bima Sabki Raksha (Amendment of Insurance Laws) Act, 2025

- “Sabka Bima Sabki Raksha” (“Insurance for All, Protection for All”) is the biggest overhaul of India's insurance law since liberalisation in 2000.
- It amends THREE Acts together: the Insurance Act, 1938; the LIC Act, 1956; and the IRDAI Act, 1999

Key Provisions

- **FDI limit raised to 100%** — from 74% to 100% of paid-up equity, via the AUTOMATIC route, in insurance companies AND intermediaries (brokers, etc.). LIC itself remains capped separately at 20% FDI. This is the single biggest headline change — first announced in the Union Budget 2025-26 speech, then codified into law.
- **Foreign reinsurance branch capital cut** — the net-owned-fund requirement for foreign reinsurer branches was reduced from ₹5,000 crore to ₹1,000 crore, easing entry, especially via GIFT City/IFSCA.
- **Insurance co-operative societies** — the ₹100 crore minimum paid-up capital requirement for such societies (life/general/health) was removed.
- **Ease of doing business for intermediaries** — introduces ONE-TIME licensing (no periodic renewal) and SUSPENSION (rather than outright cancellation) as a lighter first-resort penalty.

Segment	Before 2021	2021-2025	From 2025-26 Act (Automatic Route)
<i>LIC (State-owned life insurer)</i>	No rule	20% (2022)	20% (unchanged — LIC kept separately capped)
<i>Insurance company itself (except LIC)</i>	49%	74% (2021)	100%
<i>Insurance intermediaries (agents, brokers, surveyors, TPAs)</i>	49%	100% (2020)	100% (unchanged, reaffirmed)

What Was NOT Included

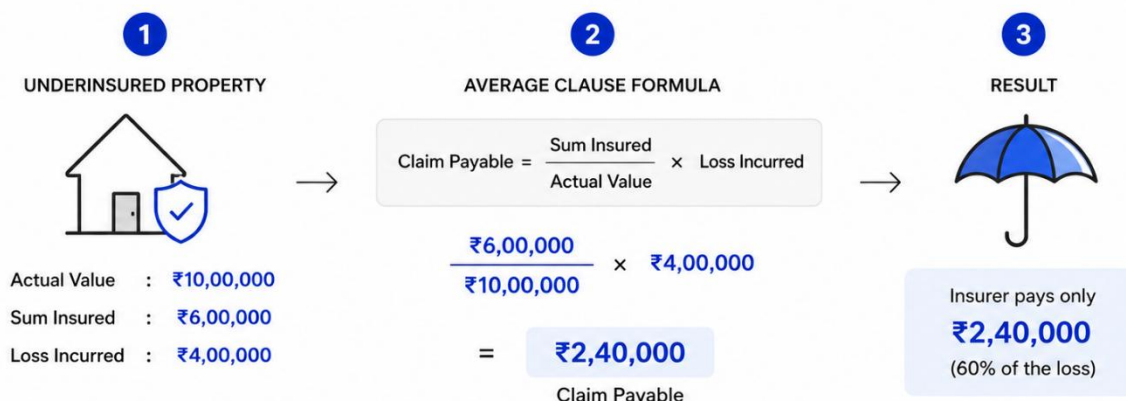
- Composite licence — allowing one company to sell life + general + health insurance under a single licence

GST Reform — 0% GST on Individual Life & Health Insurance (Sept 2025)

- 56th GST Council meeting announced “GST 2.0” — simplifying 4 slabs (5/12/18/28%) into essentially two (5% & 18%), with 40% for sin/luxury goods.
- GST on INDIVIDUAL life insurance (term, ULIP, endowment, riders) and INDIVIDUAL/family-floater HEALTH insurance cut from 18% to NIL (0%).
- Applies to premiums paid ON OR AFTER 22 Sept 2025 (even for pre-existing policies) — GST rate is determined by the instalment payment date, not the policy's original issue date.
- GROUP life & GROUP health insurance (e.g., typical employer-provided policies) CONTINUE to attract 18% GST — the exemption is only for INDIVIDUAL (non-group) policies.
- Motor insurance and other general insurance products continue at 18% GST — unaffected by this reform.

Insurance Claims Accounting: Loss of Stock & Loss of Profit - *High Yield*

Loss of stock claims and the average clause



- The Average Clause applies where the policy amount is LESS than the value of the stock on the date of the fire — i.e. where the insured is under-insured. Its purpose is to penalise under-insurance.
- Claim under the average clause = Loss of stock × (Policy amount ÷ Value of stock on the date of fire).
- If the policy amount equals or exceeds the value of stock, the full loss is payable and the average clause has no effect.
- Memorandum Trading Account is prepared from the date of the last Balance Sheet to the date of the fire to compute the stock on the date of fire, using the normal gross profit ratio.

Loss of profit (consequential loss) policy

A loss of profit policy insures the gross profit lost as a result of the reduction in turnover following a fire, together with any increase in the cost of working incurred to limit that reduction. It supplements, and does not replace, the loss of stock policy.

- **Indemnity Period** — the maximum period (from the date of fire) during which business results are affected, as stated in the policy — max. permissible 12 months, extendable by agreement.
- **Standard Turnover** — turnover of the CORRESPONDING period in the 12 months immediately preceding the fire.
- **Annual Turnover** — turnover of the full 12 months immediately preceding the fire.
- **Short Sales** — Standard Turnover – Actual Turnover during the indemnity period.
- **Gross Profit Ratio** — (Net Profit + Insured Standing Charges) ÷ Turnover, of the preceding accounting year.
- **Increased Cost of Working** — additional expenditure incurred SOLELY to avoid/diminish the reduction in turnover.
- **Sum Insurable** — Annual Turnover (adjusted for special circumstances) × Gross Profit Ratio.
- **Average Clause (LOP)** — applies if the sum insured is LESS than the sum insurable (same under-insurance penalty logic as stock claims).

The special circumstances clause

Where the trend of the business shows growth, the special circumstances clause permits the turnover figures to be adjusted upward by the specified percentage before computing the standard turnover, the annual turnover and hence the sum insurable. Without it, a growing business would always be under-insured.

$$\text{SUM INSURABLE} = \text{Adjusted Annual Turnover} \times \text{Gross Profit Ratio.}$$

Two steps:

- (1) take the annual turnover of the twelve months before the fire and **increase it by the special-circumstances percentage**;
- (2) multiply by the agreed GP ratio.

Q23. (UPSC EPFO, 2017)

From the information given below, calculate the sum insurable: Date of fire — 01.03.2016; Turnover from 01.03.2015 to 29.02.2016 — ₹88,00,000; Agreed GP ratio — 20%; Special circumstances clause provided for the increase of turnover by 10%.

- (a) ₹19,36,000
- (b) ₹48,40,000
- (c) ₹10,32,000
- (d) ₹24,20,000

Answer: (a) ₹19,36,000

- Step 1 — Annual turnover for the twelve months immediately preceding the fire = ₹88,00,000.
- Step 2 — Apply the special circumstances clause: $88,00,000 \times 110\% = ₹96,80,000$.
- Step 3 — Sum insurable = $96,80,000 \times 20\% = ₹19,36,000$.

Practice questions

Q1. Which one of the following is not a contract of indemnity ?

- (a) Fire insurance
- (b) Marine insurance
- (c) Life insurance
- (d) Motor insurance

Q2. Consider the following statements regarding life and general insurance:

1. Life insurance is generally treated as a contract contingent upon the happening of a specified event.
2. General insurance seeks to indemnify the insured against an actual financial loss.
3. The amount payable under life insurance must necessarily equal the actual financial loss suffered.

Which of the statements given above is/are correct?

- (a) 1 and 2 only
- (b) 2 and 3 only
- (c) 1 and 3 only
- (d) 1, 2 and 3

Q3. The principle of utmost good faith requires the parties to an insurance contract to:

- (a) Disclose all material facts relevant to the risk
- (b) Share the insurance claim equally
- (c) Transfer ownership of the insured property
- (d) Minimise the amount of premium payable

Q4. In a life insurance contract, insurable interest must exist:

- (a) Only when the claim arises
- (b) At the time of taking the policy
- (c) Only at the time of maturity
- (d) Throughout the entire policy period

Q5. Which of the following pairs is correctly matched?

- (a) Subrogation — Sharing loss between two insurers
- (b) Contribution — Insurer acquiring rights of the insured after payment of claim
- (c) Proximate cause — Determining the nearest effective cause of loss
- (d) Indemnity — Disclosure of material facts

Q6. A factory is insured against fire. A fire breaks out and the insured, instead of taking reasonable steps to control it, allows the fire to spread. Which principle is most directly relevant?

- (a) Subrogation
- (b) Mitigation of loss
- (c) Contribution
- (d) Insurable interest

Q7. An insured property is covered by two insurers for the same risk. Both insurers are liable for the same loss. Which principle determines the manner in which the insurers share the loss?

- (a) Subrogation

- (b) Contribution
- (c) Proximate cause
- (d) Utmost good faith

Q8. An insurer pays compensation to the insured for damage caused by a third party and subsequently acquires the insured's rights against that third party. This illustrates:

- (a) Contribution
- (b) Subrogation
- (c) Indemnity
- (d) Mitigation

Q9. A fire causes a loss of ₹8 lakh to stock valued at ₹10 lakh. The stock is insured for ₹6 lakh. Assuming the average clause applies, the claim payable will be:

- (a) ₹4.80 lakh
- (b) ₹6.00 lakh
- (c) ₹8.00 lakh
- (d) ₹4.00 lakh

Q10. Under the average clause, the amount of claim is generally determined by:

- (a) $\text{Loss} \times \text{Policy Amount} \div \text{Value of Property}$
- (b) $\text{Loss} \times \text{Value of Property} \div \text{Policy Amount}$
- (c) $\text{Policy Amount} - \text{Loss}$
- (d) $\text{Value of Property} - \text{Policy Amount}$

Q11. A stock worth ₹12 lakh is insured for ₹9 lakh. A fire causes a loss of ₹4 lakh. If the average clause applies, the claim payable is:

- (a) ₹2.25 lakh
- (b) ₹3.00 lakh
- (c) ₹4.00 lakh
- (d) ₹9.00 lakh

Q12. Which one of the following statements regarding the average clause is correct?

- (a) It protects the insured against under-insurance
- (b) It applies where the sum insured is less than the value of the property at risk
- (c) It guarantees payment of the full amount of loss
- (d) It applies only to life insurance policies

Q13. A business has an annual turnover of ₹80 lakh and a gross profit ratio of 25%. If the policy period requires an additional 20% allowance for special circumstances, the sum insured under a loss of profit policy would be:

- (a) ₹20 lakh
- (b) ₹24 lakh
- (c) ₹25 lakh
- (d) ₹30 lakh

Q14. The primary purpose of a loss of profit policy is to compensate for:

- (a) Physical destruction of fixed assets only
- (b) Loss of profit arising from interruption of business following an insured event
- (c) Death of the proprietor
- (d) Increase in the market value of stock

Q15. Consider the following statements regarding insurance principles:

1. The principle of indemnity seeks to prevent the insured from making a profit out of a loss.
2. The principle of subrogation generally follows the principle of indemnity.
3. The principle of contribution applies where the same subject matter is insured with more than one insurer.

Which of the statements given above are correct?

- (a) 1 and 2 only
- (b) 2 and 3 only
- (c) 1 and 3 only
- (d) 1, 2 and 3

Q16. Which one of the following situations most directly violates the principle of insurable interest?

- (a) A person insures his own house against fire
- (b) A creditor insures the life of a debtor to the extent of his financial interest
- (c) A person purchases insurance on a property in which he has no financial or legal interest
- (d) An employer insures an employee where permitted by law

Q17. If a loss is caused by several events, the principle of proximate cause is primarily concerned with identifying the:

- (a) First event in the chain
- (b) Last event in the chain
- (c) Nearest effective cause of the loss
- (d) Most expensive event in the chain

Q18. Which one of the following is correctly matched with its function?

- (a) Insurance agent — Represents multiple insurers independently
- (b) Surveyor/Loss Assessor — Assesses the quantum of loss
- (c) Reinsurance broker — Directly settles claims with policyholders
- (d) TPA — Regulates insurance companies

Q19. Reinsurance differs from co-insurance because in reinsurance:

- (a) Two insurers directly insure the same policyholder
- (b) An insurer transfers part of its risk to another insurer/reinsurer
- (c) The policyholder becomes the reinsurer
- (d) No insurance contract exists

Q20. Consider the following statements about insurance intermediaries:

1. An insurance agent generally represents a single insurer.
2. A direct broker can place insurance business with multiple insurers.
3. A reinsurance broker places reinsurance business with reinsurers.

Which of the statements given above are correct?

- (a) 1 and 2 only

(b) 2 and 3 only

(c) 1 and 3 only

(d) 1, 2 and 3

Q21. Which one of the following correctly describes the role of IRDAI?

- (a) It provides insurance cover directly to policyholders
- (b) It regulates and supervises the insurance sector in India
- (c) It functions as India's national reinsurer
- (d) It settles all insurance claims directly

Q22. With reference to IRDAI, consider the following statements:

1. It regulates registration of insurers.
2. It supervises the financial soundness of insurers.
3. Appeals against its orders lie with the Securities Appellate Tribunal.

Which of the statements given above are correct?

- (a) 1 and 2 only
- (b) 2 and 3 only
- (c) 1 and 3 only
- (d) 1, 2 and 3

Q23. Which of the following correctly describes the relationship among Bima Sugam, Bima Vistaar and Bima Vahak?

- (a) All three are insurance products
- (b) Bima Sugam is a digital marketplace, Bima Vistaar is a composite insurance product and Bima Vahak is a distribution initiative
- (c) Bima Sugam is a reinsurer, Bima Vistaar is a broker and Bima Vahak is a surveyor
- (d) Bima Sugam and Bima Vistaar are both insurance regulators

Q24. Consider the following statements regarding the Sabka Bima Sabki Raksha (Amendment of Insurance Laws) Act, 2025:

1. It amended the Insurance Act, 1938.
2. It raised the FDI limit in insurance companies other than LIC to 100%.
3. It increased the foreign reinsurance branch net-owned-fund requirement from ₹1,000 crore to ₹5,000 crore.

Which of the statements given above is/are correct?

- (a) 1 and 2 only
- (b) 2 and 3 only
- (c) 1 and 3 only
- (d) 1, 2 and 3

Q25. Under the 2025 insurance-law changes described in the chapter, the FDI limit for insurance companies other than LIC was raised to:

- (a) 49%
- (b) 74%
- (c) 100%
- (d) 51%

Q26. Which one of the following statements regarding LIC and general insurance nationalisation is correct?
 (a) LIC was established through nationalisation of general insurance in 1972
 (b) Life insurance was nationalised in 1956, while general insurance was nationalised in 1972
 (c) Both life and general insurance were nationalised in 1972
 (d) Life insurance was nationalised in 1972, while general insurance was nationalised in 1956

Q27. Insurance penetration is generally measured as:
 (a) Insurance premium as a percentage of GDP
 (b) Insurance premium per person
 (c) Claims as a percentage of premium
 (d) Sum assured as a percentage of GDP

Q28. Insurance density refers to:
 (a) Insurance premium as a percentage of GDP
 (b) Insurance premium per capita
 (c) Claims paid per policy
 (d) Sum assured per insurer

Q29. Consider the following statements regarding PMJJBY and PMSBY:

1. PMJJBY provides life insurance cover for death due to any reason, subject to the scheme's terms.
 2. PMSBY primarily provides accident insurance cover.
 3. Both schemes are administered by IRDAI as insurance companies.
- Which of the statements given above are correct?
 (a) 1 and 2 only
 (b) 2 and 3 only
 (c) 1 and 3 only
 (d) 1, 2 and 3

Q30. A business has stock worth ₹15 lakh, insured for ₹10 lakh. A fire causes a loss of ₹6 lakh. Assuming the average clause applies, the amount of claim payable would be:
 (a) ₹4 lakh
 (b) ₹6 lakh
 (c) ₹10 lakh
 (d) ₹15 lakh

Answers & Explanations

Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.	Q. No.	Ans.
1	c	2	a	3	a	4	b	5	c
6	b	7	b	8	b	9	a	10	a
11	b	12	b	13	b	14	b	15	d
16	c	17	c	18	b	19	b	20	d
21	b	22	d	23	b	24	a	25	c
26	b	27	a	28	b	29	a	30	a

Q1. Answer: (c) Life insurance

• Life insurance is not a contract of indemnity because the insured amount is payable on the occurrence of the specified event rather than being limited to the actual financial loss.

Q2. Answer: (a) 1 and 2 only

• Life insurance is generally contingent upon the occurrence of a specified event, while general insurance is based on indemnification of actual loss. Life insurance is not necessarily equal to the actual financial loss suffered.

Q3. Answer: (a) Disclose all material facts relevant to the risk

• Utmost good faith requires both parties to disclose all material facts that may influence the decision to enter into the insurance contract.

Q4. Answer: (b) At the time of taking the policy

- Life insurance: insurable interest is required at the inception of the policy.
- General insurance: insurable interest is generally required at the time of loss.

Q5. Answer: (c) Proximate cause — Determining the nearest effective cause of loss

- Proximate cause identifies the nearest effective cause of a loss for determining whether the loss is covered by the policy.

Q6. Answer: (b) Mitigation of loss

- The insured has a duty to take reasonable steps to minimise or prevent the loss after an insured event occurs.

Q7. Answer: (b) Contribution

- Contribution applies when the same risk is insured with more than one insurer and the insurers share the loss.

Q8. Answer: (b) Subrogation

- Under subrogation, after paying the claim, the insurer acquires the rights of the insured against the third party responsible for the loss.

Q9. Answer: (a) ₹4.80 lakh

- $\text{Claim} = \text{Loss} \times \text{Policy Amount} \div \text{Value of Property}$.
- $= ₹8 \text{ lakh} \times ₹6 \text{ lakh} \div ₹10 \text{ lakh} = ₹4.80 \text{ lakh}$.

Q10. Answer: (a) $\text{Loss} \times \text{Policy Amount} \div \text{Value of Property}$

- Under the average clause, the claim is reduced proportionately when the property is under-insured.

Q11. Answer: (b) ₹3.00 lakh

- $\text{Claim} = ₹4 \text{ lakh} \times ₹9 \text{ lakh} \div ₹12 \text{ lakh} = ₹3 \text{ lakh}$.

Q12. Answer: (b) It applies where the sum insured is less than the value of the property at risk

- The average clause applies in cases of under-insurance and reduces the claim proportionately.

Q13. Answer: (b) ₹24 lakh

- $\text{Gross Profit} = ₹80 \text{ lakh} \times 25\% = ₹20 \text{ lakh}$.
- $\text{Sum Insured} = ₹20 \text{ lakh} \times 120\% = ₹24 \text{ lakh}$.

Q14. Answer: (b) Loss of profit arising from interruption of business following an insured event

- A loss of profit policy covers financial loss arising from interruption of business due to an insured event.

Q15. Answer: (d) 1, 2 and 3

- Indemnity prevents the insured from making a profit from a loss.
- Subrogation generally follows indemnity.
- Contribution applies when the same risk is insured with multiple insurers.

Q16. Answer: (c) A person purchases insurance on a property in which he has no financial or legal interest

- Insurable interest requires the insured to have a recognised financial or legal interest in the subject matter of insurance.

Q17. Answer: (c) Nearest effective cause of the loss

- Proximate cause means the dominant or nearest effective cause that sets the chain of events resulting in the loss into motion.

Q18. Answer: (b) Surveyor/Loss Assessor — Assesses the quantum of loss

- A surveyor or loss assessor assesses the extent and quantum of loss for the purpose of claim settlement.

Q19. Answer: (b) An insurer transfers part of its risk to another insurer/reinsurer

- Reinsurance is insurance taken by an insurer to transfer part of its risk to another insurer called the reinsurer.

Q20. Answer: (d) 1, 2 and 3

- An insurance agent generally represents an insurer, while a broker can arrange insurance with insurers and a reinsurance broker facilitates reinsurance placement.

Q21. Answer: (b) It regulates and supervises the insurance sector in India

- IRDAI is the statutory regulatory authority responsible for regulating and supervising the insurance sector.

Q22. Answer: (d) 1, 2 and 3

- IRDAI regulates registration of insurers, supervises their financial soundness and its orders can be appealed before the Securities Appellate Tribunal.

Q23. Answer: (b) Bima Sugam is a digital marketplace, Bima Vistaar is a composite insurance product and Bima Vahak is a distribution initiative

- These initiatives serve different purposes: Bima Sugam provides a digital insurance marketplace, Bima Vistaar is a standardised composite product and Bima Vahak focuses on distribution.

Q24. Answer: (a) 1 and 2 only

- The 2025 Act amended the Insurance Act, 1938 and raised the permissible foreign investment in Indian insurance companies to 100%. It also reduced the net-owned-fund requirement for foreign reinsurers from ₹5,000 crore to ₹1,000 crore.

Q25. Answer: (c) 100%

- The 2025 amendment allows foreign investment in an Indian insurance company to extend up to 100% of paid-up equity capital, subject to prescribed conditions.

Q26. Answer: (b) Life insurance was nationalised in 1956, while general insurance was nationalised in 1972

- Life insurance was nationalised in 1956 with the formation of LIC, while general insurance was nationalised in 1972.

Q27. Answer: (a) Insurance premium as a percentage of GDP

- Insurance penetration measures the size of insurance premiums relative to the country's GDP.

Q28. Answer: (b) Insurance premium per capita

- Insurance density represents the average insurance premium per person in the population.

Q29. Answer: (a) 1 and 2 only

- PMJJBY provides life insurance cover for death due to any cause subject to the scheme's terms, while PMSBY provides accident insurance cover. They are implemented through participating insurers and banks rather than being administered by IRDAI.

Q30. Answer: (a) ₹4 lakh

- $\text{Claim} = \text{Loss} \times \text{Policy Amount} \div \text{Value of Property}$.
- $= ₹6 \text{ lakh} \times ₹10 \text{ lakh} \div ₹15 \text{ lakh} = ₹4 \text{ lakh}$.